



TRANSFER PRICING

Tax and Transfer Pricing

“Keeping it arm’s length”


Oxford University Law Faculty Taxation Guest Lecture
28 April 2010

TAX

AUDIT • TAX • ADVISORY

Outline of presentation

- What is transfer pricing?
- Why is it important?
- Overview of OECD Transfer Pricing Guidelines
- UK Transfer pricing
- Transfer Pricing and Private equity



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WHAT IS TRANSFER PRICING?

TRANSACTIONS BETWEEN ASSOCIATED ENTERPRISES

NOT INDEPENDENT

ONE ENTERPRISE PARTICIPATES IN THE MANAGEMENT, CONTROL OR CAPITAL OF THE OTHER (DIRECTLY OR INDIRECTLY)

OR SAME PEOPLE CONTROL BOTH ENTERPRISES



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WHY IS IT IMPORTANT?

**TRANSACTIONS BETWEEN MULTINATIONALS (MNEs)
ACCOUNT FOR ROUGHLY 30% WORLD TRADE**

**TAX ADMINISTRATIONS : NEED A FAIR ALLOCATION
OF TAX BASE**

**MNEs : NEED TO MINIMISE RISK OF DOUBLE TAXATION
TO INVEST**

BALANCE THESE NEEDS: WIN/WIN

OECD MEMBERSHIP CONDITION

1979 TRANSFER PRICING REPORT



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REVISED 1995 GUIDELINES

Reaffirms consensus around the core idea of the ALP

Greater practical guidance

- application of methods, administrative approaches, difficult areas (intangibles) and dispute resolution

Use of transactional profit methods as last resort

Guidelines are an agreed consensus

- Adopted by a Recommendation of OECD Council

Not legally binding but agreed to be followed in mutual agreement proceedings

Encouraged to follow in domestic practices



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ALP: Article 9 OECD Model Convention

If conditions made or imposed between associated enterprises in their commercial or financial relations differ from those which would have been made between independent enterprises, then profits that, but for those conditions, would have accrued to one of the enterprises may be included in the profits of that enterprise and taxed.



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ALP: Implications of Article 9

Analysis must be transactional

- global formulary apportionment rejected

Comparability analysis required

- With what would have happened between independents



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ALP: Transactional - aggregation rules

aggregation permitted where separate transactions are so closely linked that they cannot be evaluated on a separate basis

Examples

- range of closely linked products when individual pricing is impractical
- cross-rights to use intangible property
- licensing of know-how and supply of components



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ALP: Comparability (1)

- None of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (i.e. price or margin), or reasonably accurate adjustments can be made to eliminate the effect of any such differences
- In particular need to focus on
 - characteristics of property or services
 - functional analysis
 - contractual terms
 - economic circumstances
 - business strategies



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ALP: Recognition of Actual Transactions

Cannot disregard or restructure transactions unless exceptional circumstances (1.36-1.38)

Exceptional cases:

- economic substance differs from form
- form would not have been used by independent enterprises AND
- actual structure practically impedes the tax administration from determining an appropriate transfer price

Becoming the rule rather than the exception for HMRC!



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ALP: Range and Multiple Year data

TRANSFER PRICING IS NOT AN EXACT SCIENCE!

May arise when there is more than one comparable transaction

May arise from the application of more than one method

Important when using profit methods

Multiple year data

- Generally useful to examine data from year under examination and prior years
- Discover patterns, business and product cycles
- Data from subsequent years may also be used, but with care



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Transfer Pricing Methods

Traditional Transaction Methods (Chapter II)

- CUP
- Cost Plus
- Resale Price

Transactional Profit Methods (Chapter III)

- Transactional Net Margin Method (TNMM)
- Profit Split Method
- These are LAST RESORT where traditional methods cannot be applied reliably



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UK Transfer Pricing

- Background
- Incorporation of the OECD Guidelines
- The basic rule on transfer pricing
- Other aspects of the legislation
- Exemptions
- Penalties
- Documentation
- HMRC Guidance



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Background

UK's first comprehensive transfer pricing legislation appeared in the Finance Act of 1951

Major overhaul of UK transfer pricing legislation in Finance Act 1998

New legislation applies to accounting periods which ended on or after 1 July 1999, onwards

Amended:

- 2004 to remove UK-UK exemption and incorporate thin cap legislation
- 2005 to introduce anti-avoidance legislation with regard to financing (more later on this)



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Key Aspects Of The Legislation

Legislation acts on a transactional basis, and includes all aspects of a transaction not just the price

CTSA returns must be made in accordance with the arm's length principle

- Every time a company signs the declaration on its corporation tax self assessment return it will have to consider transfer pricing and whether transactions with associates are taxed as though they were undertaken on an arm's length basis

Penalties under Sections 95/96 TMA 1970 up to 100% of the tax due

Statutory obligation to keep documentation. Fixed penalty under CTSA legislation for failure to keep records

Legislation incorporates the OECD Transfer Pricing Guidelines



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OECD Model and Transfer Pricing Guidelines

Paragraph 2 of Schedule 28AA incorporates Article 9 of the OECD Model Tax Convention ('OECD Model') and the OECD Transfer Pricing Guidelines into the legislation

Section 2(1) Schedule 28AA

This Schedule shall be construed...in such manner as best secures consistency between:

- (a) the effect given to paragraph 1 above; and
- (b) the effect which, in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so.



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The OECD Transfer Pricing Guidelines

Section 2(3) Schedule 28AA

In this paragraph "the transfer pricing guidelines" mean:

- (a) all the documents published by the Organisation for Economic Co-operation and Development, at any time before 1st May 1998 as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations;...



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The Basic Rule On Transfer Pricing

Paragraph 1 of Sch 28AA sets out the basic rule on transfer pricing

Subsequent paragraphs of the legislation then contain the rules for the interpretation of the basic rule



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Key Aspects Of The Basic Rule

The transfer pricing legislation applies where:

- There is a PROVISION
- By Means of a TRANSACTION or SERIES of TRANSACTIONS
- There is an aspect of CONTROL between the two parties
- The TERMS differ from those which INDEPENDENT parties would have used
- There is a LOSS of UK TAXATION



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Sch 28AA para 1

(1)...where

- provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions, and
- at the time of the making or imposition of the actual provision
 - one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or
 - the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons



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Sch 28AA para 1

(2)...if the actual provision

- differs from the provision ("the arm's length provision") which would have been made as between independent enterprises, and
- confers a potential advantage in relation to United Kingdom taxation on one of the affected persons, or (whether or not the same advantage) on each of them,

the profits and losses of the potentially advantaged person or, as the case may be, of each of the potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.



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Sch 28AA para 1

(3) For the purpose of the Schedule the cases in which provision made or imposed as between any two persons it to be taken to differ from the provision that would have been made as between independent enterprises shall include the case in which provision is made or imposed as between any two persons but no provision would have been made as between independent enterprises

That is, the legislation applies where at arm's length NO PROVISION would have been made, ie, the transaction would not have happened



Provision

- The legislation applies where "provision...has been made or imposed as between any two persons...by means of a transaction or series of transactions"
- The term "provision" is not defined in the legislation
- The term provision is meant to mirror the OECD Article 9 reference to 'conditions made or imposed'
- The dictionary definition of provision is 'something supplied or provided'
- The HMRC is taking a wide view



Provision- Example of implications

20 year royalty agreement

- Rate is low and arm's length at time of making the agreement
- Arm's length provision would be 5 year agreement
- HMRC will be able to review (and adjust) rate after 5 years



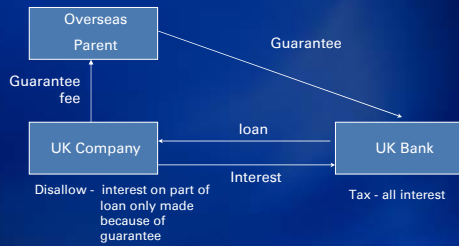
Transaction or Series of Transactions

Paragraph 3 of Sch 28AA applies the legislation to a transaction and series of transactions

- The term "transaction or series of transactions" is meant to mirror the OECD Article 9 reference to commercial and financial relations
- Broad scope – includes transactions involving goods, services, finance, intellectual property, etc
- End to arguments over whether business facilities and certain financial services are caught by transfer pricing legislation

Series Of Transactions - Funding

Inward indirect funding



Control

Paragraph 1(1) Sch 28AA

- (b) at the time of the making or imposition of the actual provision
 - (i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or
 - (ii) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons

Legislation uses "affected persons" to describe those caught by the transfer pricing legislation

Management, Control, or Capital

Paragraph 4 'Participation in the management control or capital of a person' defines the control relationship

- Need to look wider than just shareholdings
- Control is defined by s840 of ICTA 1988
- Control includes:
 - Share ownership
 - Voting power
 - Power to manage company/direct the directors
 - Powers set out by Articles of Association or other document

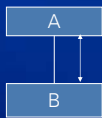
This definition has been extended by Finance Act (2) 2005 with the insertion of paragraphs 4A and 4B

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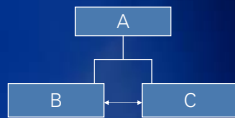
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Affected Persons



A&B are affected persons
A can be an individual, a company or a partnership
B can be a company or a partnership
A is **directly** participating in the management, control or capital of B



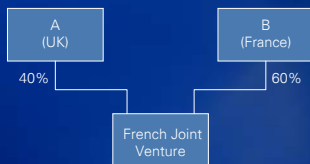
B&C are affected persons
A can be an individual, a company or a partnership
B & C can be companies or partnerships
A is **directly** participating in the management, control or capital of B & C

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Joint Ventures – The 40% Rule



Transactions between French Joint Venture and A will be caught

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Tax Advantage

Paragraph 5 “Advantage in relation to UK Tax” defines tax advantage

- The legislation applies where one or both parties to the transaction gain a UK tax advantage
- A tax advantage is:
 - A reduction in profits
 - An increase in losses
- Where a tax advantage is gained, then the arm’s length provision must be substituted for the actual provision



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Removal of the UK-UK exemption

- In the original legislation, paragraph 5 contained an exemption for transactions between two UK entities
- This exemption was removed by FA2004 with effect from 1 April 2004
- All transactions between related parties are now potentially caught by the legislation regardless of residence
- Compensating adjustments mean that there should be no UK double taxation but in some instances there may be more tax to pay
- Balancing payments mean that payment can be made up to the amount of the compensating adjustment



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Compensating Adjustments

Paragraph 6 ‘Elimination of double counting’ explains the process for claiming compensating adjustments

- Idea is to mirror effect of mutual agreement procedure in the tax treaties
- Claim is made in tax return of disadvantaged company
- Capped to amount of transfer pricing adjustment in advantaged company
- Discrimination in method of giving adjustment?
 - UK-UK compensating adjustment appears automatic



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The SME Exemption

Paragraph 5B 'Exemption for Small and Medium Sized Enterprises' defines the exemption for SMEs

- This is not a blanket exemption. For SMEs, the transfer pricing legislation will NOT apply to provisions between:
 - Two UK businesses
 - UK businesses and foreign qualifying businesses
- Foreign qualifying businesses is defined in paragraph 5E
 - business in a country with which the UK has a double tax treaty containing a suitable non-discrimination article
- For medium sized enterprises the HMRC will have a reserve power to require transfer pricing adjustments in exceptional cases (paragraph 5C)



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Definition of Small and Medium-Sized Enterprises

Paragraph 5D defines SMEs. This refers to the Annex to the Commission Recommendation 2003/361/EC of 6 May 2003

- Small enterprises
 - Fewer than 50 employees; and
 - Either turnover or balance sheet total not exceeding €10m
- Medium enterprises
 - Fewer than 250 employees; and
 - Either
 - turnover of less than €50m, or
 - Balance sheet total not exceeding €43m
- Limits are applied on a group basis not a single entity basis. Group is similar to consolidated group for accounting purposes



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The New Penalty Regime

Overview

- Applicable to returns for periods beginning on or after 1 April 2008
- A penalty can now be imposed when there is failure to take reasonable care
- The amount of the penalty will depend on whether the need for an adjustment was due to:
 - A failure to take reasonable care; or
 - A deliberate understatement; or
 - A deliberate understatement with concealment
- Innocent errors when reasonable care was taken will not be liable to a penalty
- Penalties can be imposed when a loss is adjusted by HMRC



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Mistake or Misinterpretation

Mistake or Misinterpretation:

- An innocent error after taking reasonable care
- A reasonable view of the law that proves to be wrong or is not pursued
- An action or omission that does not form part of a pattern of behaviour, is untypical of the taxpayer concerned
- The adoption of a treatment for tax purposes that is clearly disclosed to HMRC in a return or accounts, even if subsequently changed by determination of a tribunal

Examples:

- Small arithmetical errors
- Misclassification of unusual/small items
- Misinterpretation of legislation in respect of unusual/small items



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Failure to Take Reasonable Care

Failure to Take Reasonable Care:

- Not doing something the person knew or should have known ought to be done and which the person concerned had the power to do
- Omitting to do something a reasonable person would do and the person concerned could do, or doing something a reasonable person would not do
- The absence of such care, skill and diligence as it was the duty and capacity of the person to bring to the work

Example:

- Not having appropriate accounting systems in place, including to capture items in the correct return period (failure over a sustained period may be an indication of "deliberate understatement")



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Deliberate Understatement

Deliberate Understatement:

- Deliberately not doing something that ought to be done; or
- Deliberately getting something wrong

Examples:

- Adopting inappropriate accounting treatment in circumstances that appear to rule out genuine misunderstanding
- Describing transactions inaccurately or in a way likely to mislead
- Deliberately misinterpreting the law with a view to understatement



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Implications for Transfer Pricing

Robust Systems

- To avoid the possibility of penalties there is a need to have robust systems in place to implement transfer pricing methods and provide support for the accuracy of the figures in tax returns

Suspension Regime

- How the suspension regime will be applied remains to be seen. It may be reasonable to assume that HMRC will take into account the past compliance record of the taxpayer in reaching a decision on whether to use this power



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Documentation

- Section 12B TMA 1970 and para 21, Schedule 18 FA 1998 require taxpayers to keep and preserve the records needed to make and deliver a correct and complete Return in any chargeable period
- Tax Bulletin 37, issued by the Inland Revenue in October 1998, stated what the Inland Revenue expected companies to keep to document the transfer pricing of their intra group transactions
- The Inland Revenue gives guidance at INTM433030 on record keeping and also at INTM461020 on risk assessment and tax at stake



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Transfer Pricing and Private Equity

Change in TP rules ATCAs



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TP Position Post FA05 (No. 2)

Changes:

- TP rules extended to include the following additional circumstances, where:
 - i. a number of persons (who may be companies, partnerships or individuals) act together in relation to the financing arrangements of a business (a company or a partnership) and;
 - ii. collectively those persons would be capable of controlling the company, if all their actual or potential rights and powers were aggregated

As such, the transfer pricing regime now applies to all debt in a PE transaction (and indeed, far wider)

Transitional rules:

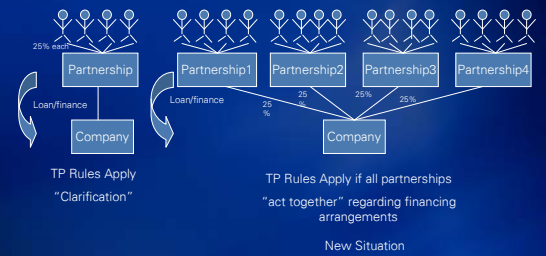
- Transactions/financing arrangements entered into prior to 4 March 2005 are grandfathered until April 2007
- However, any changes to debtor/creditor relationship may bring all existing arrangements into the new rules
- HMRC have published guidance on:
 - 'Acting together'
 - 'Transitional rules'

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FA (No 2) 2005 Example 1

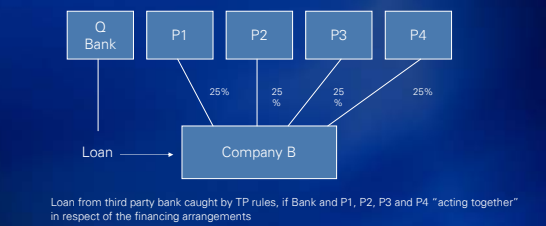


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FA (No 2) 2005 Example 2



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Grandfathering Provisions

- Arrangements entered into pre FA 2005 grandfathered until April 2007
- Any changes to debtor/creditor relationships will bring existing arrangements into the new rules, e.g.
 - partial repayments / additional borrowings
 - changes to the inter-creditor agreement
- Post 1 April 2007 TP rules now apply to all PE debt!
- Level Playing field between PE and non-PE backed investments?
 - Still easier to leverage PE backed deals?
- New regime for obtaining TP certainty – ATCAs replace CoP10



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Advance Thin Capitalisation Agreements (ATCAs)

- What is an ATCA?
 - Unilateral Advanced Pricing Agreement ('APA') with HMRC using existing APA legislation (s85-87 FA99)
 - Provide assurance to treatment of applicant's capital structure for specified period
- Scope – flexible: treatment of a single financial instrument or overall debt position of a group
- Term: typically 3-5 years
- Before making an application it is important to consider the business case, the initial arrangement and the resulting ratios
- Securing an agreed interest deduction can have a significant impact on tax provision



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HMRC Views

Consequences of breaching financial covenants

- HMRC does not advocate an approach to a breach on covenants based on what a third party lender might do if the terms of a loan agreement were breached.
- A breach is most likely to occur when the business does not perform in line with the forecasts provided when the ATCA was negotiated, the nature of trading is different from what planned, or the balance sheet structure has been changed.
- A breach is properly recognised only if the company decides not to accept the disallowance, this is the decision of the company.
- Renegotiate the ATCA – may be appropriate for future years but not retrospectively.
- Consistent with Schedule 28aa?



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