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Transfer Pricing Briefing 2012

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Transfer pricing is a critical component of any multi-national company's global tax strategy. Transfer pricing rules govern the pricing of transactions undertaken between related parties, common examples being:

- the provision of services from one company to another
- the rate of interest applied on an inter-company loan
- the royalty rate applied to a license

Most developed countries have introduced relatively complex rules governing related party transactions, the common thread being the arm's length principle established by the OECD. The UK has adopted these guidelines in its tax law.

In the UK, transfer pricing rules apply to almost all forms of related party transactions, including sales or purchases of goods and services, exploitation of intellectual property, debt or other transactions not reflected in any accounts. The interaction with other areas of tax law can be complex with several special sets of transfer pricing rules for specific issues in different parts of the Taxes Acts.

An unusual feature of the UK's transfer pricing rules is the exemptions available to small and medium sized entities.

Legislation

Existence of Transfer Pricing Laws/ Guidelines

The UK transfer pricing legislation is contained in sections 147-217 Taxation (International and Other Provisions) Act 2010 (“**TIOPA**”). TIOPA rewrites previous UK transfer pricing legislation (Schedule 28AA of ICTA 1988) without making any material changes. Two key statutory requirements of the legislation are:

- taxpayers are required to use arm’s length transfer prices in making their own assessment of their taxable profits; and
- the rules, as matters of law have to be construed consistently with Art. 9 of the OECD Model Tax Convention and the OECD’s Transfer Pricing Guidelines.

HMRC (the UK tax authority) has published detailed guidelines on transfer pricing notably within the International Manual and the Tax Compliance Risk Management Manual.

Transfer Pricing Scrutiny

The guidance provides that HMRC will vary its enquiry activities in response to risk, thereby reducing significantly the number of checks and enquiries for low risk customers and increasing the intensity and effectiveness of interventions for high risk customers.

For low risk businesses, HMRC expects that the majority of its engagement will take place in real-time, as issues arise. If a customer is low risk, HMRC will generally review whether the customer continues to meet the low risk criteria on a three year cycle.

For the highest risk businesses it is likely that several meetings will be necessary each year, with annual risk reviews. HMRC expects that regular intervention will be necessary, while, at the same time, striving to engage in real-time discussions and to target its resources on the most significant issues in order to get to the heart of the matter more quickly.

HMRC guidance states that the following factors will be taken into account, both in determining the risk profile of a business and as reasons for initiating an audit:

- the existence of tax haven entities in the group but outside the controlled foreign corporation rules (UK anti-avoidance provisions that prevent the retention of income in low tax jurisdictions), which are profitable despite the absence of significant activities carried out in their locations;
- profit margins in the United Kingdom are lower than in the group generally and there are reasons to believe that this should not be the case;
- the UK company possesses the resources to generate high-margin profits yet produces only a routine low- margin profit. In this context, HMRC will look for the presence of, for example, heavy investment, highly skilled and remunerated technical or R&D workforce and intangibles such as trade names, know-how, and patents;
- royalty or management fee payments that do not appear to make commercial sense and which substantially impact the UK taxable profit, such as payments for a brand name unknown in the United Kingdom, technology to which significant value has been added by complex processes carried out in the United Kingdom and nebulous bundles of intangibles;
- poor performance over a number of years when there is no obvious prospect of super-profits in later years to justify the risk of continuing losses;
- any period in which changes in intra-group contractual arrangements purport to adjust the risk profile and, hence the reward, of the UK group. Examples include where a distributor becomes a commissionaire (and net profits fall away), or where a full manufacturer becomes a contract manufacturer and R&D activities that once generated royalties move to a contract basis; and
- Cost-sharing arrangements have been introduced.

Definition of Related Party

The related party requirement is applied by reference to body corporates or partnerships which are controlled by a person.

The term “Person” can cover individuals as well as corporates or other legal entities.

"Control", in relation to a body corporate, means the power of a person to secure –

- by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or
- by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,

that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person and, in relation to a partnership, means the right to a share of more than one- half of the assets, or of more than one- half of the income, of the partnership.

There are two important additions to the control definition:

- the 40% test (section 160(3) TIOPA) that applies to joint venture companies where each party has an interest of at least 40 per cent; and
- attribution rules (section 160(5) TIOPA) that trace control relationships through a number of levels in determining whether parties are controlled.

Transfer Pricing Penalties

A tax related penalty can be imposed under schedule 24 of FA 2007 on a company of up to the amount of the tax understated, where:

- a return is made that is not in accordance with the arm's length principle;
- the inaccuracy was deliberate and concealed; and
- United Kingdom tax is lost as a result.

In addition, where a transfer pricing assessment is raised on an individual (for example where an individual is providing services to a related company and the service fee is not arms-length), FA 2010 introduced paragraph 4A of Schedule 24 FA 2007 under which the penalty for understated tax can be up to ***twice*** the amount of the tax where:

- the inaccuracy was deliberate and concealed;
- it involves an "offshore matter"; and
- the offshore territory in question falls within a list of designated offshore jurisdictions (so called Category 3 territories).

In determining whether a jurisdiction is a Category 3 territory the UK Treasury considers the existence and quality of information exchange agreements. A list of Category 3 territories is published on the HMRC website (see http://www.hmrc.gov.uk/news/territories-category.htm) and includes jurisdictions such as Mauritius, Brazil and United Arab Emirates.

In addition, all other corporate tax penalties can apply and in particular:

- Para. 23 of Schedule 18 of the FA 1998 imposes a penalty on a company of up to £3,000 for a failure to keep and preserve records;
- Para. 39 of Schedule 36 of the FA 2008 imposes a penalty of £300 for a failure to produce documents and other information plus £60 for each day during which the failure continues.

Advance Pricing Agreement (APA)

The legislation provides for legally binding written agreements between taxpayers and HMRC. These are available for accounting periods ending after 27 July 1999.

Two kinds of APA are outlined in HMRC guidance:

- the "unilateral" type, in which only the taxpayer and HMRC are involved (including UK to UK transactions); and
- the "bilateral" type, where there is a double taxation treaty and the tax authorities of the relevant treaty partner country are also involved.

HMRC encourages applications for bilateral APAs wherever this is possible. HMRC consider APAs apply only where there are complex transfer pricing issues and can decline to consider an APA if the situation does not seem complex enough to justify their use of the resource. The quantum of the transaction is also very relevant. Unless the figures involved are significant (hundreds rather than tens of millions) it is unlikely HMRC will agree to issue an APA.

Advance Thin Capitalisation Agreements (ATCAs) are also available to resolve potential thin capitalization issues. Unilateral ACTAs allow taxpayers to gain certainty without having to seek relief through double taxation treaties.

Documentation and Disclosure Requirements

Tax Return Disclosures

The annual tax return must be adjusted for non-arms length transactions.

Level of Documentation

The HMRC guidance recommends a business:

- should, on request, make documentation available and accessible to HMRC (including, where appropriate, translation from another language). The form in which the documentation is stored should be at the discretion of the business;
- should maintain documentation for a permanent establishment on the same basis as for a legal entity;
- should identify the associated businesses with which the relevant transactions took place and the nature of the association;
- should describe the nature of the business in the course of which the relevant transactions took place and the property (tangible and intangible) used in that business;
- should set out the contractual or other understandings between the associated businesses and the risk assumed by each party;
- should describe the method used to establish an "arm's length" result and explain why that method was chosen;
- need not provide evidence about associations or transactions between businesses where those associations or transactions are not within the scope of UK transfer pricing rules;
- need not provide evidence related to each relevant transaction, but may provide aggregated evidence related to a class of similar transactions;
- need not create new evidence for transactions that occur after evidence has been created in respect of transactions that are similar and there have been no material changes in the circumstances for determining an "arm's length" result;
- need not commission the production of evidence from a professional adviser if the business is able to produce appropriate evidence itself;
- may choose to explain its general commercial and management strategy, or that of the group of businesses and technological environment, competitive conditions, and regulatory framework; and
- may choose to make documentation on relevant transactions available to HMRC before the tax return in which those transactions are reflected is due to be made.

Record keeping

Documentation must, in general, be kept for a period of 6 years from the end of the chargeable period to which it relates.

Language for documentation

Documentation should be maintained in English.

Small and medium sized enterprises (SMEs)

Small and medium sized enterprises are generally exempt from the transfer pricing rules. Small businesses are those with fewer than 50 employees and either turnover or assets of less than €10 million. Medium-sized businesses are those that are not small businesses but which have fewer than 250 employees and either turnover of less than €50 million or assets of less than €43 million. (These figures are calculated on a group basis).

For medium sized businesses only, HMRC has a reserve power to apply the rules in exceptional cases justified by significant tax at risk.

To protect the tax base, the rules are retained for transactions with certain overseas territories (countries with which the UK does not have a double tax treaty containing a suitable non-discrimination article).

Deadline to Prepare Documentation

Documentation must be in place at the time a tax return is submitted.

Deadline to Submit Documentation

Must be made available upon request by tax authorities within such time as is "reasonably specified" in the information notice. There is no minimum response / disclosure period, although such period must be "reasonable". HMRC has indicated that it might be reasonable to expect that most information could be provided within 30 days of any notice.

Statute Of Limitations

Generally, where HMRC consider an enquiry should be made, it must do so within 2 years from the end of the accounting period in which the transfer pricing issue arose. In certain circumstances, HMRC can make a discovery assessment six years after the end of an accounting period. In cases involving a loss of tax brought about deliberately, this can be extended to 20 years from the end of an accounting period.

Transfer Pricing Methods

The OECD Guidelines are applied by the UK legislation. Therefore, all methods outlined in the OECD guidelines may be accepted.

Comparables

Where the tested party is located in the UK, there is a preference for UK comparables. However, the use of pan-European databases has been accepted in the European Joint Transfer Pricing Forum.

Milestone International Tax Partners LLP
45 Clarges Street, London W1J 7EP

Phone: +44 (0)20 7016 5480
Fax: +44 (0)20 7016 5481
Email: info@milestonetax.com