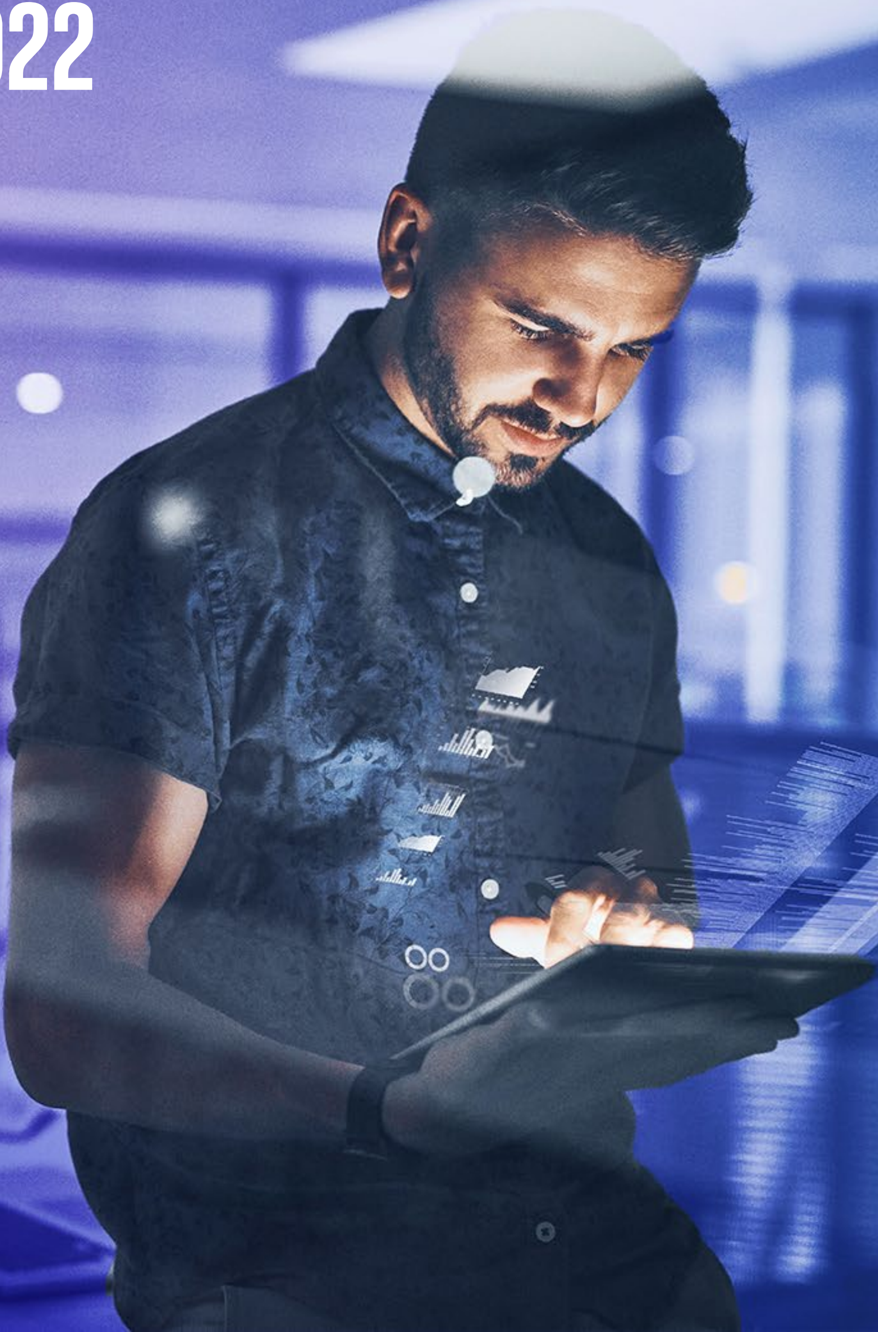
KPMG UK report: HMRC transfer pricing & Diverted Profits Tax statistics for year ended 31 March 2022

February 2023



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Introduction and headlines

The release of HMRC's annual transfer pricing ("TP") and Diverted Profits Tax ("DPT") statistics are always eagerly awaited as they provide valuable insights into how HMRC is addressing transfer pricing compliance risks both domestically and internationally.

The latest data published, for the 12 months ended 31 March 2022 ("FY22"), show some interesting trends which we have explored in more detail in the subsequent sections of this report.

The headlines are:

- The transfer pricing yield fell by 31% to £1,482 million, which is likely to be at least in part due to a reduced impact from the settlement of diverted profits investigations.
- HMRC also collected £198m of net DPT, the highest reported since FY18, and there were a further 100 ongoing diverted profits investigations at the end of March 2022 where the total amount of tax under consideration was £2.4 billion.
- HMRC settled 175 TP enquiry cases (including real time interventions), a significant increase on previous years, and the average time to settle those cases was 34 months.
- The data on the Profit Diversion Compliance Facility ("PDCF"), launched by HMRC in January 2019, continues to demonstrate the success of this initiative in resolving cases and the benefits for taxpayers as an accelerated route to resolution of UK transfer pricing issues.
- HMRC resolved 131 transfer pricing and profit attribution Mutual Agreement Procedure ("MAP") cases taking an average of 21 months – this is a step change versus prior years and a notable success for HMRC.
- There were 40 new applications for Advance Pricing Agreements ("APAs") made, the largest number seen since FY16 and this is even more encouraging as we expect that, unlike FY16, these will be materially all bilateral or multilateral APAs.
- The average time taken to agree APAs remains an area of concern with the 20 cases agreed in FY22 taking almost five years on average but there are a number of important international developments, in which HMRC have played an important role, which are intended to improve the effectiveness of future APA processes.

£1.5 bn

Transfer pricing yield for FY22

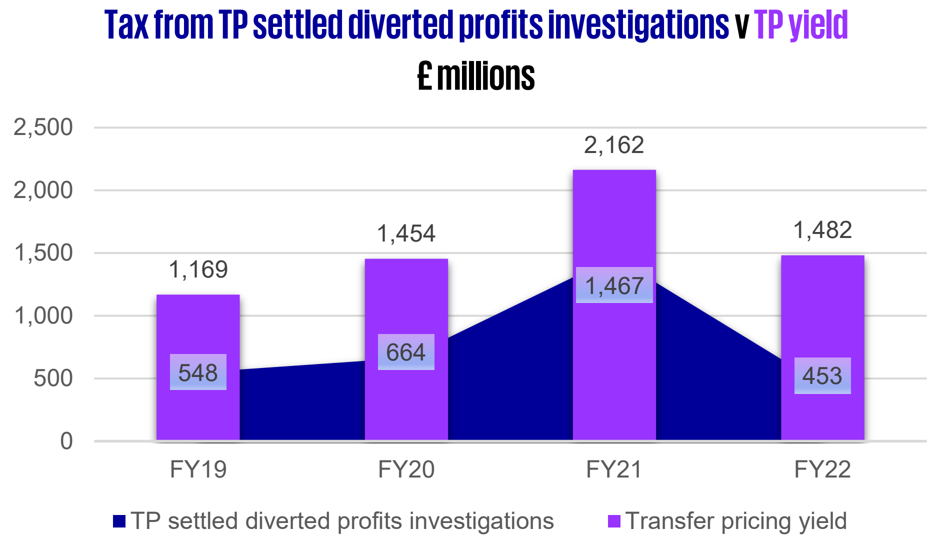
Transfer pricing yield

When the last set of statistics (for FY21) was published, the transfer pricing yield was the headline act, hitting a record high of £2,162 million. The yield reported for FY22 is £1,482 million, down over 30% on the previous year, but still slightly above the £1,454 million reported for FY20.

The transfer pricing yield figure includes additional tax revenue from enquiries (including real time interventions), APAs including Advance Thin Capitalisation Agreements ("ATCAs"), and the outcome of competent authority negotiations with treaty partner countries under a MAP after a HMRC enquiry or intervention. Our understanding is that transfer pricing adjustments agreed under the PDCF are included within the transfer pricing yield on a year of impact basis.

Transfer pricing yield is lumpy as it is sensitive to the timing of settlement of investigations where there are very large amounts of tax at stake. HMRC changed the way it reported the transfer pricing yield from FY19 so data for the period FY19 to FY22 is not calculated on a comparable basis to pre-FY19 data making longer term analysis of trends in the yield more difficult.

The data suggests that the FY21 yield was boosted by unusually large settlements based on (i) the number of settled enquiries for FY21 being lower than the three immediately preceding years; and (ii) the year by year breakdown of the DPT investigations results shows that in FY21 there was a big spike in the additional tax from transfer pricing settled investigations into diverted profits as shown below[1].



[1] Note: the figure for TP settled diverted profits investigations is calculated on a different basis to the transfer pricing yield figure so it is not the case that the £1,482m TP yield for FY22 includes the full £453m figure as there are phasing differences.

£198m

Diverted Profits Tax net amount

Diverted Profits Tax receipts

HMRC report a DPT net amount which represents the amount of DPT received during the year from charging and supplementary notices and not repaid. Where DPT is repaid it is usually because an enquiry has been settled on a transfer pricing basis and additional corporation tax has been paid. It was expected that the net DPT take would be low because taxpayers would ultimately reach settlement with HMRC on the basis of a transfer pricing adjustment to mitigate the penal effect of the higher rate of DPT[2].   The impact of DPT on the settlement of transfer pricing enquiries can be seen in the transfer pricing yield data reported since the introduction of DPT in 2015 so it is somewhat surprising the see that HMRC collected a net amount of £198 million in FY22 (the highest reported since FY18) and £349 million over the last 2 years.

HMRC received DPT notifications from 30 multinational groups in FY22, an increase of 5 on the prior year, and HMRC issued preliminary notices to 14 groups and charging notices to 14 groups.

At 31 March 2022 HMRC had around 100 ongoing diverted profits reviews (including those who have registered under the Profit Diversion Compliance Facility) and the total amount of tax under consideration in these cases was £2.4 billion.

The message is clear, DPT remains a potent tool at HMRC's disposal to tackle the perceived diversion of profits out of the UK, and it is still being very actively used.

Some might question whether DPT is still needed given the direction of travel with international tax reforms being thrashed out by members of the OECD/G20 Inclusive Framework. Considerable progress has been made on global minimum taxation and there are continuing efforts to build consensus around Pillar One but it is unlikely these changes will precipitate the repeal of DPT. The DPT regime was specifically designed to *"reduce the information bias inherent in complex cases and promotes full disclosure and constructive early engagement with HMRC"*[3]. The speed of the Government's legislative response[4] to the direction by the First-tier Tribunal in the Vitol Aviation case demonstrated its continued commitment to ensuring the proper functioning of the DPT regime.

[2] 25% rate for taxpayers who do not have profits subject to oil and gas ring fence taxation or the banking surcharge, where higher rates apply

[3] INTM489520 - Diverted Profits Tax: introduction and overview: overview

[4] See section 28 Finance Act 2022 which made amendments to the DPT legislation in Part 3 Finance Act 2015

175 cases

settled in an average of 34 months

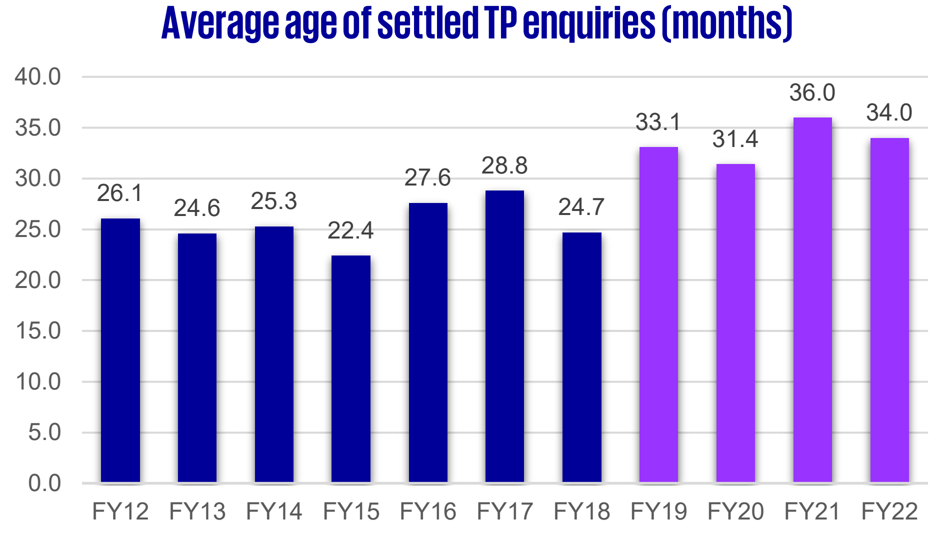
Settlement of enquiries and average age of settled enquiries

HMRC does not report data for their inventory of transfer pricing enquiries so the best indicator we have of the activity levels for HMRC compliance interventions is the number of settled cases (which includes real time interventions as well as formal enquiries into tax returns). HMRC settled 175 cases in FY22 which was 51 more than FY21 and 37 more than the previous highwater mark over the preceding 5 years.

When considered in the context of the transfer pricing yield data above we can see that the average yield per settled enquiry was £8.5 million, about half what it was for FY21 (£17.4 million). HMRC appear to have offset some of the impact from fewer high-value settlements (compared with previous years) by settling a significantly higher volume of cases, which would be expected to free up their resources for new enquiries.

One area where HMRC could improve its statistics would be to report settled enquiry data segmented based on whether the taxpayer's tax affairs are handled by HMRC Large Business Directorate ("LB") or the Wealthy and Mid-Sized Business Directorate ("WMSB"). This would help reinforce the point that it is not only LB taxpayers whose transfer pricing is being subject to compliance checks by HMRC. We understand that recent tranches of nudge letters for HMRC's Profit Diversion Compliance Facility ("PDCF") have been fairly evenly balanced between LB and WMSB taxpayers, so it is clear HMRC are conscious that transfer pricing compliance risks are not limited to large multinationals.

The graph below charts the average age of settled enquiries over the last 6 years.



175 cases

settled in an average of 34 months

Settlement of enquiries and average age of settled enquiries

The average time taken for the 175 enquiries settled in FY22 was 34 months, a modest improvement on the 36 months average for the 124 enquiries settled in FY21. The chart on the previous page shows that for the most recent four years HMRC enquiries have taken longer on average to resolve than was the case over the seven preceding years. This is consistent with our experience that HMRC fact finding has become more intensive, meaning it generally takes significant time to get to a discussion on the transfer pricing methodology itself in an enquiry.

There is a stark contrast between the enquiry settlement timelines and the speed of resolution of transfer pricing issues addressed through the PDCF, which we look at in more depth below. The best prospect of shorter enquiry timelines is by reducing the amount of fact gathering needed by HMRC and this starts with investing in the quality of the transfer pricing documentation, particularly the functional analysis and referencing of the key sources and timing of evidence collected.

HMRC have an ongoing project looking at changes to help address long-running enquiries, under the Review of Tax Administration for Large Businesses programme. As part of this review HMRC has been engaging with external stakeholders to explore ways to improve transfer pricing enquiry effectiveness, recognising that these enquiries can be particularly difficult. The discussions have focused on issues and barriers in relation to transfer pricing documentation, trust and transparency, fact finding and evidence, and governance and case resolution. We understand that HMRC intends to establish new, objective indicators of long-running enquiries and a clear and transparent process to accelerate their resolution.

16.5 months

average time to complete process

Profit Diversion Compliance Facility

The PDCF was launched by HMRC in January 2019 and has enabled HMRC to secure over £516 million in additional revenue from resolution proposals and changes in taxpayer behaviour. The data suggests the average yield from resolution proposals is lower than the average yield from HMRC enquiries over the same period, but cases are resolved quicker and with less pressure placed on HMRC resources.

HMRC issued 30 PDCF nudge letters in FY22 (+2 on FY21), there were 23 new registrations (+3 on FY21) and 26 cases were resolved (+4 on FY21). There have been 165 nudge letters issued since the PDCF began and over 70% of the multinationals who were issued nudge letters registered for the facility.

The average time taken from the registration meeting to receiving a decision from HMRC, is 16.5 months, which has risen on the 12 months figure reported last year, but still compares very favourably with the 34 months average time to settle normal enquiries.

96% of the final proposals made by taxpayers under the PDCF were accepted by HMRC which demonstrates that the process is highly effective for HMRC and the businesses concerned. HMRC is investigating those registrants whose final proposals were rejected, and most multinationals that received PDCF letters and chose not to register.

HMRC commissioned independent market research on the PDCF and this research is based on 35 qualitative in-depth interviews with representatives from multinational groups who are customers of HMRC's LB and WMSB Directorates, carried out in April and May 2022. The majority of the businesses interviewed:

- preferred to register to use the PDCF rather than risk an HMRC enquiry.
- considered that the timescales were realistic and the settlements reasonable.
- felt the process had a positive impact on their working relationship with HMRC (none felt that it had a negative impact).
- felt that it was an effective approach to resolving tax uncertainty as it put the responsibility on the business to do most of the investigation and reporting. It encouraged a cooperative approach, and is likely to be less invasive, costly and potentially publicly damaging than an HMRC enquiry.

Following on from DPT, HMRC can chalk the PDCF up as another effective mechanism for accelerating the collection of tax on transfer pricing risks, and HMRC have indicated they are now reviewing how the PDCF might be expanded to address other areas of tax risk. Given its success we are expecting another batch of nudge letters to be issued in the coming months as Nick Stevart explained in his recent LinkedIn post.

131 cases

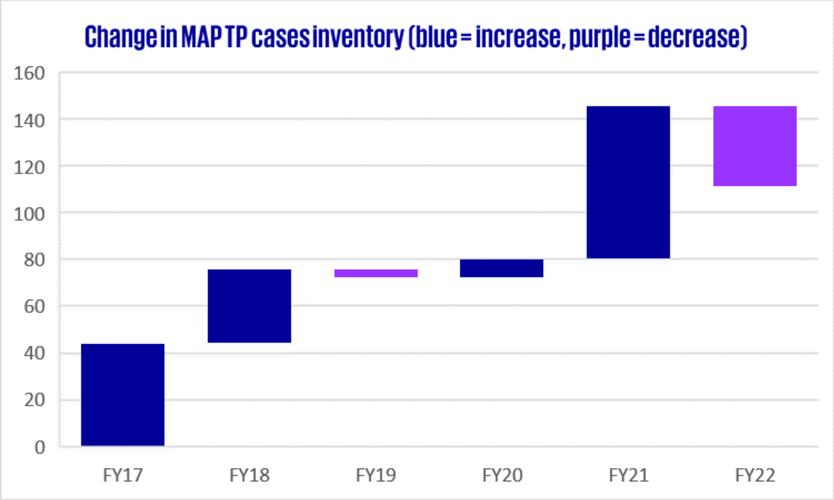
resolved in an average of 21 months

Mutual Agreement Procedure

Most of the UK's double taxation agreements include a MAP article allowing tax administrations to resolve cases of double taxation by consultation and mutual agreement. The UK has also committed to mandatory binding arbitration through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI") and does not restrict access to MAP or arbitration in cases where a decision on the issues subject to the MAP request have already been rendered by a court or administrative tribunal.[5] As part of its annual statistical reporting HMRC reports figures on MAP cases covering transfer pricing and permanent establishment profit attribution issues.

HMRC resolved 131 MAP cases in FY22, a step-change versus an average of 67 for the previous five years and the first time the number of cases resolved in HMRC's financial year has exceeded 100. The statistics reported by the UK for the FY21 calendar year under the OECD MAP Statistics Reporting Framework provide some useful further insights as they show a marked increase in unilateral relief, in particular in cases where Germany and the United States are the counterparty. Another positive development indicated by the OECD data is that HMRC were able to resolve a significant number of MAP cases bilaterally with Germany and Italy, traditionally two of the more difficult countries to have on the opposite side of the transaction. This is important as those two countries accounted for over 30% of the UK's closing inventory of transfer pricing and profit attribution cases at 31 December 2021.

The number of new cases admitted to MAP remains high at 96, which is a positive indicator of trust in the process, and HMRC have managed to reverse the trend of increasing MAP inventory seen in recent years, as shown by the chart below.



[5] INTM423080 - Transfer pricing: methodologies: Mutual Agreement Procedure: Arbitration

131 cases

resolved in an average of 21 months

Mutual Agreement Procedure

In our commentary on the FY21 statistics we noted that the UK Competent Authority team had made a concerted effort to try to resolve a number of older cases during 2020 and were successful in doing so. This strategy appears to have paid dividends in FY22 as the average time to resolve cases in FY22 was 21.1 months, the shortest since FY16, which is quite an achievement given the record number of cases resolved. As noted above, increased use of unilateral relief may be one of the factors driving faster outcomes.

The 24 months target for resolving MAP cases set as part of BEPS Action 14 minimum standard and the peer review process and MAP Statistics Reporting Framework appear to be having a positive impact by bringing an increased focus on resolving disputes in a timely, efficient and effective manner. There is also the spectre of mandatory arbitration which now features in an increased number of the UK's treaties.

20 APAs

agreed in an average of 58 months

Advance Pricing Agreements

APAs are recognised as international best practice by the OECD in managing compliance with transfer pricing rules and the statistics show 40 new applications were made in FY22, the largest number seen since FY16. 11 applications were withdrawn in FY21, an unusually large number, and there may have been a bounce back effect in FY22. The statistics clearly demonstrate that there is still strong demand for APAs from large multinationals and it is often the best tool available to obtain certainty in relation to complex and important cross-border transfer pricing arrangements.

HMRC agreed 20 APAs in FY22, which was down on the numbers for previous years but not unexpected given the likely impact of Covid-19 on multinationals' international business activities during FY21 and continuing into FY22.

The average time taken to reach agreement on the 20 APAs agreed in FY22 was 58.3 months, or almost 5 years. There are a number of factors we think contribute to APAs taking longer on average to revolve than MAP cases, even though the same delegated competent authorities handle both types of cases:

- APAs are intended to agree transfer pricing for covered transactions on a prospective basis and the dynamics are different to a MAP case where one country has already undertaken an investigation in order to make an adjustment.

- Connected to the point above, APAs are aimed at agreeing the transfer pricing methodology to be applied prospectively by a taxpayer, whereas in a MAP scenario when looking back at prior periods competent authorities are not required to agree on a methodology for the future where the business results and other facts are unknown. Resolution can be achieved based on pragmatically agreeing on an outcome without committing to a particular methodology.

- APAs are most suitable for complex transactions which may take longer to consider than a lot of audit adjustments which end up in MAP.

- Where relevant, recourse to mandatory arbitration encourages tax administrations to resolve MAP cases within a fixed time period.

- There is increased appetite for multilateral APAs. Multilateral APAs can be incredibly valuable to taxpayers but are more complex and so likely to take longer to negotiate.

20 APAs

agreed in an average of 58 months

Advance Pricing Agreements

There are reasons for optimism that APA negotiation timelines can be improved.

Recent APA statistics published by major trading partners of the UK have shown improvements in the time taken to negotiate APAs.

The OECD Forum on Tax Administration ("FTA") MAP Forum, in conjunction with the FTA Large Business International Programme, has developed the Bilateral Advance Pricing Arrangement Manual ("BAPAM') which is intended as a guide for streamlining the Bilateral APA ("BAPA") process and identifies 29 best practices for BAPAs. If there is increased adoption of these best practices by the UK's treaty partners this may feed through into improved APA negotiation times in future years.

On 1 February 2023 the OECD released its Manual on the Handling of Multilateral MAPs and APAs (MoMA). Multilateral MAPs and APAs offer greater tax certainty to both taxpayers and tax administrations where intra-group arrangements are covered by multiple bilateral tax treaties. However, most jurisdictions (unlike the UK) have limited experience in coordinating multilateral MAP and APA cases. The MoMA is intended as a guide from both a legal and procedural perspective and suggests different approaches based on the practices of jurisdictions, without imposing a set of binding rules. The MoMA also outlines the actions and cooperation expected from taxpayers.

APAs have not previously been subject to an OECD Statistical Reporting Framework in the way that MAP cases are. However, this is changing and the OECD/G20 Inclusive Framework has agreed that all members that have an APA programme should start reporting annual APA statistics which would be published on the OECD website in a common format. The APA Statistics Reporting Framework was released in January 2023 and is a more flexible and streamlined process than for MAP. It is expected to be up and running in 2024. This additional transparency is a positive development which should bring an increased focus to APA negotiations in the way it has for MAP case resolution and enable business to better understand the potential time taken for their APA when considering their business case for investing in a BAPA.

The complexity of transfer pricing issues faced by large multinationals continues to grow, driven by interconnected trends such as new technology and categories of intangible assets, and more globally mobile and dispersed senior management within corporates. APAs remain a very useful tool to address complex transfer pricing issues and given the reliance of the new Pillar Two global minimum tax rules on arm's length transfer pricing the certainty benefits of an APA are only likely to increase in the future.

HMRC have a strong track record of successful APA negotiations with treaty partners with APA programmes, including multilateral APAs, and continue to play a prominent role in the development of international best practice (including BAPAM) as a leading member of the FTA MAP Forum.

7 ATCAs

agreed in an average of 44 months

Advance Thin Capitalisation Agreements

An ATCA is a form of unilateral APA, agreed between a business and HMRC, which sets out how the transfer pricing rules apply to funding issues. The number of ATCAs agreed each year has been steadily declining since the introduction of the Corporate Interest Restriction effective 1 April 2017. There were only 7 ATCAs agreed in FY22, compared with 23 in FY21 and 213 when ATCAs were at their peak in FY15. There were only 41 ATCAs remaining in force at 31 March 2022.

Despite the significant drop in demand for ATCAs the average time to agree ATCAs has increased significantly over the last 5 years and the 7 ATCAs agreed in FY22 took an average of 44 months.

Whilst data suggests that we may be reaching the end of the line with ATCAs it should be borne in mind that we have now entered a period of higher interest rates. This may prompt changes in intra-group financing arrangements and increase the certainty benefits provided by ATCAs, but it remains to be seen whether this generates renewed interest from taxpayers.

As we noted in our commentary on the FY21 statistics, the publication of the new Chapter X guidance on financial transactions also creates new opportunities for bilateral APAs for financial transactions but remains problematic due to divergent approaches to capital structure (i.e. debt quantum) under the domestic laws of some important treaty partner countries.

398 FTEs

working on international issues

HMRC resources & resource to risk approach

HMRC do not report headcount data for transfer pricing specialists. HMRC used to report data on the number of international specialists but starting from FY19 they began reporting the number of full-time equivalent ("FTE") staff working on international issues, which includes dedicated international specialists along with other tax and industry specialists and technical advisers. HMRC views transfer pricing as part of a group of international tax risks they need to consider and this is consistent with the broad scope of the PDCF and changes HMRC have made to its governance.

It is interesting to see that there has been a reduction in the number of FTEs working on international issues. The FY22 figure was 398 compared to 431 for FY21 and 456 for FY20.

The investment case for HMRC resourcing transfer pricing enquiries is very strong – the average yield per FTE for FY22 was £3.7 million based on the transfer pricing yield alone. Layer on the yield from DPT and other international issues and that number would likely be significantly above £4 million per FTE. Staff retention and continuity of staff working enquiries is likely to be a significant challenge for HMRC, given the high demand for transfer pricing skills in the market.

Given HMRC's resourcing constraints, we can expect a continued focus from HMRC on improvements in how it identifies transfer pricing risks and resolves enquiries efficiently. There have been some notable recent developments in this area.

The PDCF has been a major success both in terms of risk identification and expedient resolution through a process that reduces the demands on HMRC resources through the emphasis on the quality of taxpayer's disclosure. As mentioned earlier, HMRC are also working on a project looking at improving transfer pricing enquiry effectiveness, which builds on the learnings from the PDCF.

An uncertain tax treatment notification requirement, which includes transfer pricing related uncertainties, was introduced for large businesses in relation to tax treatments adopted in corporation tax returns due on or after 1 April 2022. For example, a taxpayer would need to notify HMRC[6] if it booked a provision in its statutory accounts of over £5m in relation to an uncertainty over the arm's length price for a cross-border transaction included in its corporation tax return for the year ended 31 December 2021. Whilst it is unlikely there will be a large volume of transfer pricing related notifications, the requirement provides an added incentive for large businesses to engage early with HMRC on areas of uncertainty.

[6] Assuming the general exemption was not met

UK TP documentation requirements

HMRC is increasingly focused on the quality of transfer pricing documentation. In addition to introducing a new statutory transfer pricing documentation requirement for multinational companies within the scope of Country-by-Country Reporting, aligned with the OECD Master File-Local File standard, HMRC have been exploring a supplementary Summary Audit Trail (“SAT”) requirement which would be unique to the UK.

The SAT is intended to be a short, concise document summarising the work already undertaken by a taxpayer in arriving at the conclusions in their Local File transfer pricing documentation. The genesis for the SAT was the evidence log required as part of a disclosure under the PDCF. The SAT was intended to be a more concise version of this requirement. The additional transparency serves the dual purposes of (i) encouraging taxpayers to undertake sufficient work to support transfer pricing policies, and (ii) enabling HMRC to undertake high level quality assurance on the transfer pricing documentation allowing them to focus on higher risk areas during enquiries.

The introduction of the SAT has been delayed and a public consultation is expected to take place later in the year.

The new Master File-Local File requirements are expected to apply for accounting periods commencing on or after 1 April 2023, so for an in-scope UK entity with a December year-end the first accounting period covered by the new requirements will be the year ended 31 December 2024.

Contact us

Phil Roper
Partner & KPMG UK National Technical Lead

Phil joined KPMG in 2012 from a senior position within AstraZeneca's tax team where he where had a varied role including managing transfer pricing disputes and advising the business on a major supply chain transformation and several M&A transactions. At KPMG Phil had advised a number of listed businesses on major value chain transformation projects. Phil is KPMG's Transfer Pricing National Technical Leader and represents KPMG on HMRC's Transfer Pricing and Thin Cap Forums

Email: Phil.Roper@kpmg.co.uk

Graeme Webster
Partner, KPMG UK TP Controversy Management and Dispute Resolution (Financial Services)

Graeme is a Partner specialising in Transfer Pricing for Financial Services. He joined KPMG in 2018 following 17 years with HM Revenue & Customs where led on Financial Services transfer pricing policy, MAP and APA cases. At KPMG Graeme advises financial services clients on a wide range of policy issues and leads for the UK firm on tax authority engagement on financial services transfer pricing matters.

Email: Graeme.Webster@kpmg.co.uk

Nick Stevart
Director, KPMG UK TP Controversy Management and Dispute Resolution (Corporates)

Nick joined KPMG in 2018 after over 18 years with HM Revenue & Customs (HMRC) where he was the leader of the UK Competent Authority team responsible for Non-Financial APA and Transfer Pricing MAP cases. Part of this leadership included governance roles on APAs and Diverted Profits Tax. At KPMG Nick specialises in leading the firm's work around HMRC's Profit Diversion Compliance Facility as well as working with a range of clients more widely on Tax Authority engagement and dispute resolution strategies and solutions including on HMRC investigations and APA/MAP.

Email: Nicholas.Stevart@kpmg.co.uk

Gareth Hann
Director, KPMG UK TP Controversy Management and Dispute Resolution (National Markets)

Prior to joining KPMG in 2018, Gareth spent 13 years as a tax inspector at HM Revenue & Customs, dealing with complex, high-value disputes; latterly he led HMRC's Large Business transfer pricing and international tax team in Scotland and Northern Ireland. He now leads transfer pricing for KPMG in Scotland and has experience of helping our clients to resolve MAP, APA and enquiry cases across a range of industry sectors. At HMRC Gareth gained first-hand experience of litigation up to UK Court of Appeal level.

Email: Gareth.Hann@kpmg.co.uk

kpmg.com/socialmedia