The New Régime

GARETH GREEN sets out a guide to help those who are unsure if the new United Kingdom transfer pricing rules drag them into the régime or relieve them from it.

ONE OF THE least welcome early Christmas presents in Gordon Brown's Pre-Budget Report last December was his confirmation of earlier proposals that there be a far-reaching extension to the transfer pricing régime by withdrawing the previous exemption for transactions between United Kingdom taxpayers. The 17 March 2004 Budget rejected appeals to defer introduction to allow more time for consultation. Many United Kingdom businesses that have no tax presence overseas will therefore have to grapple with the régime for the first time. Others, who may have had only limited cross-border transactions that were subject to the old régime, may find that further types of transactions are now caught or that the sums involved are much larger.

Recognising the intolerable compliance burden that this would impose on United Kingdom business, the Government also introduced a new exemption for small and medium-sized enterprises. Not only will this be a boon to many taxpayers who would otherwise be drawn into the régime for the first time, it may also provide welcome respite for some of the smaller cross-border businesses that were previously obliged to comply with the régime.

If transfer pricing rules apply, they are included in the requirement to self assess, and are potentially subject to tough penalties of up to 100 per cent of any tax adjustment, so it is crucial for taxpayers and their advisers to determine whether they are subject to the new régime. This article aims to help readers do this.

An article of this kind (and relative brevity) necessarily has to make generalisations and cannot cover every 'if and but'. Furthermore, many terms from the legislation have been replaced by more user-friendly terms, potentially sacrificing absolute precision for the sake of readability. For instance, it is hoped that referring to whether parties are 'related' is less likely to make the eyes glaze over than using the strictly correct term: 'directly or indirectly participating in the management, control or capital of the other [party]'.

Timing

Despite robust submissions to the Government that more time should be allowed before the new rules come into effect, the Chancellor confirmed in the 2004 Budget that the new régime will apply from 1 April 2004. Taxpayers with year ends other than March will have to apply the new rules part way through their financial year. Although it may be possible to make adjustments later, up until the year end or even at the time of filing the tax return, there may be complications in doing so, and it would be best for taxpayers to determine as early as possible whether they need to make any changes to their internal pricing.

Are you caught?

The process of determining whether a taxpayer is caught by the new rules can be boiled down to a number of sequential steps. Each step is a test. If the test is failed, it is necessary to move on to the next step. If the test is passed, this may, depending on the step, rule out the transfer pricing rules for the taxpayer altogether or for a particular type of transaction by that taxpayer. The five key steps are as follows:

Step 1: Are there any related parties?
Step 2: Are there any transactions with related parties?
Step 3: Does the small-sized enterprise exemption apply?
Step 4: Does the medium-sized enterprise exemption apply?
Step 5: Does the dormant company exemption apply?

These steps are considered below.

Step 1: Related parties

Any United Kingdom taxpayer that has no related parties cannot be subject to the transfer pricing rules, so each United Kingdom taxpayer should first determine if it has any related parties. Usually, this will be obvious, but the principles are as follows.

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).

This raises a number of intriguing scenarios. For example, some pop stars, who tend to supply their services *via* personal services companies, could, depending on their turnover in a particular year, find themselves having to self assess whether the salary they extract from the company is sufficiently high. Also, entrepreneur businessmen might have to review their interactions with the companies they control.

However, the rules do not apply to transactions between, for instance, a husband and wife, or an individual and a trust. Having said that, the article will focus here on companies.

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

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Broadly speaking, control of a company arises from voting power of more than 50 per cent, though in some circumstances as little as 40 per cent control 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 (as are A&B and B&C).

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 this purpose, individuals are connected with their spouse, brother, sister, ancestor and lineal descendant. Trusts are connected with the settlor of the trust and any persons connected with the settlor. For instance, if Frank owns 30 per cent of Company A, and his wife, father and sister own ten per cent each, then Frank is deemed to have 60 per cent voting power, so he and Company A are related.

Step 2: Transactions with related parties

If there are no transactions (or 'provisions', to use the somewhat ambiguous term in the legislation) with any related parties, the transfer pricing rules cannot apply. However, it is important to appreciate that the rules have 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 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, had that other party not been related to them. For instance, the lack of any payment, invoice, or binding contract does not mean that 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 intercompany balance;
- use of A's brand name.

This may be particularly the case if A and B both pay United Kingdom 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.

Finally, it should be noted that a series of transactions can be taken together and treated by the Inland Revenue as a single composite transaction, even if there is no direct transaction between the two related parties. An example might be if Company A pays over the odds to an independent supplier in return for the supplier making a supply to A's subsidiary, B, on terms more preferential than B would have received on a stand-alone basis. Even though the legal transactions are with the supplier, not between A and B, the transactions together form a series of transactions that bring about a benefit to B, so the transfer pricing rules might require that A's profits be increased by the amount by which it overpaid the supplier.

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

Step 3: Small-sized enterprise exemption

Many taxpayers will be pinning their hopes on the exemptions for 'small and medium-sized enterprises', and, for a large number of them, these hopes will be fulfilled. The good news for some small United Kingdom taxpayers that have been subject to the régime for the last six years, is that this exemption may benefit them, as well as the small purely domestic businesses that, were it not for the exemption, would have been newly subject to the régime.

However, not all who consider themselves too small for it to be fair to expect them to comply with the régime will find that the Government agrees with them. Even those who are relieved to find that they are sufficiently small may not be let off the hook entirely. Let us examine these limitations.

How small is small-sized? The draft legislation proposes to use a definition recommended, although not specifically for the purpose of transfer pricing or even tax, by the European Commission. This definition imposes two conditions, both of which must be met:

- the enterprise must have fewer than 50 employees. Part-time employees or new hires and departures during the year count as fractions of an employee. Staff headcount includes owner-managers and partners, but not apprentices and certain students; and
- either (or both) its turnover and assets must be no more than €10 million (at current rates, approximately £7 million).

These thresholds are applied on a current year, annual basis. This raises the practical difficulty that enterprises which experience an unexpected surge in staff numbers, or turnover, or assets, close to the year end, could be tipped into the régime for the whole year, at a stage when it may be too late to correct any transfer prices for transactions earlier in the year if they do not meet the arm's length test. A sudden strengthening of Sterling *versus* the Euro could presumably have the same effect.

One potential trap is that these thresholds are not applied to each taxpayer on a stand-alone basis. Rather, each taxpayer's staff numbers, turnover and assets must be determined on the basis of its consolidated accounts (if there are any), plus the accounts of any 'linked enterprises'. Readers can view the specific definition of 'linked enterprises' on the Inland Revenue website, but the test boils down to a concept very similar to control, as discussed earlier in this article.

Among the consequences of this are that, no matter how small a company may be, it cannot benefit from the exemption unless its entire worldwide group (subsidiaries,

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sister companies, parents, and ultimate majority shareholders) meets the thresholds on a consolidated basis. Similarly, no matter how far an individual is below the thresholds on a personal basis, they may not be exempt if they exceed the thresholds when combined with any company they control.

The European Commission's use of the word enterprise begs the question as to whether one would naturally think of an individual or a trust that is not in business as an 'enterprise'. Enterprise is defined quite widely, as 'any entity engaged in an economic activity irrespective of its legal form'. Arguably, merely owning an interest in a company or partnership is an economic activity, but it would perhaps have been better to use a more tailored definition, to remove uncertainty.

As mentioned above, qualifying as a small-sized enterprise may not get you completely out of the woods. The exemption does not apply to transactions where the other related party is a resident of certain countries ('non-qualifying territories'). Further, where there is a series of transactions which forms a composite transaction that is caught by the transfer pricing rules, the exemption is disapplied if any of the parties to any of the component transactions (even if that party is entirely independent) is resident in a 'non-qualifying territory'.

The definition of non-qualifying territory will have the effect that the small-sized enterprise exemption is only available for transactions that are:

- wholly within the United Kingdom; or
- with (or *via*) countries with which there is a double tax agreement that contains certain non-discrimination provisions.

Although many countries do have United Kingdom double tax agreements with the relevant provision, there are a number of significant exceptions. For instance, the United Kingdom has substantively no double tax agreement with Hong Kong or with Brazil. Moreover, readers would be wise to check that any relevant agreements do have the required non-discrimination wording. At least one agreement with a major trading partner, namely Australia, currently has no non-discrimination article. A new double tax agreement that contains the required wording was agreed in August 2003 and, having been ratified much more quickly than the normal year or two, comes into effect for the purposes of United Kingdom corporation tax for the first financial year beginning on or after 1 April 2004.

Therefore, United Kingdom companies which have transactions with a related party in Australia and which meet the requirements to be a small-sized enterprise may have to wait for exemption on those transactions for up to 11 months. For instance, if the company's year end is December, the exemption will not apply until 1 January 2005. (*Stop press:* material released on the Inland Revenue website as we went to press says that it considers the Australian double tax agreement to have the appropriate article as at 1 April 2004, though it is not clear on what grounds.)

The draft legislation includes powers for the Government to override these tests, to include or exclude any country they name. Guidance on the Revenue website following the Budget confirms that the Government has no specific plans to use these powers. It had been speculated that the exemption would be denied for low tax rate countries like Ireland, but it would appear that, at least initially, this is not the case.

It should also be remembered that many other countries have transfer pricing rules. Cross-border transactions that are exempt in the United Kingdom may therefore still be subject to transfer pricing principles overseas.

Step 4: Medium-sized enterprise exemption

For taxpayers that exceed the small-sized thresholds, all is not lost. There is also an exemption for 'medium-sized enterprises'. All the comments in Step 3 are applicable here, although the thresholds are higher. The reason for this being a separate step is that there is a further limitation which seems likely in practice to deny medium-sized taxpayers much of the certainty that they might have hoped to gain from qualifying for the exemption.

Here are the thresholds. As with small-sized enterprises, the European Commission definition imposes two conditions, both of which must be met:

- the enterprise must have fewer than 250 employees; and
- either its turnover must be no more than €50 million (approximately £34 million), or its assets must be no more than €43 million (approximately £30 million).

The additional limitation is that, 'to further protect revenues', the Revenue will have the power to withdraw the exemption for medium-sized taxpayers whom it notifies. The draft legislation published in December was blank at this point, and the Government invited submissions on how these powers should work. The material made available by the Revenue up until we went to press, unfortunately leaves us none the wiser about any decisions that may have been made, with less than two weeks to go until the new régime applies.

There are, however, a few clues in the Revenue technical note which was issued at the time of the Pre-Budget Report. The intention appears to be that the Revenue will exercise its power retrospectively, 'after the tax return has been made'. It is not clear whether any withdrawal of the exemption will necessarily apply to all of the taxpayer's transactions with related parties, or could relate to specified transactions only.

The note also reveals that this power will only be used 'where a significant amount of tax is at stake'. Judging by past form, the legislation will not define what is a significant amount of tax, and nor will any Revenue guidance, so we will be at the mercy of individual Inspectors. If medium-sized companies still face a realistic risk of transfer pricing adjustment, the only real benefit of being 'exempt' will be that they presumably cannot incur penalties on top of any tax adjustment. In practice, many United Kingdom taxpayers with significant transactions with related parties (in the United Kingdom or overseas) may decide they have no choice but to carry out at least some high level analysis of their transfer pricing position, in order to determine their potential exposures.

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Step 5: Dormant company exemption

In order to publish as soon as possible, the text of this article was finalised within a few hours of the Chancellor's Budget speech. Only skimpy details of any changes to the December proposals are available at this point. However, it would appear that there is to be a further exemption for companies that are, as at 1 April 2004, dormant for the purposes of the Companies Act 1985 (and therefore not required to be audited or to file a tax return) and continue to be dormant thereafter.

To qualify as dormant in a given accounting year, a company must have recorded no accounting transactions in that year. Banks, insurance companies and financial services companies cannot be dormant. This new exemption appears to be in response to submissions about group companies that have ceased any activity and whose only asset is a loan to their parent company, on which no interest is paid (so there is no accounting entry to make). If the group is large enough to fail the tests for the small and medium-sized exemptions, the new transfer pricing rules might have required a deemed interest charge for the dormant company, and this would create a tax liability which would mean the company was no longer 'dormant'. It remains to be seen if the actual legislation will, in practice, provide relief for the many such companies.

It seems that the exemption will only apply to United Kingdom-United Kingdom transactions, so taxpayers will still need to consider whether their dormants have any cross-border transactions.

Words of comfort

It is hoped that this article will have brought comfort to most readers, as it will have added support to their hopes that they, or their clients, will escape the régime. They should now refer to the draft legislation and technical note (see http://www.inlandrevenue.gov.uk/pbr2003/ct-reform.pdf) to confirm this, seeking professional advice if required.

Regrettably, there will be another category of readers whose hopes may have been dashed by the above descriptions of the various traps and limitations to the proposed rules. These they now need to investigate further. A third category of reader will have been under no illusions that they, or their clients, would be caught. A further article, expected to be published in the next few weeks, is for these second and third categories of reader. It will explain a little more about what transfer pricing is, and aim to help determine how to reach a sensible level of compliance without excessive expenditure or risk of tax adjustment and penalties. For instance, it will explain why what was described by the Chancellor as 'a relaxation of the penalty régime for a transitional period of two years to give businesses time to adjust to the new rules' is in fact a mirage. It will also consider if there is a level at which a transaction is so small that it can be ignored by taxpayers.

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More On The New Régime

GARETH GREEN completes his discussion of the revisions to the United Kingdom transfer pricing rules.

FIVE KEY STEPS to determine whether a United Kingdom taxpayer will be caught by the new transfer pricing rules that came into effect from 1 April 2004 were outlined in my article, 'The New Régime' in *Taxation*, 1 April 2004. Those who concluded that the answer is yes, may be asking themselves: 'what now?' and 'how much do I really need to do?'.

A number of factors, in many cases, temper the need for extensive transfer pricing analysis. This article sets out to help readers understand those factors, so that they can judge the appropriate sensible level of work they should do. Most of the comments will be of help not only for those readers newly caught by the recent changes, but also for those who were already subject to the old régime.

What is transfer pricing?

For those who have not yet had to deal with transfer pricing, the first article arguably put the cart before the horse, as it did not explain what transfer pricing is, owing to pressure of space. Before going any further, let us put right this omission.

Related companies, individuals and other entities often interact with one another. For instance, they may transfer goods between themselves, perform services for one another, provide funding to one another, or share resources. The price that the provider charges to the recipient for whatever is supplied is known as the transfer price.

Such interactions are not limited to related parties. Any parties that transact with one another must necessarily set a transfer price. It is worth noting, in passing, that although the term 'transfer pricing' is often used as if it is an inherently pejorative term, this is a prejudiced misuse. It is certainly possible to carry out transfer pricing abusively, just as it is possible to carry out, say, accounting abusively. But just as most accounting is entirely above board, so is most transfer pricing.

If the parties to a transaction are not related, *i.e.* they are at arm's length, then they will naturally bargain with one another to reach what they both regard as a fair price for the transaction. One will want as high a transfer price as possible, while the other will seek to minimise the price. It is generally considered that this pricing mechanism ensures the appropriate allocation of profits in the supply chain.

For instance, a machine manufacturer will want to buy its steel as cheaply as possible, whereas its steel supplier will push for as high a price for the steel as it can. If a taxpayer only transacts with unrelated parties, then a tax Inspector can rely on the fact that the taxpayer is unlikely to have overpaid any suppliers or accepted less than it could have obtained for any supplies it made.

Although related parties may bargain just as hard as arm's length parties, tax authorities cannot be sure that this has happened. If the related parties have different effective tax rates, or some other difference in tax attributes, there is a risk that they might manipulate the transfer price to move profit to whichever of them has the lower tax rate, and so reduce the tax that they jointly pay. There is also a risk, far more common in practice, that they may simply not be as assiduous in bargaining on the price, given that it is all in the family.

The purpose of transfer pricing legislation in the United Kingdom and overseas is, therefore, to ensure that the taxable profits of a country's taxpayers are not understated as a result of using transfer prices that are, inadvertently or by design, higher or lower than the price (known as the arm's length price) that would have applied between unrelated parties, all other factors being the same. The process of checking whether the actual price meets this requirement is known as the arm's length test. If the test is not met, the profits are increased to what they would have been had the arm's length price been used.

In practice, applying this test can be extremely tricky, because it involves hypothesis about what would have happened at arm's length. Usually, this is highly subjective. The process is not helped by the fact that related parties often interact in ways that they would be unlikely to use, were they unrelated. This analysis is generally accepted as requiring some specialist input, either internal (some major multinationals have transfer pricing teams with staff numbers in double figures) or external, although by no means does all the work require specialist expertise.

Penalty holiday

The United Kingdom has tough penalties for non-compliance with United Kingdom tax law, and these have applied to transfer pricing since the introduction of corporation tax self assessment in 1998. Therefore, United Kingdom taxpayers will have welcomed the Government's announcement that there is to be 'a relaxation of the penalty régime for a transitional period of two years to give businesses time to adjust to the new rules'.

The above words are extracted from the Inland Revenue's press release which accompanied the Pre-Budget Report. The words sound reassuring, and it is indeed a helpful concession, particularly as it appears to apply universally, even to cross-border transactions that have already been subject to transfer pricing rules in prior years. However, taxpayers should not allow themselves to be misled; the relaxation is far more limited than these words might suggest. No matter how tempting, it would be rash to conclude that penalties cannot be incurred in relation to transfer pricing and, therefore, that transfer pricing can safely be ignored for the next two years.

As this article goes to press, the Finance Bill 2004 is still under wraps, so all we have to go on is the draft

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legislation published at the same time as the above press release. This makes it clear that the relaxation is in fact only in relation to record keeping; there is no relaxation of penalties for failure to apply the arm's length test.

There are in fact two types of penalty. The first is a penalty of £3,000 per tax return for failure to keep proper records. In the context of transfer pricing, proper records means (in addition to the primary accounting records and tax adjustment calculations which any taxpayer will have as a matter of course):

- Documents identifying transactions to which the transfer pricing rules apply.
- Documents setting out the taxpayer's evidence to demonstrate that it meets the arm's length test.

On this £3,000 penalty, there appears to be a real relaxation as the penalty 'will not apply if the records which the person in question fails to keep or preserve are records relating to an arm's length provision'.

However, it is the second type of penalty that is potentially much more costly for most taxpayers, and in this case the relaxation is illusory. The penalty applies if an understatement of United Kingdom tax is found to have been caused by negligent tax compliance (or fraud) on the part of the taxpayer. The penalty is up to 100 per cent of the tax, though in practice there are mitigating factors that are taken into account, which typically reduce the penalty to around 40 per cent of the tax.

It seems clear the Revenue will continue to enforce the old régime.

The draft legislation says that a taxpayer will not be regarded as having been negligent for the purposes of this penalty 'by reason *only* of his failure … to keep or preserve records relating to an arm's length provision' (italics added). The writer doubts whether a failure to keep or preserve records in and of itself could constitute negligence, so arguably this concession is meaningless. But if this relaxation has any value at all, it merely means that taxpayers do not have to record their analysis. It seems clear that they do still have to carry out analysis, and that failure to apply the arm's length test will be treated as negligence for penalty purposes.

If a taxpayer has gone to the bother of identifying the transactions that are caught, and applying the arm's length test to them, it is not much of a concession that a written record is optional. In most cases, a written record will automatically be produced as part of the process of carrying out the analysis. Even in cases where producing a written record would be an incremental step, it is rarely going to save much cost or time, given that the analysis has already been done. Having carried out the underlying analysis, most taxpayers will wish to document what they have done, so that they are in a position to show the Inland Revenue that they have not been negligent. Moreover, it will be much more efficient to capture the information contemporaneously, while it is fresh in the mind of the person who carried out the analysis and while that person is still an employee.

Therefore, although this concession is billed as the Government 'responding to the concerns of business', it is in practice little more than a cruel mirage.

Impact on prior years

The news is more hopeful in other areas. For instance, taxpayers who were ostensibly caught by the old (pre-1 April) régime will be wondering whether the changes represent tacit confirmation that the old régime was ineffective. The answer is that the changes probably do.

The Government has stated that the changes are in response to anti-discrimination judgements by the European Court of Justice, such as *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt (Case C-324/00)* [2003] STC 607. It has made an heroic effort to maintain that the changes are almost certainly unnecessary, and are a mere precaution. It is obliged to insist on this, because the alternative is to admit that the old régime was ineffective for most taxpayers, which is not only hugely embarrassing, but also has significant implications for the United Kingdom tax base prior to 1 April 2004.

The problem is that because the old rules exempted domestic (*i.e.* United Kingdom-United Kingdom) transactions, they inherently discriminated against overseas taxpayers, and their United Kingdom affiliates. But the European Union Treaty, and most of the United Kingdom's double tax agreements, arguably prohibit the United Kingdom from such discrimination, and a string of legal judgments was coming closer and closer to confirming this. In truth, the Government had no choice but to make drastic changes to shore up the régime for future years.

Having said that, the Government does have some arguments to support the old régime, so it would be unwise to disregard transfer pricing compliance for prior years. It seems clear the Revenue will continue to enforce the old régime. The fact that changes were made does not prove that it was ineffective; that is, it is unlikely to be given any explicit weight by a court. But the changes are certainly evidence of weakness, and emphasise that United Kingdom taxpayers, who have not already done so, should be considering their position for prior years in relation to any continuing transfer pricing disputes and any transfer pricing adjustments they may have made.

Successfully patched?

A follow-on question is whether the changes the Government has made have successfully removed any prohibited discrimination. There are potential arguments that discrimination remains but, at this stage, such arguments are speculative. Taxpayers may wish to take steps to preserve their rights, should the new rules be struck down, but it would be courageous to rely on these arguments as the basis for ignoring the United Kingdom transfer pricing rules.

There are several grounds to argue that there is still discrimination. For instance, the compensating adjustment mechanism is also potentially discriminatory. Under this mechanism, if a United Kingdom taxpayer has its profits increased by a transfer pricing adjustment, the other party to the transaction will have its profits reduced by a matching amount, but only if that other party is also a United

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Kingdom taxpayer. Viewed narrowly, this is discrimination, as the United Kingdom will not allow a compensating adjustment where the other party is not a United Kingdom taxpayer. There will be no net extra tax payable on most domestic transactions (unless the parties to it have different tax rates), whereas the United Kingdom tax effect will be completely one-sided in the case of cross-border transactions. The Government will no doubt point out that the overseas party should receive a compensating adjustment from its own tax authority so, taking into account combined United Kingdom and overseas tax, a domestic transaction is not advantaged. Expect some interesting legal battles about whether discrimination should be judged only in terms of United Kingdom tax.

Enforcing the rules

The need to avoid discrimination has left the Government performing a precarious balancing act in relation to domestic transactions. It wants to reassure taxpayers that the new rules will not in most cases mean excessive additional compliance costs on such transactions, although the reason for this is largely to prevent the Revenue wasting time on transactions where, because of a compensating adjustment, a transfer pricing adjustment would raise no extra tax. Yet, the more efforts it makes in this direction, the greater the risk that it will have exchanged statutory discrimination for extra-statutory discrimination.

It seems inevitable that at some point the European Court of Justice will be asked to consider whether it is unacceptable discrimination to adopt less assiduous enforcement on most domestic transactions than on cross-border ones. It would be ludicrous if the European Court of Justice insisted that the Revenue must devote as much effort to domestic transactions as cross-border ones. But the European Court would no doubt reply that it is not its duty, nor within its powers, to compensate for unintended consequences of the European Union Treaty.

The Government does appear to be wise to this risk, judging by the very careful way in which the Budget press releases and new draft guidance have been phrased. The writer has not spotted a single instance where the Government has explicitly said that it will focus on cross-border transactions. Nevertheless, it seems clear that this is what it will do. For instance, the new transfer pricing page on the Revenue website says:

> '… the Inland Revenue would only put resources into making enquiries into the way a business has applied transfer pricing, and would only require to inspect extensive documentation, where the amounts of tax at stake appear to be large.'
>
> 'The amounts at stake would not generally be significant where both parties to a transaction were subject to similar levels of taxation.'

It would appear, then, that the official line is that it is merely fortuitous that the levels of taxation will, for most domestic transactions, be identical (as both parties will be paying the standard 30 per cent corporation tax rate). Whether or not this is a little contrived, United Kingdom taxpayers can take some genuine comfort from these and other similar statements. However, it is important to note that the Revenue guidance is far from a guarantee that it will ignore domestic transactions, even where both parties are paying full rate corporation tax.

Furthermore, this tactic starts to look a bit wobbly when one realises that it would seem to follow, from the above statements, that the Revenue is unlikely to be making enquiries in relation to cross-border transactions with countries where the tax rate is similar to the United Kingdom. For instance, Australia and Denmark both have a 30 per cent rate of corporation tax, so one might expect United Kingdom-Australia and United Kingdom-Denmark transactions to experience enquiry no more often than purely domestic transactions.

It would, however, make no sense to stop there. If the Revenue considers that there is low risk of transfer pricing mis-statement where the overseas corporation tax rate is the same as the United Kingdom's, surely there is even less motivation where the overseas rate is higher than the United Kingdom's? Thus it should follow that there is little risk of enquiry in relation to transactions with most of the United Kingdom's major trading partners, *e.g.* the United States (40 per cent corporation tax rate), France (34 per cent), Germany (38 per cent), Japan (42 per cent), China (33 per cent).

If the above reasoning is correct, future Revenue enquiries will predominantly be experienced only by United Kingdom taxpayers to the extent they have large transactions with related parties in countries with low effective corporation tax rates, such as Ireland, the Netherlands, and Switzerland. However, this article does not recommend that those who primarily transact with high tax rate countries should sigh with relief and ignore transfer pricing. In practice, although low tax rates may indeed heighten the risk of enquiry, it is a safe bet that the Revenue will continue to target any substantial cross-border transactions, and will be much less concerned with domestic ones. This is because there is usually no United Kingdom tax at stake for domestic transactions, and it is United Kingdom tax that the Revenue cares about.

Priority actions

So, what should be the priorities for United Kingdom taxpayers who are caught by the new régime?

The highest priority should probably be to ensure that your cross-border transactions meet the arm's length test. The most important impact of the revised rules for many people will be that the Revenue will renew its attention in this area, as it considers (rightly or wrongly) that the new rules are now 'European Court of Justice-proofed'. There is anecdotal evidence that the uncertainty about the old régime led the Revenue to slacken its efforts on transfer pricing over the last year or so but, if this is correct, it is likely now to change.

Next, consider any domestic transactions where one end of the transaction is taxed more advantageously than the other end. For instance, there could be ring-fenced losses, or a transaction between a taxpayer that pays corporation tax and one that pays income tax (at a different rate). It seems clear that these transactions will be targeted. The most forthright confirmation of this is to be found in a regulatory impact assessment. It states that the expected increased tax take from the new rules will come 'largely' from transactions with businesses with accumulated losses.

The steps outlined above should be regarded as a bare minimum, but how much more to do becomes a matter of judgment. For other domestic transactions, it will be necessary to weigh up a number of factors, such as:

- The extent to which you are willing to sign a self-assessment return without having applied the legislation.
- Your level of risk aversion.
- The extent to which transfer pricing seems to be on the tax Inspector's radar screen.
- How reasonable the Inspector is (some may take the guidance on risk assessment with a pinch of salt).
- The magnitude of the domestic transactions.
- Other calls on your time and budget.

The decision to carry out some analysis is not an all-or-nothing matter. Many taxpayers will wish to start with at least a high level review, to:

- identify transactions that are subject to the rules;
- estimate the likely risk of Revenue enquiry;
- estimate the magnitude of any likely transfer pricing adjustment, and the tax cost; and
- estimate the likely cost to carry out further analysis.

Such a review will highlight the priority issues and equip the taxpayer to judge whether it is worth doing further work (and where the conclusion is no, to justify why not). For instance, it might be identified that there are a number of large domestic transactions where no charge is currently being made, so the transfer pricing is clearly 'wrong'. It might be a relatively simple and inexpensive matter to implement a charge, without necessarily worrying too much whether the charge is precisely right. A small risk of a ten per cent adjustment is a lot better than a higher risk of a 100 per cent adjustment. Typically, the 80/20 rule applies; it takes only a small effort to remove most of the risk.

De minimis rule

Unfortunately, the Government has rejected submissions that there should be an exemption for immaterial transactions, *i.e.* transactions with an annual arm's length value of less than a certain threshold. However, the Revenue's draft guidance on documentation does confirm that it will abide by the principle in the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines that taxpayers should be expected to determine how much effort to devote to transfer pricing compliance 'in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance'.

This may effectively support a taxpayer who adopts a reasonable *de minimis* policy, though it is more consistent with a graduated approach, rather than a simple in/out threshold. The writer sometimes suggests to clients the following way to try to make sense of this 'comparable business decision' principle.

Company A has a transaction with B that is subject to the transfer pricing rules. Without proper analysis, A cannot tell whether the pricing of the transaction is compliant with the rules but, as A considers the transaction to be small, it would prefer not to carry out the analysis. A reasonable 'back-of-an-envelope' calculation indicates that, if a transfer pricing adjustment was required, A might have to pay an additional £10,000 of tax. As the transaction recurs each year, there is £50,000 at stake over the next five years.

Company A should consider other comparable business decisions. For instance, it may be relevant to consider how much effort and expense A would be prepared to go to if it had a legal case in which it could potentially sue for £50,000 of damages. One would have to consider all kinds of circumstances that might affect the decision, and try to match to the transfer pricing compliance decision as closely as possible. For instance, if the transfer pricing analysis would cost £8,000 of external professional fees, assume that the legal case would involve the same amount of lawyers' fees.

If a taxpayer decides on this basis not to carry out transfer pricing analysis on a particular type of transaction, it would be advisable to document the rationale, so that it is clear an appropriate level of care has been exercised. Otherwise, tax Inspectors may be tempted to see this as merely a flimsy defence cooked up retrospectively by the taxpayer when caught out, and therefore impose penalties for negligence. As assertions about what the taxpayer would do in hypothetical situations may be viewed with considerable scepticism by the Revenue, taxpayers should ideally base their case on what they actually did in real situations.

Conclusion

I have tried to cover the most important and widespread consequences of the new rules in this and the other article, 'The New Régime'. However, space constraints meant that there are many other issues which could not be covered. It is hoped the articles will have given reassurance to many readers and alerted others to potential exposures.

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'Come, come, Mr Kempton, nobody in your income group can claim ignorance.'