Are you prepared?

In the past, only cross-border businesses had to worry about transfer pricing rules. But now this has all changed. Gareth Green reports

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Over the coming months, the Finance Act 2004 extension of the transfer pricing rules to UK-UK transactions will hit home, as the first tax returns that are subject to these new rules must be filed. Previously, only cross-border businesses had to worry about transfer pricing rules, but now almost any UK business is potentially affected, and should be considering how this affects their self-assessed tax return.

The new rules apply to any accounting year that ended after 1 April 2004. Taxpayers with year ends other than March will have to commence application of the rules part way through their financial year, splitting their accounts for this purpose.

December year ends are most common, and the return for 2004, due for filing by 31 December 2005, will have to apply UK-UK transfer pricing to the nine months from April to December 2004. (The few businesses with year ends in April-July will already have had to file 2003/04 returns, but only a few months of the return will have been subject to transfer pricing rules.) With the approaching filing deadlines, taxpayers and tax advisers will be turning their minds to how to deal with these new rules. This article sets out to provide some brief pointers.

Removal of domestic exemption

In a nutshell, what has happened is as follows. Before 1 April 2004, the UK transfer pricing legislation contained an exemption for transactions between two UK taxpayers. Cases at the European Court of Justice suggested, however, that this discrimination against non-UK businesses might invalidate the legislation, so the government chose to remove the exemption, thus subjecting UK taxpayers to an additional compliance burden.

The arm's length test

The basic requirement of the transfer pricing rules (which are contained in Sch 28AA, Taxes Act 1988) is quite simple, at least in principle. They require an uplift of the taxable profits of a UK enterprise if they have been understated as a result of it having made an overpayment to, or received an underpayment from, a related party. The payment is 'over' or 'under' if it is greater than or less than the hypothetical price (the 'arm's length price') that would have been paid had the parties to the transaction been unrelated.

Taxpayers remain exposed to negligence penalties of up to 100% of any tax adjustment

Transactions that are caught

The legislation has deliberately been worded as widely as possible, to ensure that almost any interaction is caught. Taxpayers must therefore consider not only transactions that they have recognised as being transactions, but in fact anything from which one of the parties has derived a benefit from the other party, for which they would have been expected to make a payment if that other party had not been related to them. For instance, the lack of any payment, invoice, or binding contract does not mean there is no transaction.

Therefore, taxpayers need to consider not only the obvious (sales of goods, supplies of services, loans, royalties), but also the less obvious. For example, if company A has a small subsidiary, B, then as they are both in 'the same family' it may never have occurred to A that it should charge B for things such as:

- use of A's offices;
- the time A's finance staff spend looking after B's accounts;
- interest on a long-dormant inter-company balance;
- use of A's brand name;
- guaranteeing B's bank loans.

This may be particularly the case if A and B both pay UK tax at the same rate: there may never, up until now, have been a reason for A to go to the bother of working out a charge.

It is not just a question of pricing. It is also necessary to deny interest deductions that arise on intra-group debt that is greater than would have been borrowed from an independent lender.

Perhaps the only types of transaction that are clearly not caught are subscription for plain-vanilla share capital and the payment of dividends thereon. The scope of the transfer pricing rules is in fact so comprehensive that few parties that are sufficiently associated that they are related will be so autonomous that they have no 'transactions' between them.

What is a related party?

The transfer pricing rules are primarily seen as applying to companies and partnerships, but it is worth noting that the rules can apply to other legal 'persons', such as individuals and trusts, if they are related to a company or partnership. So, for instance, if an individual owns a company, the transfer pricing rules potentially apply to the individual as well as the company (in relation to transactions between them). However, the rules do not apply to transactions between, for instance, a father and daughter, or an individual and a trust.

Company A is related to company (or partnership) B if A controls B, or B controls A, or A and B are under common control (by another company or other person/s). A company and any other legal person (such as an individual or trust) are related to one another if the latter controls the former.

Broadly speaking, control of a company arises from voting power of more than 50%, though in some circumstances a lower figure can be sufficient. The control need not be direct. For instance, if company A owns company B, which in turn owns company C, then A and C are related.

In determining whether a person controls a company, that person is attributed with certain rights and powers, including those of any persons that are 'connected' with that person. For instance, if Frank owns 30% of company A, and his wife, father and his family trust own 10% each, then Frank is deemed to have 60% voting power, so he and company A are related.

Small company exemptions

Taxpayers will, however, be exempt if (including the employees, turnover and assets of any related parties) they meet both the following conditions:

- The enterprise must have fewer than 250 employees.
- Either its turnover must be no more than €50m (£34m), or its assets must be no more than €43m.

This exemption does not, however, apply to transactions with certain countries such as Brazil and Hong Kong, and, unless the taxpayer is below another lower set of thresholds, Revenue & Customs can specifically disapply the exemption if it considers the taxpayer is abusing transfer pricing to avoid substantial UK tax liabilities.

Penalty holiday

Penalties on transfer pricing have been suspended for two years, but only in respect of failure to keep proper records. Taxpayers who cannot show that they gave appropriate consideration to these rules remain exposed to negligence penalties of up to 100% of any tax adjustment.

Recommended tactics

In order to sign the self-assessment return with a steady hand, few taxpayers will be willing to simply ignore these new requirements.

However, a careful upfront review should show how to minimise compliance cost and effort. For most transactions, all that may be necessary is brief consideration of why the intra-group arrangements are acceptable, leaving deeper analysis to the rare transactions that warrant it.