Analysis

Tax disputes in 2017

Speed read

Diverted profits tax disputes will come into real focus this year. For many early cases, much of the one year 'review period' where negotiation and agreement are expected will be during 2017. This is new ground. HMRC is likely to seek to apply new guidance publicised following BEPS to existing transfer pricing enquiries. Expected judgments of the Supreme Court may lead to very significant time being absorbed in additional VAT disputes with many taxpayers. To settle issues, it is now clearer than ever that persuading all HMRC stakeholders, and the time needed for HMRC's governance process, must be taken very seriously.

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With the start of 2017, we reflect again on tax disputes issues. There remains pressure on tax authorities to increase yield. International tax planning remains under press scrutiny. Partly for these reasons, we believe transfer pricing and diverted profits tax (DPT) will be key areas of dispute. They are a significant focus of this article. For the remainder, we focus on VAT (and thank our colleague Lee Squires for that material).

DPT and the 12 month period

By the time of this article, it will be widely understood that HMRC has issued its first DPT charging notices, for the period to 31 December 2015. It seems likely that more will follow shortly: there is always a focus on yield in the lead-up to the end of HMRC's reporting year at the end of March.

We have written before that under DPT, the taxpayer and HMRC have a short period to agree a final liability, and that the legislation establishes significant financial incentives for the taxpayer to reach agreement in that period. In particular, adjustments agreed during the period are taxed at corporation tax rates, not DPT rates. HMRC presumably believes those incentives and external pressures will be enough to prompt taxpayers to settle. But this will be robustly tested in 2017.

The review period ends one year from issue of the charging notice. The rate differential means that as the one-year deadline approaches, HMRC's ability to press for a larger adjustment strengthens. What happens in early 2018 if there is no agreement at the end of the 'review period'? Procedurally, taxpayers can lodge an appeal under FA 2015 s 102. In principle, discussions can then continue as they do for corporation tax issues. The ongoing DPT discussion will then look much more like regular transfer pricing. It is not obvious that HMRC has planned for this situation, but taxpayers will have had to pay the money to HMRC, and their final liability will be computed at DPT rates.

For charging notices issued this tax year, under HMRC's governance process, time is already short for all their DPT stakeholders (see below) to become comfortable with a settlement proposal, and for that proposal to be approved in time for a s 101(4) amending notice to be issued within the review period. Affected taxpayers wishing to reach an acceptable agreement genuinely have no time to lose.

> In 2017, transfer pricing and the UK's diverted profits tax will be key areas of dispute

Transfer pricing: other issues

Because of BEPS, and the thinking behind the project, transfer pricing more generally may be at the point of a paradigm shift. This means uncertainty, at least for now. From experience, this will mean more disputes. And the areas of uncertainty are ones that mean disputes will take longer to resolve. We outline here just two of the topics we expect to receive HMRC focus this year.

In our view, a BEPS-related shift could well affect transfer pricing disputes in 2017.

When FA 2016 s 75 adopted the 2015 OECD *Transfer Pricing Guidelines*, it did so for the 2017 accounting period onwards (for companies with calendar year-ends). That would indicate that the new guidelines cannot affect ongoing disputes. But as some readers will know, this is not how HMRC sees it. Other tax authorities seem to take the same view. The argument is that the revisions represent only clarification of points which were already an integral part of the arm's length principle. Even if that is correct, there is significant devil in the detail. Is everything in the revisions really only a clarification of what was already implicit? For instance, before 2015 it was not widely accepted that a party that contributed only funding and had no functionality should receive at most a risk-free return (see para 1.103 of the 2015 guidelines).

This timing issue can also apply to transfer pricing as it relates to brands. Reading paras 6.5–6.12 of the revised OECD guidelines, and listening to HMRC at public forums, there is a new focus on identifying specific intangibles. In these forums, HMRC has questioned, for example, whether a brand is a single intangible asset for the purpose of transfer pricing. If instead it is a bundle of intangibles, including trademarks and goodwill, then working on the basis that goodwill cannot be separated from the underlying business, tax authorities might question a trademark which has been separated from the business (and so the goodwill). Very quickly, this becomes a matter of facts and circumstances, and agreement with HMRC will likely demand, amongst other things, thorough functional analysis and engagement with quite complex economics. In our view, even if it is evident that intangibles have

always needed to be correctly and precisely identified, the outcome may depend on which entity or entities perform the DEMPE functions (i.e. development, enhancement, maintenance, protection and exploitation), and control relevant risks.

Partly as a result of the BEPS project and the previous round of work that led to the last round of revisions of the OECD guidelines in 2010, there is also debate amongst transfer pricing specialists about whether the days of old-style models – based on the binary routine/non-routine characterisation of entities and (mixing a metaphor) one-sided, bottom-up methods of analysis – are numbered. This would mean that, apart from in the most straightforward of circumstances, the transactional net margin method and comparable profit method would no longer be accepted across-the-board by many tax authorities. This is certainly not something that has been extensively tested by the courts and tribunals, if at all. The transactional net margin method (TNMM) approach and use of comparables are also still very much approved methods, and the OECD does specifically question whether profit-split methods should be used ahead of other methods, simply because of a lack of reliable comparables (see the OECD's public discussion draft *BEPS Actions 8-10: Revised guidance on profit splits*, July 2016, para 16). Again, this sort of issue is very likely to be a focus for some corporates this year.

More data, more collaboration

Country by country reporting was formally introduced in the UK with effect from 1 January 2016 for all UK resident parent companies of a multinational group with a consolidated turnover of €750m or more. It appears that HMRC plans to use it primarily for risk assessment. Otherwise, we would presume that estimates of the additional tax its implementation will bring in would be significantly higher than the meagre £30m cited in HMRC's policy paper on the topic published on 26 February 2016.

In an article in this journal ('BEPS and HMRC', *Tax Journal*, 30 October 2015), Jim Harra, HMRC's Director General of Business Taxes, described how the UK tax authority works closely with other administrations to exchange information. There has for many years been a perception that obtaining information from other tax authorities was a difficult and unusual task for HMRC. At face value, Jim Harra's statements do suggest that this has changed. Ratification of the OECD multilateral instrument, scheduled for summer 2017, may also accelerate the development of enquiries into cross-border issues being worked jointly by two or more tax authorities.

Some VAT issues

Turning to VAT, we expect the judgment of the Supreme Court in *Littlewoods* ([2015] EWCA Civ 515, CA) later this year (following a hearing in early July) on whether taxpayers have an entitlement to compound interest on overpaid VAT. This has been long awaited. A taxpayer win could result in a large number of stayed tribunal appeals coming back to life. HMRC has indicated that it sees decisions to date in this litigation as specific to Littlewoods' circumstances and therefore not of general application. This means there is likely to be a need for further litigation, even if Littlewoods is successful.

We also expect the Supreme Court decision in *Investment Trust Companies (in liquidation)* ([2015] EWCA Civ 82, CA). The case was heard in May 2016. It concerns whether customers who received supplies on which VAT has been wrongly charged may reclaim some or all of that VAT from HMRC (in the civil courts), where the supplier is unable to make a statutory claim. Success for the taxpayer could significantly extend the time limit for reclaims. It could also lead to many claims, creating significant liabilities for HMRC.

Each of these has potential to tie up significant HMRC dispute resolution resource. The sums at stake are so large that HMRC may have to commit whatever resource is needed. As with other EU law rights, there are questions over what would happen to claims not resolved before Brexit.

We are also seeing the tribunal taking a more proactive approach to case managing appeals by multiple appellants on the same issue (for example, recovery of VAT on pension scheme costs based on *PPG* (Case C-26/12)). This is to be welcomed.

The impact of governance

We increasingly find that external pressures on HMRC, and their dispute resolution governance process, affect the resolution of disputes. This affects both timing and approach. It can be illustrated by reference to transfer pricing.

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External pressures mean that successful communication is increasingly the key to resolving prolonged disputes, or even ensuring that they do not happen in the first place. Disputes seem to happen surprisingly often, simply because documentation does not explain the facts which HMRC considers important. The same problem can continue into correspondence and face-to-face meetings. Many HMRC officers need to understand an issue from their own perspective, and be comfortable that they have tested it fully, before accepting it even provisionally.

Governance then casts a sharp light on this. Stakeholders in multiple reporting lines need to be involved for HMRC to reach comfort: the case team, DPT, CTIS Transfer Pricing Group and potentially others. They need to know that any red lines they see as being crossed are actually red herrings. And they must then advocate the proposal through governance: a process which for major issues can easily take months. So, in 2017 it will be truer than ever that just repeating the same story, or aiming for a high-level deal, will not work. Instead, what will be needed is a principled, evidenced-based proposal, and a narrative to address each potential concern that HMRC has. ■

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