

THE TRANSFER
PRICING LAW
REVIEW

SEVENTH EDITION

Editors

Steve Edge and Dominic Robertson

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PREFACE

It has been a great pleasure to edit this seventh edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's 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).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself is moving towards greater alignment of its TP rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed and the availability of APAs). Therefore, transfer pricing practitioners cannot simply assume that the OECD Guidelines contain all the answers, but must engage with their detailed application within each country.

Given their economic importance, transfer pricing rules will be high on the corporate tax agenda (and the broader political agenda) for many years to come, and they are continuing to evolve at a rapid pace. Over the next few years, we expect the following to be among the main areas of focus.

First, as many of the chapters make clear, litigation over transfer pricing disputes is becoming ever more common. Some countries have a long record of transfer pricing litigation and have resolved many of the procedural hurdles in asking a court to rule on exactly where value is created in a multinational; for example, the approach to handling (often conflicting) expert evidence and the challenge of developing factual evidence in a proportionate but comprehensive way. However, this clearly results in lengthy – and costly – hearings before the tax tribunals and many other countries will soon find themselves grappling with transfer pricing litigation for the first time.

Second, the fact-heavy nature of transfer pricing disputes means that they often take many years to reach resolution; for example, the US Tax Court judgment in *3M*, published in February 2023, involved an appeal lasting 10 years, and the UK authorities have confirmed that it now takes five years to agree an 'average' advance pricing agreement, compared to under three years in 2018/19. This can make it difficult to ensure that accurate evidence

is available – either because people have left the business or simply due to the vagaries of memory – and make it ever more important that high quality transfer pricing documentation is prepared in real time.

Third, in the *Fiat Chrysler* judgment, published in November 2022, the Court of Justice of the European Union appears to have rejected the European Commission’s suggestion that there is an ‘autonomous’ EU arm’s-length standard, holding instead that transfer pricing standards are set at the national level. (We are still waiting, however, for the Court of Justice to confirm whether this means that the €13 billion *Apple* case also needs to be decided against the Commission.) The *Fiat Chrysler* judgment reduces the ability of the European Commission to act as an additional transfer pricing watchdog, but also means that (pending any harmonisation through EU legislation) taxpayers will need to grapple with 27 separate transfer pricing regimes across the European Union.

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to progress. If it is ever implemented, which looks increasingly unlikely, Pillar One would mark a radical pivot away from the arm’s-length standard for large and highly profitable multinationals, so that a portion of their profits (above a 10 per cent hurdle rate) would automatically be reallocated to market jurisdictions. The Pillar Two ‘minimum tax’ reforms are much more likely to be implemented; for example, the European Union has already adopted a Pillar Two Directive, and the first part of the UK Pillar Two rules is included in the Finance Bill currently before Parliament. Pillar Two, as merely a minimum tax measure, has a less radical impact on transfer pricing than the Pillar One proposals; nevertheless, there will be many issues to work through here in the future. For example, what happens if a transfer pricing adjustment in country A, after several years of debate, finally causes the group’s effective tax rate in country A to increase above 15 per cent? Will any countries that have levied Pillar Two tax on the group, through the income inclusion or undertaxed payment rules, be obliged to reverse this Pillar Two charge?

We would like to thank the authors of each of the chapters for their comprehensive and illuminating analysis of each country’s transfer pricing rules, and 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

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*Steve Edge, Dominic Robertson and Tom Gilliver*¹

I OVERVIEW

Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) contain the main UK transfer pricing legislation. These rules apply the arm's-length principle and are intended to counter transactions where a potential reduction in taxable profits is created through 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 are as follows:

- a* an actual provision has been made between two persons by means of a transaction or series of transactions;
- b* one of these 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 both 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.

i Meaning of 'provision'

A 'provision' must be made for the UK rules to apply. While the term 'provision' is not defined in the legislation, His Majesty's Revenue and Customs (HMRC) guidance suggests that it should be given a wide meaning, and embraces all the terms attaching to a transaction or series of transactions. The guidance also provides that the term is broadly equivalent to the phrase 'conditions made or imposed' in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (the Model Convention) and should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines).² The Upper Tribunal has held that a share issue is a provision for transfer pricing purposes,³ which means that the term is not confined to commercial transactions, and UK transfer pricing legislation can also impact shareholder transactions.

1 Steve Edge is a senior lawyer, Dominic Robertson is a partner and Tom Gilliver is an associate at Slaughter and May. The authors wish to thank Henry Day for research assistance on this chapter.

2 HMRC International Manual (INTM412050).

3 *Union Castle Mail Steamship v. HMRC* [2018] UKUT 316 (TCC).

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 this would reduce taxable profits or increase allowable losses.

ii Degree of relationship

The participation condition sets out the required degree of relationship between the parties and can be satisfied through direct or indirect control. In relation to a body corporate, 'control' means the power of a person to ensure that its affairs 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.⁴

'Direct' control is most commonly satisfied through voting control. Additional rules apply to determine whether a person has 'indirect' control.⁵ 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 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 apply where an actual provision has been made or imposed between two 'persons'. HMRC will apply the term to include bodies corporate, partnerships and individuals. For example, the rules can apply to a provision between a company and an individual acting in their personal capacity.⁶ 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 domestic transactions fall within the scope of these 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), a connected UK party (the disadvantaged party) may, in turn, claim a compensating adjustment to its 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.⁸

4 Section 1124 of the Corporation Tax Act 2010.

5 Sections 157 to 163 of TIOPA.

6 *BCM Cayman LP and BlueCrest Capital Management Cayman Limited v. HMRC* [2020] UKFTT 298 (TC).

7 Section 196(2) of TIOPA.

8 Sections 165 to 168 of TIOPA.

The UK transfer pricing rules do not apply to the calculation of capital gains or losses except to facilitate a claim for a compensating adjustment where there has been a transfer pricing adjustment.⁹ However, a market value rule applies to many related-party transactions under the Taxation of Chargeable Gains Act 1992, which should generally produce a similar result.¹⁰

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 2022 OECD Guidelines.¹¹ HMRC view updates to the OECD Guidelines as clarificatory, and contend that transactions should always be tested under the current version of the OECD Guidelines.

II FILING REQUIREMENTS

A taxpayer must keep and retain appropriate records and documentation to support its tax return, but this has historically not (necessarily) required the production of a transfer pricing report. However, pursuant to new powers that enable HMRC to require transfer pricing records to be prepared in a standardised format for accounting periods beginning on or after 1 April 2023, the largest multinational businesses operating in the United Kingdom will soon be required to prepare master file and local file documents in accordance with the format recommended by the OECD Guidelines.¹² HMRC have mooted, but not yet stipulated, that this will need to be accompanied by a 'summary audit trail' detailing the actions taken in preparing the local file.¹³

HMRC guidance refers to four classes of records or evidence that it would review to assess whether a taxpayer's transfer pricing accords with the arm's-length standard:

- 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.¹⁴

While HMRC would expect the first three categories to be prepared before a tax return is filed, evidence supporting an arm's-length result may be required only in response to a subsequent information request from HMRC. However, where HMRC make any adjustments to the transfer pricing position in a tax return, HMRC will in practice require some evidence that the company had carefully considered the arm's-length position, to be satisfied that no

9 HMRC International Manual (INTM412040).

10 Section 17 of the Taxation of Chargeable Gains Act 1992.

11 Section 164 of TIOPA and the Taxation (International and Other Provisions) Act 2010 Transfer Pricing Guidelines Designation Order 2022.

12 Schedule 5 to the Finance (No. 2) Bill 2022–23.

13 HMRC Policy Paper, 'Transfer Pricing Documentation', published 15 March 2023.

14 HMRC International Manual (INTM483030).

‘careless error’ penalty is due.¹⁵ Traditionally, this can be conducted by preparing a formal transfer pricing report; the company should of course verify that the comparables identified in the report are genuinely functionally similar to the company itself.

III PRESENTING THE CASE

i Pricing methods

Since the United Kingdom’s domestic transfer pricing legislation must be construed in line with the OECD Guidelines, any of the five transfer pricing methods provided for in the OECD Guidelines may be adopted in the United Kingdom, provided that the relevant method satisfies the arm’s-length standard.

The OECD Guidelines permit taxpayers to adopt ‘other methods’ outside the five OECD-recognised methods where the latter are regarded as less appropriate or unworkable based on the facts and circumstances of the case. Under most of the methods, the controlled (i.e., related party) transaction then needs to be compared against an uncontrolled (i.e., independent party) transaction.

Factors influencing the selection of the most appropriate method include the nature of the controlled transaction (based, in particular, on the functional analysis), the information available, the degree of comparability and the reliability of comparability adjustments. HMRC endorse the OECD’s preference for traditional transaction methods over transaction profit methods where both can be applied in an equally reliable manner. 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 emphasise the importance of carrying out a robust comparability analysis in determining the acceptable range of arm’s-length pricing. Inevitably, this is complicated by limits on the available information on a third party’s actual position. A determination as to whether a comparable is reliable must be made case by case, based on the extent to which it satisfies the five comparability factors identified in the OECD Guidelines (i.e., characteristics of the property or services transferred, functions performed (including assets used and risks assumed), contractual terms, the economic circumstances of the parties and the business strategies of each party).

In practice, HMRC acknowledge that a small number of strong comparables are likely to give a more accurate result than a large number of weak comparables.

HMRC will carefully scrutinise any comparability adjustments made (e.g., for accounting consistency, and adjustments for differences in functions, assets and risks). In line with the OECD Guidelines, the only adjustments that should be made are those that will have a material effect on the comparison and that are expected to improve comparability. If numerous or substantive adjustments are required, this may indicate that the independent transaction is not, in fact, comparable.

15 HMRC International Manual (INTM483120).

Cost-plus

The cost-plus method is typically applied in the United Kingdom for routine low-risk activity (e.g., administrative business support functions or services that a group would often outsource). A key consideration with this method is to ensure that all relevant costs have been included in the tested party's cost base. HMRC consider that cost-plus is rarely appropriate for regional headquarter functions.

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). 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 using this method.

Cost sharing

The OECD Guidelines on cost-sharing arrangements apply in the United Kingdom. HMRC emphasise that there is no difference in the approach to 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 under a cost-sharing arrangement or not.

ii Authority scrutiny and evidence gathering

Cross-checks

While one particular method may be selected and applied to determine the arm's-length pricing of the transaction, HMRC also emphasise the importance of cross-checking this result against other methods and applying 'sense checks'.

In particular, HMRC generally want to test the outcome against the 'system' profit share in each jurisdiction in the value chain. This enables HMRC to form a view on whether the United Kingdom is getting its 'fair share' of the profits.

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

Country-by-country reporting

The United Kingdom has adopted country-by-country reporting (CbCR). 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 with HMRC containing information about global activities, profits and taxes.

Evidence gathering

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

HMRC will normally obtain information in a transfer pricing enquiry through informal information requests that are discussed and agreed with the taxpayer, but HMRC have the formal power to require taxpayers (and, subject to some restrictions, third parties) to provide information and documents, which they will use if the taxpayer is not cooperating fully with the enquiry, or where the use of HMRC formal powers is helpful to deal with any confidentiality or data privacy restrictions on disclosing documents informally. HMRC cannot require the production of legally privileged documents, or documents outside the 'power or possession' of the relevant party, which can lead to practical difficulties where documents are held elsewhere within a multinational group.

Interviews

In addition to carrying out a review of documentary evidence (including emails), witness interviews may be required. Interviews with key business personnel can help to address any gaps in HMRC's knowledge following a review of the documentary evidence, to verify HMRC's analysis of the functions and risks, and to assess whether there is any divergence between the written intra-group contracts and the practical operation of the business. In particular, HMRC are keen to meet with those working at the coalface to get a proper understanding of where they perceive the real value-generating activities of the business to be located. It is fairly unusual for expert witnesses, such as economists, to be involved prior to an appeal, but in some cases HMRC may consult its in-house economists.

In some cases, HMRC may request interviews with third parties outside the taxpayer group, including customers. To avoid undue business disruption and to protect taxpayer confidentiality, HMRC should try, where practical, to obtain information and documents from the taxpayer concerned before approaching third parties.

Information exchange powers

If information essential to a transfer pricing enquiry is not within the power or possession of a UK business or its officers, HMRC may consider invoking formal cross-border information powers, such as the exchange of information facility with other tax authorities. However, HMRC are expected to exhaust all other sources before invoking such powers. HMRC may use these facilities under a double tax treaty that contains an exchange of information article, the Joint Council of Europe and OECD Convention on Mutual Administrative Assistance in Tax Matters, and exchange of information agreements.

Exchange of information articles typically restrict HMRC's use of the exchanged information and the onward disclosure of that information. Normally, the information can be used only for the purposes of the assessment and enforcement of the taxes covered by the relevant treaty.¹⁶ While transfer pricing will fall within the scope of most double tax treaties, this may not be the case for DPT, since HMRC do not view DPT as akin to corporation tax.¹⁷

IV INTANGIBLE ASSETS

HMRC recognise that intangible assets represent a material risk area for transfer pricing.

16 HMRC International Manual (IEIM200200).

17 HMRC DPT Guidance (INTM489570).

The current OECD Guidelines provide a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles, based on the value that they create through functions performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (DEMPE). In 2018, the OECD issued guidance for tax administrations on hard-to-value intangible assets.

On the basis of recent transfer pricing enquiries involving technology businesses, it is expected that HMRC will carry out a DEMPE analysis across the global value chain of these businesses.

The framework for analysing DEMPE associated risks takes account of the capability to perform relevant 'day-to-day' decision-making functions and the actual performance of those functions. Legal ownership of intangibles alone does not determine entitlement to returns, and thus if a group member 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 group member who satisfies those requirements. To justify a higher than passive return, businesses need to evidence that the company in question has appropriately skilled and qualified employees and resources to manage the economically significant risks associated with the relevant DEMPE functions.

V SETTLEMENTS

The settlement of a transfer pricing enquiry must be approved by HMRC governance boards that specifically review transfer pricing or diverted profits tax cases (or both), which will make a recommendation to the Tax Disputes Resolution Board (TDRB) and to the Tax Assurance Commissioners (TAC) if the case falls within their remit.

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

The relevant 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 its 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 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 profits, this may, in practice, potentially be relied upon to inform the future tax return position, provided there has been no material change in the circumstances of the business or in market conditions. However, HMRC emphasise in their guidance that they cannot provide any assurances that a future return will not be subject to a transfer pricing enquiry. Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process.²⁰ Certainty will only be achieved if the critical assumptions arrived at in the APA process remain true. Negotiating these assumptions will often require significant work.

18 Sections 208 and 209 of TIOPA.

19 HMRC International Manual (INTM483070).

20 HMRC International Manual (INTM483130).

In some cases, HMRC will recommend an APA either following a transfer pricing enquiry or during the process. This has the obvious advantage of enabling a taxpayer to realise long-term benefits from the cost and effort involved in resolving the enquiry itself, although APAs can themselves take a long time to agree, and the critical assumptions on which the APA is based can mean that the APA falls away whenever the critical assumptions are breached.

VI INVESTIGATIONS

i Process

The way in which a transfer pricing enquiry is conducted will vary from case to case, although once an enquiry has been opened, the process generally involves HMRC:

- a* making and agreeing an action plan and timeline with the taxpayer;
- b* carrying out a fact-finding exercise;
- c* assessing the evidence and engaging in technical discussions with the taxpayer; and
- d* resolving the enquiry.

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

ii Time limits

In most cases, HMRC may open an enquiry into a taxpayer's return within 12 months of the date on which the tax return is filed. Once opened, there is no specified time limit for completing the enquiry. Although HMRC aim to resolve transfer pricing enquiries within 18 months for most cases, and 36 months for complex and high-risk cases, in practice many enquiries can run beyond this. The taxpayer may request HMRC (or the tax tribunal) to close an enquiry if there appears to be an unnecessary delay by HMRC in progressing the case.²¹

Where the 12-month period within which an enquiry must be opened has passed, HMRC have 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. This may be extended to six years where the underpayment of tax was due to carelessness by the taxpayer (or 20 years where the error in the taxpayer's transfer pricing position was deliberate).²²

To conclude a formal enquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend its return.²³ If a taxpayer fails to comply with the closure notice, HMRC may make a determination as to the amount of tax that it considers is payable by the company.²⁴ Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.²⁵

21 Paragraph 33 of Schedule 18 to the Finance Act 1998.

22 Paragraph 46, *ibid.*

23 Paragraph 32, *ibid.*

24 Paragraph 36, *ibid.*

25 Paragraph 39, *ibid.*

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days of the notice or assessment being issued.²⁶

iii Profit Diversion Compliance Facility

In 2019, HMRC launched a Profit Diversion Compliance Facility (PDCF) intended to enable multinational enterprises to correct transfer pricing irregularities. The PDCF is targeted at situations in which a multinational enterprise has adopted cross-border pricing arrangements that might trigger a DPT investigation because the arrangements either do not reflect what is happening on the ground or are inconsistent with the OECD Guidelines. An enterprise wishing to use the PDCF must submit a detailed disclosure of its transfer pricing affairs, including a proposal for the tax, interest and penalties payable to remedy the identified irregularities. By using the PDCF, an enterprise may obtain more control over its interactions with HMRC regarding transfer pricing, avert a future DPT investigation or benefit from lower penalties. HMRC will aim to respond to proposals submitted through the PDCF on an accelerated three-month timescale, though this may be optimistic given the time taken to investigate and resolve recent transfer pricing cases in the United Kingdom.²⁷ HMRC's latest published statistics indicate that, where cases have been resolved through the PDCF, the process has taken, on average, 16.5 months from the initial meeting to receiving a decision from HMRC.²⁸

VII LITIGATION

i Procedure

If a transfer pricing enquiry cannot be resolved by agreement, the taxpayer may appeal any final decision by HMRC to the UK's First Tier Tribunal (FTT). The time limit for taxpayers to make an appeal is generally 30 days from the date of such a 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 exceptionally be heard by the Upper Tribunal at first instance. Decisions by the FTT may be appealed to the Upper Tribunal on a point of law. Upper Tribunal decisions create legally binding precedents.

As HMRC are a public body, a taxpayer may apply to the High Court for judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if believing, for example, that an HMRC officer has failed to carry out his or her duties properly or has misdirected the taxpayer, and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims. In *R (Glencore Energy UK Ltd) v. HMRC*,²⁹ the taxpayer received a DPT charging notice and sought judicial review of the notice, arguing that the statutory appeal process was 'slow, inappropriate and ineffective'. Unsurprisingly, given the very high threshold required for a judicial review case to succeed, and the availability of an alternative remedy through the normal appeals process, the Court of Appeal refused this application.

26 Paragraph 48, *ibid.*

27 HMRC Profit Diversion Compliance Facility Guidance dated 10 January 2019.

28 Transfer Pricing and Diverted Profits Tax Statistics, 2021 to 2022.

29 [2017] EWCA Civ 1716.

The process to prepare for a transfer pricing hearing is the same as for any other tax litigation. Economists or businesspeople may give expert evidence, though there is relatively little established practice in this regard due to the dearth of transfer pricing cases in the United Kingdom (see below).

A court decision may be appealed where permission has been granted. Appeals against the decisions of the FTT can generally be made only on a point of law. However, if a party believes that the findings of fact made by the FTT are such that no judge properly could have come to that determination, an appeal may be permitted on those wider grounds.

ii Recent cases

Until recently, very few transfer pricing cases had been litigated in the United Kingdom.

*DSG Retail Ltd v. HMRC*³⁰ concerned a UK company that sold electrical goods. 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 whether 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. 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.

In the *BlueCrest* case,³¹ HMRC argued before the FTT that a UK permanent establishment that borrowed US\$165 million from related parties would have been unable to do so at arm's length, and, more surprisingly, that a further US\$200 million that it borrowed from a third-party bank could not have been borrowed from a third party acting wholly independently either (on the basis that it was supported by covenants from other members of the group). The FTT found in favour of the taxpayer on this issue, based on a careful weighing of the expert evidence, with HMRC's case not being helped by the fact that their expert sought to recharacterise the entire transaction into an alternative transaction, which would have failed to achieve the transaction's commercial aims.

In *BlackRock Holdco 5 LLC v. HMRC*,³² one of the arguments HMRC put forward to challenge an acquisition structure that (in the taxpayer's view) produced large interest deductions in the United Kingdom was that the intra-group interest costs would not have been incurred at arm's length. The expert witnesses for both parties agreed that an independent lender would have been prepared to lend the amount at similar interest rates, albeit subject to additional covenants from another group company (to secure dividend flows to service interest payments), which the FTT found would have been provided. However, HMRC argued that the group simply would not have implemented a structure under which the company borrowed from an independent lender. The FTT rejected that argument, on the basis that HMRC were speculating about what the group as a whole might or might

30 SpC [2009] SSCD 397.

31 *BCM Cayman LP and BlueCrest Capital Management Cayman Limited v. HMRC* [2020] UKFTT 298 (TC), affirmed by the Upper Tribunal [2022] UKUT 1988 (TCC).

32 [2020] UKFTT 443 (TC).

not have chosen to do, which is irrelevant to the question of what the terms of the lending transaction would have been at arm's length. However, the Upper Tribunal reversed the decision on the basis that the FTT had erred in law by permitting the additional covenants to be hypothesised, so as to justify the level of borrowing that the debtor was taking on, when asking whether an independent lender would make the same loan.³³

Both *BlueCrest* and *BlackRock* have been appealed to the Court of Appeal, but HMRC did not appeal the transfer pricing issue in *BlueCrest*.

As noted in Section I.i, it was held in the *Union Castle* case that shareholder transactions such as bonus issues can be subject to adjustment on transfer pricing grounds.

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 and how that rule would be designed. These proposals have not been taken forward, though no response to the consultation has ever been published.

ii Penalties

HMRC may impose penalties if an incorrect return is made and a taxpayer has been careless in establishing an arm's-length basis for the return; or a taxpayer does not maintain adequate records.³⁴ Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an enquiry.³⁵

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 will depend on a number of factors, including:

- a* whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed;
- b* whether the disclosure was prompted or unprompted; and
- c* the quality of disclosure.

Given that transfer pricing is more of an art than a science and identifying an arm's-length price is a matter of judgement, it can be difficult to determine what is meant by 'careless' in a transfer pricing context. While each case must be judged on its own merits and facts, HMRC provide some examples in its guidance on how it interprets these concepts. For example, where HMRC are satisfied that the taxpayer has made an honest and reasonable attempt to comply with the arm's-length principle, no penalty should apply.³⁶

33 [2022] UKUT 00199 (TCC).

34 HMRC International Manual (INTM483110).

35 Part 7 of Schedule 36 to the Finance Act 2008.

36 HMRC International Manual (INTM483120).

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

DPT was introduced from 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements.³⁷ It is intended to provide the transfer pricing legislation with a little more steel to support HMRC enquiries in high-risk transfer pricing areas (such as the digital economy). The expectation is that this, in turn, encourages better transfer pricing compliance, and greater transparency with HMRC in dealing with transfer pricing enquiries.

Broadly speaking, a DPT charge can arise in two scenarios:

- a where a UK subsidiary or permanent establishment enters into arrangements with a related person where that person or the arrangements lack economic substance, resulting in a reduction in taxable profits; or
- b where a person carries on an activity in the United Kingdom 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 permanent establishment.

The amount of DPT payable prior to 1 April 2023 was 25 per cent of the amount of ‘taxable diverted profits’. As the headline UK corporation tax rate increased to 25 per cent from 1 April 2023, the DPT rate similarly increased to 31 per cent to maintain the differential.³⁸

In most cases, a DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can accelerate resolution of a transfer pricing enquiry for the following reasons:

- a the DPT rate is considerably higher than the corporation tax rate;
- b it is not possible to postpone any DPT payment once a charging notice has been issued; and
- c DPT gives credit for transfer pricing adjustments only if they are made before or within 12 months after issuance of the DPT charging notice.

In 2021–2022, HMRC issued 49 DPT preliminary notices and 14 DPT charging notices to 14 customer groups. The amount raised from DPT charging notices and supplementary notices when not repaid during the 2021–2022 financial year was £198 million – a marked increase from earlier years – though most of the DPT revenue impact comes through transfer pricing adjustments and changes in taxpayer behaviour.³⁹

ii Double taxation

Most of the United Kingdom’s tax treaties have effective mutual agreement procedures (MAPs), some of which now include provisions for mandatory binding arbitration (MBA) in accordance with Part VI of the OECD multilateral instrument. These provisions typically permit HMRC to engage in MAP, but those that do not include MBA provisions do not require the case in question to be resolved. Consequently, there is no guarantee of relief from

37 HMRC DPT Guidance (INTM489500).

38 Section 79 of the Finance Act 2015.

39 Transfer Pricing and Diverted Profits Tax Statistics, 2021 to 2022.

double taxation under MAP. That said, the United Kingdom is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments. HMRC resolved 132 MAP cases in the 2021–2022 financial year.⁴⁰

MAP is not an alternative to the normal transfer pricing enquiry process. An enquiry will not be conducted as part of MAP and, equally, MAP will not suspend or replace an enquiry. A taxpayer cannot pursue domestic legal remedies and MAP concurrently. If a case is accepted for MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay MAP until these remedies are exhausted.⁴¹

HMRC are of the view that DPT is a separate, standalone 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.

iii Consequential impact for other taxes

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's view is 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.⁴²

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.⁴³

Import and customs duties

Similar issues arise in relation to the interaction of the transfer pricing rules with import and customs duties. Balancing payments may have 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 required.⁴⁴

iv Income tax in respect of intangible property

Since 2019, income tax is charged on income from intangible property received by non-UK residents in low-tax jurisdictions that do not have tax treaties with the United Kingdom, to the extent that this income is referable to the sale of goods or services in the United Kingdom.⁴⁵ Tax is charged on the gross amount of income, rather than on profits.

40 *ibid.*

41 HMRC Statement of Practice 1/2018.

42 HMRC VAT Valuation Manual (VATVAL 15700).

43 *ibid.*

44 HMRC VAT Valuation Manual (VATVAL 15900).

45 Chapter 2A of Part 5 of the Income Tax (Trading and Other Income) Act 2005.

If the non-UK resident subject to the income tax charge fails to pay, the tax will be recoverable from other entities in the same corporate group (whether or not the other entity is resident or taxable in the United Kingdom).⁴⁶

This income tax charge does not include any arm's-length concept, and applies even if the income is subject to a CFC or GILTI charge higher up the corporate structure. In practice, it is intended to encourage businesses to move intangible property out of low-tax jurisdictions; as most of these countries have recently adopted 'economic substance' requirements, this shift was largely happening anyway.

While this income tax charge does not fall directly within the scope of the BEPS project, it provides another mechanism to counter circumstances in which businesses generate significant income from intangible assets through activities in the United Kingdom but receive that income in low-tax jurisdictions.

v Digital services tax

Since April 2020, the United Kingdom has levied a digital services tax on large search engines, social media platforms and online marketplaces. The tax is levied at 2 per cent of the gross revenues attributable to UK users. In March 2021, the Biden administration threatened to impose tariffs on various UK exports in response to the digital services tax. However, by October, an agreement had been reached with the United States to maintain the tax until the end of 2023, pending further developments on the OECD's proposed Pillar One reforms.

X OUTLOOK AND CONCLUSIONS

DPT continues to lurk in the background of many UK transfer pricing disputes, and it has emboldened HMRC to adopt an increasingly assertive and inquisitive approach to policing multinationals' transfer pricing. In some cases, this is making it harder for taxpayers and HMRC to reach a mutually acceptable resolution, thus forcing taxpayers to resort to MAP or litigation. It is likely that the United Kingdom will see a significant uptick in transfer pricing litigation in the next few years.

Taking a wider view, the UK transfer pricing landscape continues to be reshaped by international tax reform efforts led by the OECD. The original BEPS project increased focus on functional analysis in applying the transfer pricing rules in the United Kingdom, to ensure that transfer pricing outcomes are aligned with the individuals involved in value creation. If the OECD's Pillar One proposals ever take effect, this will have a far more profound impact on the arm's-length principle. However, at the time of writing, it appears to the authors that Pillar One, unlike Pillar Two, is unlikely to proceed, thanks to opposition particularly in the United States.

⁴⁶ Sections 608O–608V of the above Act.