CHAPTER 6A

TRANSFER PRICING

6A.1 Introduction

The transfer pricing rules seek to stop companies from gaining an advantage in relation to UK **taxation** by entering into transactions with connected parties using non arm's length prices.

6A.2 Non arm's length provisions

The legislation provides that if the actual provision made between two parties, where one of those parties was directly or indirectly participating in the **management control or capital** of the other, or the same person(s) was directly or indirectly participating in the management control or capital of each, differs from the arm's length provision, then for tax purposes the transaction or series of transactions will be treated as if the arm's length provision had been made. Reference is made to OECD principles for determining arm's length prices.

TIOPA 2010, s.147

TIOPA 2010, s.148

TIOPA 2010, s.147 (3)

Thus the **adjustment** is only to be made for the purposes of the **tax calculations**. The companies can charge what they wish in their accounts. The rules apply to all transactions between connected parties, not just the sale of goods. Thus transfer pricing adjustments can be made in relation to management charges, royalties and loan relationships. Assets subject to chargeable gains have market value and connected persons rules under TCGA.

TCGA 1992, s.17

TCGA 1992, s.18

The term transaction is given a wide meaning - it can include arrangements, understandings and mutual practices whether or not they are intended to be legally binding.

TIOPA 2010, s.150

6A.3 Participation in the management, control or capital

Direct participation arises where a person controls a company or a partnership. Indirect control arises if the person has future rights to control, or rights are being exercised under his instruction, or for his benefit, or he is one of the major participants in a company.

TIOPA 2010, s.157

The definition of indirect control includes provisions to prevent a number of parties who together can control a business securing a tax advantage by putting in place specific finance arrangements. TIOPA 2010, s.161

The parties do not need to be acting together at the time the provision is made. The rules ensure that financial arrangements put into place up to six months before the control relationship exists will be subject to transfer pricing rules. TIOPA 2010, s.162(4)

This definition of indirect control only applies in relation to financing arrangements, which includes arrangements relating in any way to debt capital or other finance. TIOPA 2010, s.148(4)

Where the transfer pricing rules apply as a result of this special definition of indirect control, a compensating adjustment can be made in relation to a security, if the security is guaranteed by a person with a participating relationship with the issuer. TIOPA 2010, s.175

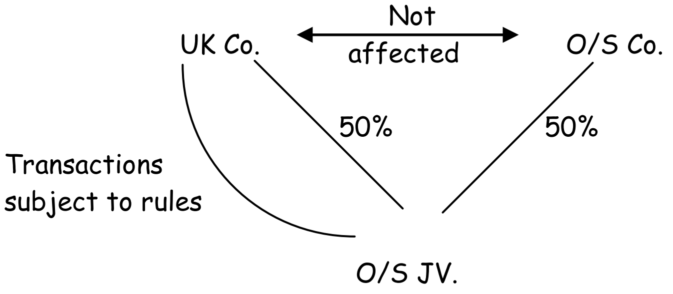
The definition of control is the power to secure that the affairs of a company are dealt with in accordance with a person's wishes, by means of shareholdings, voting power or documentary evidence. CTA 2010, s.1124

A person can be a major participant when two people taken together control the company and each of them has rights amounting to at least **40%** of the rights in the company. TIOPA 2010, s.160

In summary, the control test can be applied to cases where one company controls another, or both companies are controlled by the same person(s). It can also apply in the case of joint ventures if the 40% test is met.

In looking at control, all **future rights** are taken into account as well as those of **connected persons**. Connected persons for these purposes are spouses, relatives, relatives of spouses and spouses of relatives. Trustees are connected with settlors and their connected persons. Relatives are siblings, ancestors or lineal descendants (brothers or sisters). TIOPA 2010, s.159(7) TIOPA 2010, s.160(6) TIOPA 2010, s.163

Illustration 1



6A.4 UK Tax Advantage

TIOPA 2010, s.155

An adjustment will only be made where there is a UK tax advantage conferred as a result of the non arm's length provision.

A UK tax advantage arises if, as a result of the non arm's length provision, a smaller amount is taken into account in calculating the chargeable profits or a larger amount is taken into account in calculating any losses. TIOPA 2010, s.155

A UK tax advantage can arise where both parties are UK companies. However the provisions will not apply to certain dormant, small and medium sized companies. We will look at the exclusions in more detail below.

If a UK tax advantage is held to have arisen, then if the other party is UK tax resident and subject to UK income or corporation tax, they can make a claim to have their profits calculated using the arm's length provision. The disadvantaged person can therefore generally make a corresponding adjustment. TIOPA 2010, s.174

A balancing payment can now be made between the parties where there has been a transfer pricing adjustment without tax consequences, thus allowing the transaction to be adjusted in line with the tax computation. There is no obligation to make a compensating payment. TIOPA 2010, s.196

To qualify, the payment must be a payment made by the disadvantaged person to the advantaged person, and the sole or main reason of the payment must be that the advantaged person's taxable profits were increased by a transfer pricing adjustment.

There will be no tax consequences of the payment provided that it does not exceed the reduction made to the taxable profits of the disadvantaged person in consequence of a claim for a compensating adjustment under s.174 TIOPA 2010.

Illustration 2

Company X supplies parts to Company Y at an actual price of £180 when the arm's length price would be £280.

A transfer pricing adjustment is made on the basis that the arm's length price was received.

Company X's income will be increased by £100 and any profit will be increased (or a loss reduced or turned into a profit).

Company X is an advantaged person as its profit was originally understated.

Company Y is a disadvantaged person.

Company Y adjusts its expenditure, increasing it by £100 to reflect the same arm's length price. The resulting difference in its calculation of taxable profits or losses is the compensating adjustment.

Company X and Company Y can now calculate their tax on a consistent basis. Company X will be taxed as if it had received £280 and Company B will be taxed as if it had paid £280.

If the compensating adjustment had not been made Company X's profits or losses would be computed on the basis of the arm's length provision of a receipt of £280 and Company Y's would be computed on the basis of the actual payment of £180.

This adjustment does not change the cash position of the companies. In our Illustration, Company X is treated as thought it has received £280 from Company Y for tax purposes. It has, in fact, received only £180. Equally although Company Y is able to benefit from a compensating adjustment and be treated for tax purposes as though it has paid 280, it has, in fact only paid £180.

6A.5 Exemption for dormant companies

TIOPA 2010, s.165

The transfer pricing rules will not apply where the potentially advantaged person is a dormant company. For example, a dormant company has made an interest free loan to a connected party.

The exemption applies to a company that was dormant throughout the pre-qualifying period that continues to be dormant after this date, apart from any adjustment required by the transfer pricing rules.

The pre-qualifying period is defined as:

a) Where there is an accounting period of the company ending on 31 March 2004, that accounting period.
b) If there is no such accounting period, then the period of three months ending on 31 March 2004.

The term dormant is defined as for s.1169 CA 2006. A company will not be dormant if it enters into any transactions which give rise to receipts or expenses or does anything which requires adjustment to its assets or liabilities.

A dormant company can make a corresponding adjustment claim. However, doing so will cause it to lose its dormant status.

6A.6 Exemption for Small and Medium sized companies

The transfer pricing rules will not apply where the potentially advantaged person is a small or medium sized enterprise. However there are three exceptions to this rule, two of which relate to small and medium sized enterprises and the third one which relates to medium sized enterprises only. TIOPA 2010, s.166

The definition of small and medium is that set down in EC directive 2003/361/EC.

	Small	**Medium**
Turnover	€10m	€50m
Balance sheet	€10m	€43m
Employees	50	250

The exceptions to the exemption are as follows:

1) A small or medium sized enterprise can elect for the exemption not to apply for a chargeable period. TIOPA 2010, s.167(2)

Note the election is irrevocable and is made in respect of a particular chargeable period.

2) In the case of a small and medium sized enterprise, where the other party of the transaction is a resident of a non-qualifying territory at the time the actual provision is made. TIOPA 2010, s.167(3)

Note this applies on a provision by provision basis.

A non-qualifying territory is any territory other than a qualifying territory.

Qualifying territory means: TIOPA 2010, s.173

a) The UK; or
b) Any territory with which the UK has a double tax treaty (DTT) that includes the non-discrimination article.

The Revenue have reserved the right to publish statutory instruments naming territories as qualifying although the DTT does not have the non discrimination clause and vice versa.

3) For medium sized companies only, where a transfer pricing notice has been issued by the Revenue. TIOPA 2010, s.169

A person receiving a transfer pricing notice will be required to compute the profits and losses of the chargeable period in accordance with the arm's length principle.

Note that the notice is given for a particular chargeable period. Separate notices are required for each chargeable period. The notice may specify that some or all of the transfer pricing rules are applied. TIOPA 2010, s.169

A notice cannot be issued in respect of a return unless the return is subject to an enquiry. Anyone receiving a notice can appeal against it within 30 days of receipt but only on the grounds that the company is small not medium. The appeal should include the name of the officer of the board who issued the notice. TIOPA 2010, s.170

The person receiving the notice has 90 days to amend their tax return. The 90 day period is deferred if an appeal is made. A closure notice cannot be issued in respect of the return until the return has been amended or the 90 days has passed. TIOPA 2010, s.171

For a medium sized company that is not subject to any of the three exceptions to the exemption, a return can be made without taking account of the transfer pricing rules. TIOPA 2010, s.171(3)

A return does not become incorrect because a transfer pricing notice has been issued. However, if it is not amended within 90 days or the amendments prove to be insufficient, it will become incorrect to the extent of the understated profits. TIOPA 2010, s.171(4)

6A.7 Application to trading stock

Where a transfer pricing adjustment is made to the profits of the transferor in respect of the transfer of trading stock or WIP, the transferee can deduct a corresponding amount from his own profits in the first accounting period ending on or after that of the transferor in which the transfer occurs. TIOPA 2010, s.174

Without this rule the transferor would be taxed immediately, whereas the transferee would not be able to claim a compensating adjustment until the stock etc was sold. This could be a significant time lag.

Illustration 3

A Ltd, which has a December year end, transfers trading stock to B Ltd, a fellow subsidiary with a March year end. The transfer takes place in November 2010. The stock is sold by B Ltd in August 2011.

A transfer pricing adjustment is made in the tax computations of A Ltd relating to the stock transfer.

B Ltd is allowed to make a corresponding adjustment to the price of the stock in its accounts to 31 March 2011. Without this rule B Ltd would not be able to make the adjustment until the stock was sold in the accounting period to 31 March 2012.

6A.8 Application to CFCs

A compensating adjustment can be claimed where the advantaged person is a CFC, the profits of which have been wholly apportioned to the UK - A compensating adjustment can be claimed by a UK company, or another CFC. TIOPA 2010, s.179

6A.9 Application to share schemes

If a group share scheme is provided by a parent company we need to consider transfer pricing. If we are looking at the parent, we can see that the parent is providing something that is of benefit to the subsidiaries; this follows from the tax case, *Waterloo and others v CIR,* where it was held that the parent company was providing a business facility.

The UK has statutory rules which determine whether a company can claim a tax deduction when shares are awarded to employees, these rules also set down the amount that can be claimed.

HMRC issued guidance in 2005 confirming the interaction of the transfer pricing rules and Part 12 CTA 2009 which gives a deduction to the employing company when shares are issued under a share scheme.

In the case of the parent company HMRC confirmed that we should respect the accounting treatment. Any amount received for the scheme would be treated as capital thus there will be no adjustment in the tax computations. To the extent that the parent is providing a service of administering the scheme a transfer pricing adjustment may be required as this service should be charged for.

Looking at an employing company, where the employer makes an intra-group payment for the employee share plan facility, Part 12 CTA 2009 gives a specific statutory corporation tax deduction in computing the taxable profits of a business of whatever nature, for providing employees with shares that satisfy certain qualifying conditions. Part 12 CTA 2009 sets out the amount of the relief, when the relief is given and to whom the relief is available. In addition s.1038 CTA 2009 states that no other deductions can be claimed in respect of the costs of providing the shares either by the employer or any other company.

A charge, for administration services is not affected by s.1038 CTA 2009, and therefore the question of whether or not it is deductible for tax purposes falls to be considered under normal tax rules. The guidance states that in any case where a charge is made for a facility of this nature and the value of the "Share Award" element cannot be distinguished from the value of the administration services, then the whole amount will be treated as the "cost of providing shares" and will be disallowed under s.1038 CTA 2009.

6A.10 Advance pricing agreements

TIOPA 2010, s.218

Under CTSA, it is the **company's responsibility** to ensure that all transfer pricing adjustments are made when the CT600 is completed. If the necessary adjustments are not made, this can lead to **interest and/or penalties**. To help counter this uncertainty, an advance pricing agreement (APA) can be entered into.

Advance pricing agreements are **not compulsory** - it is the company's decision whether it wishes to apply for one. However, if an agreement is entered into it is **binding.**

The Revenue are willing to enter into unilateral agreements with a UK company. However they encourage bilateral agreements which involve the tax authorities of the other country.

An application for an APA must be made in **writing** setting out the transactions to be covered, why the company thinks they give rise to transfer pricing issues and how the company proposes to deal with them. TIOPA 2010, s.218(1)

An APA can cover a period before the agreement is reached, so long as this is set out in the agreement. APAs will be operative for a **specific period** - the company should propose a reasonable period. The Revenue have indicated that they envisage a minimum of **three** years and a maximum of **five years**.

Once an APA is in place, the **critical assumptions** set out in the application should be **monitored** and reviewed to ensure that there have not been any critical changes that lead the agreement to be obsolete.

The Revenue has the power to **nullify** an APA if information has been given fraudulently or negligently. **A fine** of up to **£10,000** can be imposed on anyone fraudulently or negligently providing information in connection with an APA application. TIOPA 2010, s.227

An APA can be **revoked** if the company does not comply with its terms. TIOPA 2010, s.226

An application for **renewal** of an APA should be made within **6 months** of the expiry of the existing APA.

The annex to **SP 3/99** sets down the detail of what should be covered in a written agreement:

- A declaration that the agreement is made for the purposes of Part 5 TIOPA 2010;
- Identification of the persons affected;
- Matters to be covered by the agreement;
- The transfer pricing method;
- Critical assumptions;
- Reporting requirements;
- Record keeping requirements;
- Rollback;
- Revocation and modification;
- Mutual agreement procedure.

HMRC have indicated that it may take 18 months or so to agree the terms of an APA. Therefore APAs tend to involve complete transfer pricing issues. Code of Practice 10 dealing with post transaction rulings may be used to come to agreement with the Revenue on less complex issues.

6A.11 Transfer Pricing Methods

In the legislation, specific reference is made to the transfer pricing methods set out in the OECD Guidelines. The methods can be split into **transaction methods** and **transactional profit split methods**. HMRC have indicated that in line with the OECD they prefer the use of the transaction methods as these are more objective.

The Transfer pricing guidelines are to be reissued in September 2010 this is the first major revision to this document since the Guidelines were first released in 1995. At the time of writing the revised guidelines were not available however they will contain new, more detailed guidance on how to perform comparability analyses in practice in order to compare the conditions of transactions between associated enterprises with those of transactions between independent enterprises.

There will also be new guidance on how to select the most appropriate transfer pricing method to the circumstances of the case and on how to apply in practice two of the OECD-approved transfer pricing methods, referred to as "transactional profit methods", namely the transactional net margin method and the transactional profit split method.

The 2010 version will also include a new chapter providing detailed guidance on the transfer pricing aspects of business restructurings. Although the document is not available at the time of writing the changes will not affect the methodologies set out below. The changes instead relate to how and when we apply the various methodologies.

(a) Comparable uncontrolled price (CUP)

This is the **most objective** method. The price is that which would be charged in a similar transaction with an unconnected party. There are two types - the CUP between two unconnected parties and the CUP that the enterprise would charge when dealing with an unconnected third party.

It is important that the transactions being looked at are comparable.

(b) Resale price

This method involves the enterprise constructing the arm's length price. It uses known resale price margins either from the company's own transactions with third parties or from transactions between unconnected parties. The transfer price is constructed. This method is most appropriate for **marketing or distribution** operations.

Illustration 1

If we take the case of goods coming into the UK from a connected party, the transfer price would be constructed as follows:

	£
UK selling price	Known
Transport costs	(X)
Advertising	(X)
Other costs	(X)
Resale price Margin*	(X)
Arm's length price	X

(c) Cost plus (C+)

This method is often used for contract **manufacturing** and the provision of services. It takes the costs incurred - direct and indirect - and adds an agreed mark up. The idea is that the mark up provides a reward for the assets employed, capital investment etc.

The OECD Guidelines indicate that whilst it is important to consider the mark up, it is also important to consider the level and type of cost to which it will be applied.

(d) Profit split

The comments below are from the 1995 version of the guidelines. The 2010 version will provide further information on the practical application of this methodology.

This is the first of the transactional methods which are not favoured by HMRC. However, this and the margin method below may be used to resolve the more complex transfer pricing exercise.

This method looks at the overall profit made on the transaction and seeks to split it between the different parts of the enterprise on the same basis as it would be split between unconnected parties.

Two possible solutions suggested by HMRC in their guidelines are:

a) Contribution analysis.

The combined, total profits from the controlled transactions made by all the enterprises involved in earning those profits are split between those enterprises based on the relative value of the functions that each carries out.

This requires careful judgement and a firm understanding of the overall trade and of what adds value to it. How economically important were the functions carried out by each party in earning the profits?

For example; was it the intrinsic nature of the product being sold that generated the profits (more profit to R&D function) or was it due to the success of the marketing activity that generated sales (more profit to distribution function).

(b) Residual analysis

Each participant is allocated sufficient profit to provide it with a basic return appropriate to the functions carried out. This will be based on what is appropriate by reference to similar types of transactions undertaken by independent enterprises.

The basic return would not take into account any return due to any unique assets (notably intangibles) possessed by the participants. Although the value of these assets need to be considered.

Then any profit (or loss) left after the allocation of basic returns would be split as appropriate between the parties – based on an analysis of how this residual would have been split between third parties. Any contributions of intangible property and the relative bargaining positions of each party should be taken into account.

The profit is split according to **a functional analysis**. This method does not need to rely on comparable data however:

- it is difficult to apply as it relies on information from foreign affiliates;
- it requires the books and records through out the enterprise to be kept on the same basis;
- it may be difficult to isolate the costs that relate to the related party transactions;
- the transaction and the market data are less connected than in the transactions methods.

(e) Transaction net profit margin

This is another transactional profit split method. This method is commonly used in the US and may be used where other methods prove difficult. The net profit for each party is calculated as a percentage of cost, turnover or return on capital employed - whichever is most appropriate. The percentage is based on what would be expected in third party transactions.

The OECD Transfer Pricing Guidelines (1995 version) state that any attempt to use TNMM should begin by comparing the net margin which the tested party makes from a controlled transaction with the net margin it makes from an uncontrolled one. A proper attempt should be made to do this.

As stated above the 2010 guidelines will provide further detail on the practical application of this method.

Where this proves impossible (there are no transactions with uncontrolled parties), then the net margin which would have been made by an independent enterprise in a comparable transaction may serve as a guide.

This method is easy to apply and relies on net margins that are not affected by functional differences. However:

- it can be affected by factors outside transfer pricing;
- comparability of prices does not focus on the market conditions and economic climate.

In practice the profit split and net margin methods are indistinguishable. Typically the profits or margins are determined of the least complex entity and appropriate profits are attributed to other companies. The more complex companies would tend to own intangibles.

(f) Pricing intra group services

There are many group services that may be subject to transfer pricing - for example marketing, IT, finance or human resources.

The OECD guidelines state that firstly we have to consider **whether a service has been supplied.** This question is considered by asking whether an independent enterprise would have been prepared to pay for such services or would have needed to perform them in house.

If the answer is yes, then a service has been provided and such services should be recharged at an arm's length price.

Two methods are allowed

(i) Direct charge

This can be used when the services are also charged to independent parties on a similar scale. This is the preferred method of the OECD.

(ii) Indirect charge

This method can be used when the direct method cannot be used and is based on an identifiable benefit. A cost plus method is typically used, even though independent parties would not use such a pricing mechanism, the Revenue's view is that such an approach can approximate the profit margin.

In looking at services it is important to identify shareholder activities. Some expenses will be incurred because of duties to shareholders or the parent company's role as a shareholder in subsidiaries, e.g. AGM's issue of shares, reporting requirements. No charge should be made for these costs.

6A.12 Transfer pricing and the OECD model treaty

As stated in the chapter outlining the OECD model treaty, article 25 of the treaty provides for mutual agreement of issues by discussions between the competent authorities. Although since 2008 some treaties do include an arbitration clause in article 15. But there is no obligation on the authorities to agree. Only under the EU Arbitration Convention on transfer pricing does such an obligation exist.

6A.13 Record keeping

The company has to keep records appropriate to justify the transfer prices used or adjustments made in the computations. The onus is on the company to ensure that the tax return includes all necessary adjustments for transfer pricing. FA 1998, Sch 18 Para 21

There should be **documentation** to support all intra group transfer prices, including management services. Documentation should be kept of all major decisions affecting the transfer prices.

6A.14 Penalties

A penalty of up to £3,000 can be levied if the company fails to keep and preserve records. FA 1998, Sch 18 Para 23

If the transfer prices are found to be lacking and the company is held to have been fraudulent or negligent in setting the price or keeping it under review, a penalty can be charged under Sch 24 FA 2007 for an incorrect return.

HMRC give the following examples:

Service charge 5% - the Revenue determine that it should have been 10%-15%. The company cannot show that they considered whether 5% was arm's length, or there is documentation that states that 5% is arm's length without any supporting evidence. A penalty under Sch 24 FA 2007 would arise.

Company uses 8% based on calculations of CUP, however the calculations turn out to be flawed. The company has made an honest attempt, therefore no penalty would be charged unless they do not adjust the price, once they are aware of the error.

6A.15 DSG Retail Ltd V HMRC TC00001 April 2009

The recent case of DSG retail is the first transfer pricing case with transfer pricing methodologies and indeed the first case on the detailed transfer pricing legislation that we have been looking at in Part 4 TIOPA, previously Sch 28AA ICTA.

The DSG group comprises the well-known Dixons, Currys and PC World chains.

Customers who purchased white goods were encouraged to purchase an extended warranty contract. The DSG arrangement at first involved an insurance-backed warranty. The group entered into an arrangement with Cornhill, the third-party insurer, whereby in-store personnel would arrange warranty insurance policies for customers with Cornhill. Thus a customer who decided to buy an extended warranty would be purchasing his goods from DSG Retail and his insured warranty (via the Dixons sales agent, latterly Coverplan) from Cornhill.

Cornhill, however, was not prepared to take more than 5% of the risk in respect of these policies and accordingly reinsured 95% of the risk with yet another DSG company, this time a wholly owned group company resident in the Isle of Man, DISL. Accordingly, 95% of Cornhill's premium income was ceded to DISL. Arrangements were made for the reinsurance premiums to be placed in a trust account in order to provide some measure of security for the price of repairs/replacements in the future.

Later it was decided to part company with Cornhill and instead a new intermediary was introduced. This company, ASL, was an Isle of Man company owned in part by Willis Group, the third-party insurance broker, and, as to the majority, between two independent individuals. Somewhat like Cornhill, ASL entered into an administration and repair arrangement with the DSG Mastercare operation. Also, similarly, ASL then insured its risk position, this time as to 100%, with DISL

The extended warranty business was extremely profitable. Having regard to the loss ratios actually experienced, a substantial part of the reinsurance or insurance premium income was left as profit in DISL

The Special Commissioners found in favour of HMRC that the arrangements were not at arm's length: if DISL had been independent it would have had to pay something to DSG.

Provision had been made or imposed as between DSG and DISL by means of a transaction or series of transactions for the purposes of Sch 28AA (as was). That provision consisted of the arrangement that DISL would insure or reinsure the extended warranty business written in DSG's stores on particular terms. The arrangement was effected by means of the series of contracts in 1993 and 1997.

A detailed review of the evidence as to possible CUPs did not yield any acceptable comparable: some alleged comparables were simply not sufficiently similar; others were potential candidates, but it was not possible to make accurate adjustments to take account of detailed differences — in particular differences in relative bargaining power. A formulaic profit split was appropriate and this should be based upon the capital asset pricing model used for calculating a return on capital. Hindsight could not be used. A profit-split method was favoured, which combined the 'contribution' and 'residual' analyses described in the OECD 1995 Transfer Pricing Guidelines (see paras 3.16 to 3.19). The value of DISL's contribution could be assessed by reference to the cost of equity; and, in view of DSG's bargaining position, all the residual profit could be allocated to it. Such an approach was in accordance with the OECD Guidelines.