# The Transfer Pricing Law Review

**Editors**
Steve Edge and Dominic Robertson

The Law Reviews

# THE TRANSFER PRICING REVIEW

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For further information please email
Nick.Barette@thelawreviews.co.uk

# THE TRANSFER PRICING LAW REVIEW

**Editors**
Steve Edge and Dominic Robertson

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# PREFACE

It has been a great honour – and an even greater education – to be asked to edit the inaugural edition of *The Transfer Pricing Law Review*.

Since the financial crisis in 2008, there has been continuous public attention on multinationals' tax position – which, for the most part, turns on their transfer pricing policy, and whether this properly aligns the taxable profits in each country with the value-generating activities taking place there. In the past couple of years, that public and political pressure has begun to turn into concrete action: for example, through the BEPS reforms on country-by-country reporting and transfer pricing; the European Commission's state aid investigations into Apple, Starbucks and others, which almost all relate to transfer pricing matters; and, as several chapters in this review make clear, increased audit scrutiny at the national level. It seems clear that transfer pricing issues will be filling tax professionals' working lives for several years at least.

This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered. Each chapter summarises the substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

This review contains contributions from 17 countries, covering a broad spread both geographically and economically. We are very grateful to the authors of the country chapters for lending their time and expertise to this project.

Four key themes that emerge from the country chapters are:

*a* More disputes: unsurprisingly, many countries (including Mexico and Poland) report an increase in transfer pricing disputes, particularly around profit allocation in a multinational supply chain.

*b* Profit splits: several countries (including Israel, Mexico and the UK) are seeing tax authorities push for a greater use of profit splits, particularly for high value-added activities where it may be difficult to find a precise comparable. (How you identify an appropriate share of profits for each different country is, of course, a separate challenge here.)

*c* TP compliance tools: many of the reporting countries have adopted rules that are designed to encourage greater transfer pricing compliance. Country-by-country reporting, which has been very widely adopted, is the prime example of this, but other instances include automatic transfer pricing penalties in Canada and Russia, and the diverted profits taxes adopted in Australia and the UK.

*d* Varied transfer pricing approaches: it is striking that different countries continue to apply transfer pricing in rather different ways. At one end of the spectrum, Brazil has rejected the OECD arm's-length principle entirely, arguing that imposing fixed ratios and limits is more effective. Even within the large majority of reporting countries that apply the OECD principles, however, there are differences in approach which could lead to diverging outcomes in practice. For example, Germany's transfer pricing rules apply a 'prudent and diligent managing director' test on top of the normal arm's-length principle (which has perhaps inspired the 'prudent economic operator' concept developed by the European Commission in their tax state aid investigations); and the Luxembourg chapter discusses a recent case in which an interest-free loan from Luxembourg to Italy resulted in taxable interest income in Luxembourg, with no corresponding deductions in Italy. These variations, of course, increase the risk of double taxation of the same profits – and it is thus important (if perhaps optimistic) that countries adopt the BEPS Action 14 recommendations on tax dispute resolution mechanisms with the same enthusiasm they have often shown for the tax-raising recommendations.

Finally, we would like to thank the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this review.

**Steve Edge and Dominic Robertson**
Slaughter and May
London
June 2017

**Chapter 15**

# UNITED KINGDOM

*Steve Edge and Orlaith Kane*[1]

## I OVERVIEW

Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) contain the main UK transfer pricing legislation that applies for corporation tax and income tax purposes. These rules apply the 'arm's-length principle' and are intended to counter transactions where a potential tax loss or reduction in taxable profits is created as a result of non-arm's length pricing between related parties.

If certain conditions are met, the rules require that a person's profits and losses are calculated for tax purposes by substituting an arm's-length provision for an actual one. In broad terms, the conditions can be summarised as follows:

*a* an actual provision has been made or imposed between two persons by means of a transaction or series of transactions;

*b* one of those persons was directly or indirectly participating in the management, control or capital of the other, or the same person or persons were directly or indirectly participating in the management or control of the two parties to the provision;

*c* the actual provision differs from the arm's-length provision that would have been made between independent enterprises; and

*d* the actual provision confers a potential UK tax advantage on one or both of the parties to it.

The main elements of these conditions are considered below.

### i Meaning of 'provision'

A 'provision' must be made or imposed in order for the UK rules to apply. While the term 'provision' is not defined in the legislation, HM Revenue & Customs (HMRC) guidance suggests that it embraces all the terms and conditions attaching to a transaction or series of transactions and should be given a wide meaning. The guidance also provides that the term is broadly equivalent to the phrase 'conditions made or imposed' in Article 9 of the OECD Model Tax Convention (the Model Convention) and, so, should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines).[2] The UK's First-Tier Tribunal (FTT) recently concluded that a share issue could be treated as a 'provision' for transfer pricing purposes. This interpretation suggests that the term is not confined to commercial transactions between companies and that the transfer pricing legislation can also

1 Steve Edge is a partner and Orlaith Kane is an associate at Slaughter and May.

2 HMRC International Manual (INTM412050).

impact shareholder transactions.[3] However, the FTT declined to follow this decision in a subsequent case[4] and held that the bonus issue of shares was not a transaction within the scope of the transfer pricing rules. This latter case is the subject of an appeal to the Upper Tribunal, which should hopefully resolve this uncertainty.

The rules operate in only one direction so that it is not possible to substitute an arm's-length provision for the actual provision where to do so would result in a reduction in taxable profits or an increase in allowable losses.

### ii Degree of relationship

The participation condition sets out the required degree of relationship between the parties and can be satisfied by way of direct or indirect control. In relation to a body corporate, 'control' means the power of a person to ensure that the affairs of the body corporate are conducted in accordance with the wishes of that person by means of holding shares, possessing voting power, or powers conferred by a document regulating the body corporate. In relation to a partnership, 'control' means the right to a share of more than half the assets, or of more than half the income, of the partnership.[5]

'Direct' control is most commonly satisfied where a person has voting control over a body corporate. Certain additional rules apply, however, for the purposes of determining whether a person has 'indirect' control.[6] Indirect control will arise in any of the following scenarios:

*a* where a person would have direct control if certain additional rights and powers were attributed to that person, including, by way of example, entitlements to rights and powers of connected persons and future rights and powers;

*b* where a person is a 40 per cent participant in a joint venture and there is one other participant who holds at least 40 per cent of the venture; and

*c* where a person acts together with other persons in relation to a financing arrangement, and that person would have direct control if the rights and powers of those other persons were attributed to it.

### iii Scope

The UK rules are stated to apply where an actual provision has been made or imposed between two 'persons'. There is no definition of 'person' in UK tax legislation but HMRC will apply the term to include bodies corporate, partnerships and individuals. The effect of the participation condition (see above), however, is that one of the parties to the actual provision must be a body corporate or a partnership.

Both cross-border transactions and UK-UK transactions come within the scope of the rules.

Where an adjustment is required by the transfer pricing rules to increase the profits (or reduce the losses) of one party (the 'advantaged party'), the connected UK party (the

3 *Abbey National Treasury Services plc v. HM Revenue & Customs*, TC/2012/02613.

4 *Union Castle Mail Steamship v. HM Revenue & Customs* [2016] UKFTT 526.

5 Section 1124 of the Corporation Tax Act 2010.

6 Sections 157 to 163 of the TIOPA.

'disadvantaged party') may, in turn, claim a compensating adjustment to their taxable profits. The rules also allow for a balancing payment to be made by the disadvantaged party to the advantaged party tax-free up to the amount of the compensating adjustment.[7]

Exemptions apply for small and medium-sized enterprises and dormant companies where certain conditions are met.

The UK transfer pricing rules do not apply to the calculation of a chargeable gain (or allowable loss) except to facilitate a claim for a compensating adjustment where there has been a transfer pricing adjustment.[8] Notwithstanding this, a market value rule may be imposed on related-party transactions under the Taxation of Chargeable Gains Act 1992, which should, in the majority of cases, produce a similar result.

### iv OECD principles

The UK rules contain an express provision that Part 4 of TIOPA should be construed in a manner that best secures consistency with the arm's-length principle in Article 9 of the Model Convention and the OECD Guidelines.[9] The definition of the OECD Guidelines has been updated to include the Base Erosion and Profit Shifting (BEPS) Actions 8-10 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation. While the strict statutory position is that these updates to the OECD Guidelines should apply only in relation to accounting periods beginning on or after 1 April 2016 for corporation tax purposes, HMRC generally views the updates as merely clarifications. Therefore, HMRC contends that applying a particular version of the OECD Guidelines to a transaction or provision which pre-dates that version coming into effect should not result in a different outcome.

## II FILING REQUIREMENTS

There is no specific requirement under the UK rules to prepare a transfer pricing report. However, given transfer pricing forms part of the UK self-assessment system, a taxpayer must keep and retain appropriate records and documentation so that it can submit a correct and complete tax return.

HMRC guidance refers to four classes of records or evidence that it would need to consider in order to assess whether a taxpayer's transfer pricing accords with the arm's-length standard, as follows:

*a* primary accounting records;
*b* tax adjustment records;
*c* records of transactions with associated businesses; and
*d* evidence to demonstrate an arm's-length result.[10]

While HMRC would expect the first three categories to be prepared in advance of submitting a tax return for the relevant accounting period, evidence to demonstrate an arm's-length result may be required only in response to an information request from HMRC as part of an inquiry into a taxpayer's return. Of course, preparing contemporaneous transfer pricing documentation should assist in demonstrating that a taxpayer has taken reasonable care in

7 Section 196(2) of TIOPA.
8 HMRC International Manual (INTM480020).
9 Section 164 of TIOPA.
10 HMRC International Manual (INTM483030).

determining its transfer pricing. Therefore, provided any transfer pricing report is credible, it should prove helpful in defending the imposition of any penalties should the taxpayer's transfer pricing subsequently prove to have been incorrect.

Recommendations about transfer pricing documentation can also be found in the OECD Guidelines. In addition, HMRC will also accept documents prepared in accordance with the EU's Code of Conduct on transfer pricing documentation.[11]

## III PRESENTING THE CASE

### i Pricing methods

Since the UK's domestic transfer pricing legislation must be construed in a manner consistent with the OECD Guidelines, any of the five transfer pricing methods provided for in the OECD Guidelines may be adopted in the UK, provided the relevant method establishes pricing that satisfies the arm's-length standard.

It is also worth noting that the OECD Guidelines permit taxpayers to adopt 'other methods' outside of the five OECD-recognised methods where the latter are regarded as less appropriate or unworkable having regard to the particular facts and circumstances of the case. Under most of the methods, it is necessary to carry out a comparison of the controlled (i.e., related party) transaction against an uncontrolled (i.e., independent party) transaction.

Generally speaking, the nature of the controlled transaction in issue (having regard, in particular, to the functional analysis), the availability of information, the degree of comparability and the reliability of comparability adjustments are factors that influence the selection of the most appropriate method. HMRC endorses the OECD's preference for traditional transaction methods over transaction profit methods where both can be applied in an equally reliable manner and, similarly, it is generally accepted that a comparable uncontrolled price (CUP) is the most effective way of assessing the arm's-length price.

#### *Comparability*

HMRC emphasises the importance of carrying out a robust comparability analysis as this may have a considerable impact on the acceptable range of arm's-length pricing. However, it is difficult for a CUP to be entirely robust given that access to information on a third party's actual position is limited. A determination as to whether any given comparable is reliable must be made on a case-by-case basis having regard to the extent to which they satisfy the five comparability factors identified in the OECD Guidelines (i.e., the characteristics of the property or services transferred, the functions performed taking into account the assets used and risk assumed, the contractual terms, the economic circumstances of the parties and the business strategies pursued by the parties).

In practice, both quantitative and qualitative data will be used to include or exclude potential comparables. HMRC acknowledges that a small number of strong comparables is likely to give a more accurate result than a large number of weak comparables.

The feasibility of carrying out reasonably accurate comparability adjustments is equally important when performing a comparability analysis. Examples of comparability adjustments include adjustments for accounting consistency and adjustments for differences in functions, assets and risks. However, in line with the OECD Guidelines, the only adjustments that

11 HMRC International Manual (INTM483030).

should be made are those for differences that will have a material effect on the comparison and that are expected to improve comparability. If numerous or substantive adjustments to important comparability factors are required, this may be an indication that the comparability of the independent transaction is not, in fact, sufficiently reliable.

***Cost-plus***

The cost-plus method is typically applied in the UK for routine low-risk activity (e.g., administrative business support functions or services that a multinational group would be prepared to outsource). A key consideration in applying this method is to ensure that all relevant costs have been included in the tested party's cost base.

***Profit split***

In contrast, the profit split method is often applied for highly integrated operations or where both parties make unique and valuable contributions (e.g., contribute unique intangibles) to the transaction. This method is more commonly applied where the level of integration or contribution made by the relevant parties is akin to a joint venture. A search for reliable comparables must have been suitably exhausted before availing of this method. Following a consultation in 2016, the OECD is in the process of revising its guidance on the application of the profit split method, which is expected to be published later this year.

***Cost sharing***

The guidance contained in the OECD Guidelines on cost sharing arrangements applies in the UK. In applying this guidance, HMRC emphasises that there is no difference in the approach for analysing transfer pricing for cost sharing arrangements than for any other transactions and that parties performing activities under similar economic circumstances should receive the same expected return irrespective of whether those activities are performed within the framework of a cost sharing arrangement or not.

The BEPS Actions 8-10 Final Reports make clear that contributions made to such an arrangement should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of the participants. While cost share methods are acceptable in the UK, it is expected that arrangements of this kind will be less commonly used in the future due to this general requirement to measure contributions at fair value (rather than cost).

**ii Authority scrutiny and evidence gathering**

***Cross-checks***

While one particular method may be selected and applied for the purposes of determining the arm's-length pricing of the transaction, HMRC also emphasises the importance of cross-checking this result against other methods and applying sense checks. In light of the increased public interest in the tax affairs of multinational companies, HMRC will be interested in how the 'man on the street' would perceive the result. While this is, of course, a valid consideration, it must be balanced with the need to arrive at a principled arm's-length price having due regard to the established rules and OECD guidance. This can involve exercising judgement based on experience as to the reasonableness of the result from a business and economic perspective.

Another sense check that HMRC is keen to examine is the global tax position for multinational groups and the profit share in each jurisdiction. This enables it to form a view on whether the UK is getting its 'fair share' of the profits. Major difficulties can arise in trying to value the rate of return on IP across a multinational group. In a financial services context, however, it is generally easier to value the return on capital employed.

Following the introduction of the diverted profits tax (DPT) legislation (see Section IX, *infra*), HMRC now expects to be provided with information on a group's full supply chain, and the profits earned in each entity. Details on the transactions between UK and non-UK affiliates are unlikely to be sufficient, so taxpayers should expect to be required to provide information on pricing or profit allocation between non-UK members of the group also.

***Country-by-country reporting***

Consistent with the outcome of the BEPS project, the UK has adopted country-by-country reporting (CBCR) rules with effect for accounting periods beginning on or after 1 January 2016. The rules require any UK headed multinational enterprises or, in certain circumstances, UK sub-groups of multinational enterprises with a consolidated group turnover of €750 million or more to file an annual report containing information about global activities, profits and taxes to HMRC. The Finance Act 2016 afforded HM Treasury the power to make regulations requiring CBCRs to be included in a group's published tax strategy. The UK government has confirmed that it is keen to achieve an international consensus for such a public model before exercising its powers to make such regulations.

***Evidence gathering***

HMRC's governance process plays a key role in shaping how transfer pricing investigations are conducted. In order for any settlement to be approved by HMRC's governance process, the HMRC case team must conduct a comprehensive fact-finding exercise.

***Interviews***

In addition to carrying out a review of documentary evidence, witness interviews may also be needed. Interviews with key business personnel can serve as a useful tool to address any gaps in HMRC's knowledge following a review of the documentary evidence, to verify HMRC's analysis of the material functions and risks in the business, and to assess whether there is any divergence between the related parties' conduct and the terms of the written contracts between them. In addition to speaking with the tax personnel in the business, HMRC is keen to meet with those working at the coal face to get a proper understanding of where they perceive the real value generating activities of the business to be located.

Depending on the facts and circumstances of a particular inquiry, HMRC may request interviews with third parties outside the taxpayer group, including customers. In order to avoid any undue business disruption, it is generally accepted that HMRC should try, where possible and practical, to obtain information and documents from the taxpayer concerned before approaching third parties. That said, third-party witness interviews can enable HMRC to independently check information provided by a taxpayer and to gain a more holistic picture of the business concerned.

In the case of customers, HMRC will liaise in the first instance with the taxpayer concerned to coordinate the interviews. If the taxpayer or the third party refuses to comply with this informal request, HMRC may decide to issue a third-party information notice that would legally require the customer to give HMRC certain information and/or documents to

help it check the relevant taxpayer's position. Before making such a decision, HMRC case teams are advised to consider carefully whether they can be satisfied in any way other than by issuing a third-party information notice. In addition, the approval of the tribunal is required in order to issue such a third party information notice. HMRC cannot, however, require the third party to produce a document that is not in its possession or power or that is subject to legal professional privilege.

***Information exchange powers***

If information essential to a transfer pricing inquiry is shown not to be within the power or possession of a UK business or its officers, HMRC may consider invoking formal information powers, such as the exchange of information facility with other tax authorities. However, HMRC is expected to exhaust all other sources before invoking such powers. HMRC may avail of these facilities pursuant to a double tax treaty that contains an exchange of information article, the Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters, various EU directives and regulations (pending Britain's formal exit from the EU) and exchange of information agreements where no double tax treaty is in force.

Exchange of information articles typically restrict HMRC in the specific uses to which it may put the exchanged information it receives and the onward disclosure of that information. The usual rule is that the information can be used only for the purposes of the assessment and enforcement of the taxes covered by the relevant treaty.[12] While transfer pricing will fall within the scope of most double tax treaties, this may not be the case for diverted profits tax (DPT) since HMRC views DPT as a tax 'in its own right' and not as corporation tax. However, HMRC may be able to obtain information for the purposes of a DPT investigation under the Convention on Mutual Administrative Assistance in Tax Matters as this effectively applies to all taxes.

## IV INTANGIBLE ASSETS

HMRC recognises that the use and transfer of intangible assets represent a material risk area for transfer pricing, particularly in the context of multinationals.

The BEPS Actions 8-10 Final Reports provide revised guidance specifically tailored to determining arm's-length conditions for intangible asset transactions. The revised guidance provides a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles based on the value they create through functions performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (otherwise known as DEMPE).

Based on recent transfer pricing inquiries involving multinationals in the technology area, it is expected that HMRC will look to carry out a DEMPE analysis across the global value chain of these multinationals so as to ensure that the transfer pricing resolution accords with the guidance in the BEPS Actions 8-10 Final Reports.

The framework for analysing DEMPE associated risks builds upon existing OECD guidance, which requires one to take into account both the capability to perform relevant 'day-to-day' decision-making functions together with the actual performance of those functions. Legal ownership of intangibles alone does not determine entitlement to returns,

12 HMRC International Manual (INTM156050).

so if a member of a multinational group contractually assumes a specific risk but neither exercises control over that risk nor has the financial capacity to assume the risk, the risk should be allocated to another multinational group member that satisfies those requirements. In order to justify a higher than passive return for a member of a multinational group, it would be necessary to evidence that the member in question has appropriately skilled and qualified employees and resources to manage the economically significant risks associated with the relevant DEMPE functions.

## V INVESTIGATIONS

### i Process

The way in which a transfer pricing inquiry is conducted will vary from case to case, although once an inquiry has been opened the process generally involves HMRC (1) making and agreeing an action plan and timeline with the taxpayer; (2) carrying out a fact-finding exercise; (3) assessing the evidence and engaging in technical discussions with the taxpayer; and (4) resolving the inquiry.

A transfer pricing inquiry is undertaken by large business service or local compliance case teams headed by their respective customer relationship manager (CRM). A transfer pricing specialist is allocated to each inquiry. The CRM is responsible for HMRC's relationship with the customer and for the planning and direction of the work of the case team.[13]

Due to the punitive rate of DPT and for the other reasons outlined in Section IX, *infra*, DPT can represent a strong incentive for taxpayers to be open and cooperative with transfer pricing inquiries.

### ii Time limits

In the majority of cases, HMRC may open an inquiry into a taxpayer's return within 12 months from the date on which a tax return is filed. Once opened, there is no specified time limit for completing the inquiry, although HMRC's 'Review of Links with Large Business' commits HMRC to resolving transfer pricing inquiries within 18 months for the large majority of cases, and 36 months for those that are particularly complex and high risk. In its guidance, HMRC comments that a transfer pricing inquiry should not be opened without the approval of the Transfer Pricing Panel or Transfer Pricing Board. The taxpayer may request HMRC (or the tax tribunal) to close an inquiry if there appears to be an unnecessary delay by HMRC in progressing the case.[14]

Where the 12-month period within which an inquiry must be opened has passed, HMRC has the power to raise a discovery assessment where there has been incomplete disclosure or careless or deliberate conduct by the taxpayer. The time limit for raising a discovery assessment is generally four years from the end of the relevant accounting period to which the assessment relates. This may be extended to six years where the assessment is made to recover an underpayment of tax due to carelessness by the taxpayer (or 20 years where the error in the taxpayer's transfer pricing position was deliberate).

13 HMRC International Manual (INTM481080).

14 Section 33 of the Finance Act 1998.

In order to conclude a formal inquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend their return.[15] If a taxpayer fails to comply with the contents of the closure notice, HMRC may make a determination as to the amount of tax that it considers is payable by the company. Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days after the notice or assessment was issued.

## VI SETTLEMENTS

The settlement of a transfer pricing inquiry must be approved by the Transfer Pricing Panel or the Transfer Pricing Board, following the submission by the HMRC case team of a resolution report. However, if arrangements have been identified as meeting the conditions for a potential DPT charge, a newly formed Diverted Profits Board will consider both the transfer pricing and DPT issues in point. A resolution report will include a summary of the case, a recommendation by the CRM as to how the case should be settled and a statement about culpability.[16] The statement about culpability is intended to assist the relevant panel or board in assessing whether penalties should be imposed. Therefore, while the relevant panel or board is charged with approving or rejecting the resolution paper, the CRM retains a degree of influence over the process.

The Transfer Pricing Board makes decisions on high-profile or contentious transfer pricing enquiries. It also makes recommendations to the Tax Disputes Resolution Board (TDRB) about transfer pricing risks that fall within the TDRB's remit. In 2015–2016, it considered 22 cases (28 in 2014–2015).[17] The Diverted Profits Board similarly makes recommendations to the TDRB on HMRC's largest and most sensitive cases. The Tax Assurance Commissioner expects to report on the activities of the Diverted Profits Board in future years.

This governance framework is intended to ensure consistency across taxpayers and provide assurance to taxpayers that HMRC treats taxpayers fairly and even-handedly, irrespective of the size or complexity of the taxpayer or its affairs.

The relevant panel or board will examine the recommendations made in the case team's resolution report. If the settlement is authorised, HMRC will confirm the agreement and its terms in writing to the taxpayer and their advisers. The taxpayer is then afforded a 30-day 'cooling-off period' in which it may withdraw from the agreement before a closure notice or assessment is issued.[18]

If the resolution report is not approved, the relevant panel or board will set out the reasons why and the basis upon which the case team should revisit the negotiation or proceed to litigation.[19]

Where a settlement has resulted in an adjustment to a taxpayer's returned profits, this may be relied upon to inform the future returning position provided there has been no

15 Section 32 of the Finance Act 1998.

16 HMRC International Manual (INTM481060).

17 The Tax Assurance Commissioner's Annual Report 2015–2016.

18 Section 208 of the TIOPA.

19 HMRC International Manual (INTM483070).

material change in the circumstances of the business or in the market conditions in those future periods. In such cases, HMRC may provide comfort that the inquiry period will be regarded as 'low risk'. However, HMRC emphasises in its guidance that it cannot provide any assurances that a future return will not be subject to a transfer pricing inquiry.[20] Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process. Certainty will only be achieved, of course, if the critical assumptions arrived at in the APA process remain true. Negotiating these assumptions will often require significant work in any APA discussions.

In certain cases, HMRC will recommend an APA either following a transfer pricing inquiry or during the process. This has the obvious advantage of increasing certainty that the transfer pricing method agreed upon will not be challenged and enables a taxpayer to realise more long-term benefits from the cost, time and effort involved in resolving the inquiry itself.

Notwithstanding the fact that an APA may be in place or HMRC may have agreed to treat a particular period as 'low risk', it is still open to HMRC to raise a discovery assessment in circumstances where it believes there has been incomplete disclosure or careless or deliberate conduct by a taxpayer.

## VII LITIGATION

### i Procedure

If a transfer pricing inquiry cannot be resolved by agreement, the taxpayer may appeal any final decision by HMRC to the FTT. The time limit for taxpayers to make an appeal is generally 30 days from the date of such final decision.

Most appeals will, in the first instance, be considered by the FTT. Where an appeal turns on a particularly complex point of law, without any disputed facts, it may be heard by the Upper Tribunal at first instance, where the parties agree and with the consent of the Chamber Presidents. Decisions by the FTT may be appealed to the Upper Tribunal on a point of law where permission has been granted. The Upper Tribunal will be a Superior Court of Record, which means that its decisions create legally binding precedent.

As a public body, a taxpayer may seek judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if, for example, it believes an HMRC officer has failed to properly carry out his or her duties or misdirected the taxpayer and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims.

The process to prepare for a transfer pricing hearing is the same as for any other tax litigation. The timeline for any given tax trial will vary according to the complexity of the dispute in question.

A court decision may be appealed where permission has been granted. Appeals from the FTT must be applied for within 56 days of the tribunal decision. Appeals from the Upper Tribunal and the Court of Appeal must be applied for within one month and 28 days, respectively. Appeals against the decisions of lower tribunals or courts can generally be made only on a point of law. However, if a party believes that the findings of fact made by the lower court or tribunal are such that no judge properly could have come to that determination, an appeal may be permitted on such wider grounds.

20 HMRC International Manual (INTM483130).

### ii Recent cases

Very few transfer pricing cases have been litigated in the UK.

*DSG Retail Ltd v. HMRC*[21] is one of very few transfer pricing cases to have reached the tribunal. This case concerned a UK company that sold electrical goods by retail. It encouraged customers to purchase extended warranty agreements. The liability to customers under those warranty agreements was insured or reinsured by an associated Isle of Man company via a third-party insurer. The tribunal considered the extent to which transfer pricing rules apply to the indirect provision of a business facility between connected companies where there is no contractual relationship between those companies, and the appropriate transfer pricing methodology for an adjustment.

The tribunal held that the UK company had provided an indirect business facility to its Isle of Man subsidiary, by enabling the subsidiary to enter into commercially advantageous insurance contracts with a third-party insurer. The tribunal further held that, if the UK company and its Isle of Man subsidiary had been dealing at arm's length, the subsidiary would have remunerated its parent for the provision of that business facility, thereby increasing the UK company's taxable profits.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

### i Secondary adjustments

The UK government launched a consultation in 2016 on whether a secondary adjustment rule should be introduced into the UK's transfer pricing legislation and how that rule would be designed. The effect of the secondary adjustment rule (if introduced) would be to reverse the additional financial benefit arising from the non-arm's length pricing of an underlying transaction that currently remains after the application of the UK's transfer pricing rules. For example, if a UK company purchased products from a related overseas company at a price in excess of the arm's-length pricing, the UK transfer pricing legislation would adjust the incorrect pricing by reducing the deduction in calculating the UK company's taxable profits and the secondary adjustment would seek to remove the benefit obtained from the retention of that excess cash by the related overseas party. Responses to the consultation document have not been published to date.

### ii Penalties

HMRC may impose penalties if (1) an incorrect return is made and a taxpayer has been careless or negligent in establishing an arm's-length basis for the return; or (2) a taxpayer does not maintain adequate records. Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an inquiry.

Tax-geared penalties apply for inaccuracies in tax returns and documents submitted to HMRC. This means that they are calculated as a percentage of the tax that is due. The percentage to be applied will depend on a number of factors including, among others, (1) whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed; (2) whether the disclosure was prompted or unprompted; and (3) the quality of disclosure.

21 SpC [2009] SSCD 397.

Given that transfer pricing is more of an art than a science and to some extent what is an arm's-length price is a matter of judgement, it can be difficult to determine what is meant by 'careless' or 'negligent' in a transfer pricing context. While each case must be judged on its own merits and facts, HMRC provides some examples in its guidance on how it interprets these concepts. For example, where HMRC is satisfied that the taxpayer has made an honest and reasonable attempt to comply with the arm's-length principle, no penalty should apply.

## IX BROADER TAXATION ISSUES

### i Diverted profits tax

DPT was introduced from April 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements. It is intended to provide the transfer pricing legislation with a little more steel to support HMRC inquiries in high-risk transfer pricing areas (such as the digital economy and IT). The expectation is that this, in turn, will encourage better transfer pricing compliance, and greater transparency with HMRC in dealing with transfer pricing inquiries.

Broadly speaking, a DPT charge can arise in two scenarios: first, where a UK subsidiary or a UK permanent establishment (PE) enters into arrangements with a related person where that person or the transaction(s) lack economic substance resulting in a reduction of the UK subsidiary's or UK PE's taxable profits; secondly, where a person (whether or not UK-resident) carries on an activity in the UK connected to the supply of goods, services or other property made by a non-UK resident company in the course of its trade in a way that avoids creating a UK PE. The amount of DPT payable is 25 per cent of the amount of 'taxable diverted profits'.

In the majority of cases, any DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can represent a strong stick to accelerate resolution of a transfer pricing inquiry for the following reasons: (1) the DPT rate is considerably higher than the UK corporation tax rate; (2) it is not possible to postpone any DPT payment once a charging notice has been issued; and (3) DPT gives credit for transfer pricing adjustments only if they are made before DPT is assessed.

### ii Double taxation

Most of the UK's tax treaties have effective mutual agreement procedures (MAPs). These provisions typically permit HMRC to engage in the MAP but do not require the case in question to be resolved. Consequently, there is no guarantee of relief from double taxation under a MAP. That said, the UK is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments.

The EU Convention (90/463/EEC) on the elimination of double taxation in connection with the adjustment of profits of associated enterprises may provide an alternative to the MAP procedure where residents of EU Member States are potentially subject to double taxation. The MAP may be invoked under a treaty, under the EU Convention or under both simultaneously. While the UK will not cease to be a party to the EU Convention by virtue of Brexit, the territorial scope of the EU Convention is defined by reference to EU membership. Therefore, the UK will fall outside the territorial scope of the EU Convention following the UK's formal exit from the EU. It is not yet clear what (if any) new or, indeed, transitional arrangements the UK, or the EU 27, will seek to put in place post-Brexit.

The MAP is not an alternative to the normal transfer pricing inquiry process. An inquiry will not be conducted as part of a MAP and, equally, a MAP will not suspend or replace an inquiry. A taxpayer cannot pursue domestic legal remedies and the MAP concurrently. If a case is accepted for the MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay the MAP until these remedies are exhausted.[22]

Part VI of the multilateral instrument that was adopted pursuant to Action 15 of the BEPS project enables countries to include mandatory binding arbitration (MBA) in their double tax treaties. MBA applies only between countries that expressly choose to apply it with respect to their double tax treaties. Twenty countries (including the UK) have committed to adopt and implement MBA in their bilateral tax treaties. These provisions will provide taxpayers with certainty that a case submitted to the MAP will be resolved.

HMRC is of the view that DPT is a separate, stand-alone charge on diverted profits and is not income tax, capital gains tax, or corporation tax. Consequently, HMRC would not make it the subject of a bilateral APA or enter into MAP discussions concerning it. This is another reason why it is important to agree transfer pricing disputes before disputing DPT.

### iii Consequential impact

#### *VAT*

Where a business records its transactions with related parties on arm's-length terms, no transfer pricing issues should typically arise in respect of those transactions for VAT purposes. Furthermore, HMRC is of the view that balancing payments do not in themselves create taxable supplies for VAT purposes. However, the existence of a transfer pricing adjustment or the payment or receipt of a balancing payment may indicate that the value of a previous VATable supply has been understated so that a VAT correction may be required.[23]

Where the advantaged party and the disadvantaged party are within the same VAT group at the time of the original supply and subsequent adjustment, no VAT liability would normally arise.

If a balancing payment is made conditional by one party in return for another VATable supply, it may, depending on the particular circumstances, be considered (in whole or in part) as non-monetary consideration so that an open market value direction under Schedule 6 of the Value Added Tax Act 1994 may be appropriate.

#### *Import and customs duties*

Similar issues arise in relation to the interaction of the transfer pricing rules with import and custom duties. Balancing payments may need to be considered in ascertaining whether there has been an under- or overvaluation of the import price of a particular transaction and, therefore, in determining whether an adjustment is needed.[24]

22 HMRC Statement of Practice 1/2011.

23 HMRC VAT Valuation Manual (VATVAL 15700).

24 HMRC VAT Valuation Manual (VATVAL 15900).

## X OUTLOOK AND CONCLUSIONS

Following the BEPS project, there is an increased focus on the functional analysis in applying the transfer pricing rules in the UK so as to ensure that transfer pricing outcomes are aligned with value creation.

Following the investigations by the House of Commons Public Accounts Committee into the tax affairs of multinational companies in late 2012 and the decisions of the European Commission in the more recent state aid investigations, the profile of transfer pricing has been raised in the media and has led to heightened public interest in the tax affairs of multinationals. While transfer pricing inquiries in the UK are being conducted by HMRC with increased vigour as a result, one tide that is yet to change is the widespread public criticism of multinational taxation. It is hoped that the implementation of the BEPS project will change public perception and make it easier for BEPS-compliant multinationals to convince their stakeholders and the court of public opinion that they pay their fair share of taxes in accordance with internationally agreed rules.

**Appendix 1**

# ABOUT THE AUTHORS

## STEVE EDGE

*Slaughter and May*

Steve joined Slaughter and May in 1973 and has been a partner since 1982. He advises on the tax aspects of private and public mergers, acquisitions, disposals and joint ventures and on business and transaction structuring (including transfer pricing in all its aspects) more generally. A large part of Steve's practice involves advising non-UK multinationals (particularly those based elsewhere in Europe and in the US) on cross-border transactions and tax issues of various types. In that area of his practice, he works closely with other leading international tax advisers around the world.

In recent years, Steve has been heavily involved in several large-scale interventions under HMRC's high-risk corporates programme and in many in-depth tax investigations of specific domestic or international issues including transfer pricing in particular.

Steve is ranked as a star individual in the most recent editions of *Chambers UK*, *Chambers Europe* and *Chambers Global*. He is listed as a leading individual for corporate tax and is recommended for tax litigation and investigations in *The Legal 500, 2016*. Steve is listed in *Who's Who Legal 2016* and the ITR's *Tax Controversy Leaders Guide 2016*. Steve also appears in the *Tax Directors' Handbook 2016*, *TDH250* (the best individual tax advisers in the world (according to clients)).

## ORLAITH KANE

*Slaughter and May*

Orlaith joined Slaughter and May in 2016. Her practice covers all direct taxes, stamp duties and value added tax with a strong focus on corporation tax. She has experience of corporate transactions, including, in particular, mergers and acquisitions (public, private, domestic and cross-border) and group reconstructions. Orlaith also has experience of advising on transfer pricing and diverted profits tax disputes with HMRC.

**SLAUGHTER AND MAY**

One Bunhill Row
London
EC1Y 8YY
United Kingdom
Tel: +44 20 7600 1200 / +44 20 7090 5022 / +44 20 7090 5158 / +44 20 7090 3848 / +44 7825 006709
Fax: +44 20 7090 5000
steve.edge@slaughterandmay.com
orlaith.kane@slaughterandmay.com
www.slaughterandmay.com