

International Business Review

UK transfer pricing legislation

How does it affect you?

Businesses working across borders face the temptation to seek to realise profits in the country where it is most convenient, or where taxes are most favourable. Unfortunately, tax authorities around the world are similarly determined to ensure that profits are not artificially manipulated. We set out below some of the general issues businesses should consider when trying to resolve this conflict between businesses and tax authorities.

UK transfer pricing background

In the UK over recent years, tax legislation has significantly changed and 'transfer pricing', namely prices charged for cross-border transactions between related parties, has become an area which is highly regulated by the UK tax authorities.

Most significantly, the burden of proof has shifted so that the onus is no longer on the UK tax authorities to prove that profits have been artificially deflated. Instead the taxpayer must now prove that proper transfer prices have been applied on an arm's length basis - as if the UK business had been a wholly independent, unrelated entity.

Since 2004 the UK's transfer pricing legislation has been extended to apply to both UK and cross-border transactions.

Who is caught by these transfer pricing rules?

All connected companies with related parties' transaction are caught by the transfer pricing rules. Broadly, connected companies are those under common control, or where one controls the other. However, the transfer pricing regime also applies to transactions with a 40% participant in a joint venture. Exemptions are available for dormant, small and medium sized enterprises (SMEs).

Broadly, a small enterprise is defined as a business with less than 50 employees and either turnover or assets of less than Euro 10 million and a small or medium sized enterprise as a business with less than 250 employees and either turnover of less than Euro 50 million or assets of less than Euro 43 million.

Associated enterprises, worldwide, are taken into account in determining whether a company is a small or medium sized enterprise.

SMEs are generally exempt from the UK's arm's length transfer-pricing regime. However, this important 'let-out' does not apply in the following situations:

1. Where an SME elects to disapply this exemption for a particular accounting period.
2. To transactions with an overseas company that is resident in a non-qualifying territory (that is, a country that does not have a double tax treaty with the UK with a suitable non-discrimination clause).
3. In case of medium sized enterprises only, where the UK tax authorities issue a notice requiring the advantaged party to adjust the results to reflect the arm's length price.

Please note that the adjustment is only for the purposes of tax calculation. Thus, the companies can charge what they wish in the accounts subject to relevant accounting and audit rules.

What kind of transactions?

Areas with potential for contention include:

- the purchase and sale of goods;
- the provision of management and other services;
- rent and hire charges;
- transfer charges for the use of intangible property, such as trademarks, patents and know-how;
- sharing of expertise, business contacts, supply systems, etc. and
- provision of finance and other financial arrangements.

Financing transactions

In 2004, rules regarding the excessive payment of interest to related parties by companies that were thinly capitalised i.e. high debt:equity ratio were brought into the transfer pricing legislation.

The same rules apply if the rate of interest charged is higher than prevailing market rates. Interest attributable to the excessive part of debt finance between connected companies is disallowed under the transfer pricing legislation. This means that careful consideration will need to be given to the finance structure adopted by businesses.

Also, the UK Government is introducing the worldwide debt cap rules for accounting periods beginning on or after 1 January 2010. In broad terms, the total eligible internal finance expense of the UK corporates within a group will be capped at the level of the group's net non-UK external finance expense. This is achieved by disallowing the UK tax relief for interest, to the extent that the interest costs of the UK part of the group on its debt (both externally and intra-group) exceed the interest costs of the entire group on its external borrowings. These rules are in addition to the existing transfer pricing rules and hence, an interaction of two sets of rules.

Proof of arm's length transactions

Written proof should be retained on file to demonstrate that the directors have satisfied themselves that all transactions with connected parties have been on an arm's length basis. Signature of the annual tax return signifies effective confirmation that the correct procedures have been followed. The proof normally takes the form of a transfer pricing report. The main components of the transfer pricing report are:

- functional and risk analysis of the businesses concerned;
- analysis of the appropriate pricing model to be adopted; and
- a benchmark study for an arm's length pricing policy.

Penalties and enquiries

Penalties for failing to properly set transfer prices can be very severe.

Additionally, enquiries and investigations in this regard can arise some considerable time after the transactions to which they relate have taken place and the internal and external costs of resolving such issues can be high.

Particular factors influencing an enquiry

The following could result in an enquiry into a business's transfer pricing policy:

- Activities in or involving tax havens or tax shelters
- Losses over a number of years
- Large royalty/management fees
- Charges for the use of intellectual property
- Innovative business structures

Additionally, however, enquiries can also arise as a matter of routine or on a random basis.

Pricing models

The transfer pricing model adopted in each instance should reflect the commercial reality of the business's transactions. This is very important to minimise penalties and the costs and time of enquiries from tax authorities.

The transfer pricing model adopted should also reflect the functions and associated risks of the business. For instance, cost-plus methods may be applicable for a UK subsidiary that performs only a marketing function for its overseas parent's products, where it does not have any risks, is being supported financially by the parent company and does not have any trading contracts with third parties. However, cost-plus would not be appropriate for a subsidiary that buys stock from its parent company and independently sells the stock to third party customers. In this scenario either a comparable uncontrolled price method or resale price method may be more appropriate.

Advance Pricing Agreements (APA)

Companies may enter into APAs with the UK tax authorities to agree that the internal prices used on specified transactions conform to the arm's-length standard and will be acceptable while the APA remains in force. APAs are particularly useful for very complex transactions where there are considerable difficulties or doubts in determining the method by which the arm's-length principle should be applied.

Conclusion

If a business falls within the size criteria described above, it needs to think carefully about its related party pricing policy. The last thing you want is to have to spend time and money in an argument with the tax authorities over what can be a prolonged period of time.

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