Fresh Developments

GARETH GREEN reports further developments in the new United Kingdom transfer pricing régime.

KEEPING UP WITH the transfer pricing rules is, of late, becoming increasingly like painting the Forth Bridge or tidying up after one's children: a never-ending task. No sooner has a writer or reader finished an article, than a new development has arisen.

In my articles, 'The New Régime' and 'More on the New Régime' in *Taxation*, 1 April 2004, pages 8 to 11 and 15 April, pages 61 to 64 respectively, I reviewed the new United Kingdom transfer pricing rules. The subsequent publication of the Finance Bill has not made any fundamental changes to the new régime, but the Bill did contain a few noteworthy last-minute additions, particularly regarding the medium-sized enterprise exemption.

We will also examine some of the draft transfer pricing guidance notes emanating thick and fast from the Inland Revenue. Although the Revenue has, for the last six years, seen the need to publish only limited guidance on how taxpayers should deal with transfer pricing, the new régime seems to have inspired it to upgrade its guidance considerably. With little fanfare, the Revenue's transfer pricing website, www.inlandrevenue.gov.uk/international/transfer-pricing.htm, has, over the last few weeks, seen the release of no less than ten draft guidance notes. Although some of this guidance is relatively mundane and unremarkable, there are a number of points that are worth highlighting.

The notes issued as at the date of writing cover the following topics:

- small and medium-sized enterprises;
- dormant companies;
- documentation;
- risk assessment;
- centrally provided services;
- thin capitalisation;
- securitisations;
- foreign exchange gains and losses on matching loans;
- scope of Schedule 28AA – enterprises;
- trading stock.

There are two more on the way, covering:

- corresponding adjustments;
- employee share schemes.

Medium-sized enterprise exemption

The main difference between the small and medium-sized exemptions is that the small-sized exemption is a definite exemption. Except for transactions with countries that have no double tax treaty with the United Kingdom, a taxpayer whose group meets the small-sized tests can be sure that the United Kingdom transfer pricing rules do not apply. In contrast, the medium-sized exemption is provisional only. It can be withdrawn if the Revenue thinks that a transfer pricing misstatement has given rise to a 'significant loss of tax'.

Until the publication of the Finance Bill in April, we knew little more than that, as the Government deferred the release of any draft legislation in relation to the medium-sized exemption, pending submissions from taxpayers. We are still, unfortunately, none the wiser about what is considered to be a significant loss of tax, which leaves considerable uncertainty for taxpayers who are ostensibly exempt. However, the Revenue is stressing that this reserve power will only be exercised in exceptional circumstances and only after approval by International Division, which should at least ensure some consistency and help to curb abuse of this power by over-enthusiastic Inspectors.

We do at least now know more about the consequences for taxpayers from whom the exemption is withdrawn. As we shall see, it is clear from this that being exempt does not mean that a taxpayer can disregard transfer pricing.

Taxpayers who are in groups that meet the medium-sized tests will be able to file their tax returns without being required to apply the arm's length test. However, once the return has been filed, the Revenue will, if it considers significant amounts of tax to be at stake, have the right to issue a 'transfer pricing notice' requiring the taxpayer to revise the return for any understatement of profits arising from non-arm's length transfer pricing. This is very similar to the pre-1998 transfer pricing rules, section 770, Taxes Act 1988, under which no taxpayer was subject to the arm's length test unless the Revenue had issued a 'direction'. The notice may apply to specified transactions only, or to the whole return.

In other words, qualifying as medium-sized means that you might be exempt, but you will not find out for sure until at least 12 months after your tax return filing date. The legislation contains no explicit time limits for transfer pricing notices, but a deadline for the Revenue to issue a transfer pricing notice is indirectly imposed, because such a notice may only be given once a corporation tax self assessment notice of enquiry has been given.

Unless the return has been filed late, the time limit for a notice of enquiry is 12 months after the due date for filing the tax return. If this time limit has expired without receiving a notice of enquiry, it would seem that taxpayers can finally be sure they were exempt for the relevant period. Notably, it would appear that if it did not issue a notice of enquiry, the Revenue cannot at a later stage use the discovery mechanism to provide the pretext for issuing a transfer pricing notice.

The twist of the knife in these new provisions is that taxpayers will have only 90 days from the day the transfer pricing notice is issued in which to refile the amended tax return. Any transfer pricing adjustments that the Revenue subsequently makes to the amended return will be subject to the normal penalties of up to 100 per cent of the tax at stake.

Taxpayers who are ostensibly exempt therefore need to ask themselves a series of questions before deciding how much comfort they can take from the exemption. First, they should consider how likely it is that they will be issued a transfer pricing notice. To answer this and the following questions, it will be necessary to carry out at least a high level review to determine what transactions may be caught and the size of any potential transfer pricing adjustment to them. If the taxpayer has no large transactions with overseas related parties or with related United Kingdom parties where there is real United Kingdom tax at stake, it may be reasonable to rely on the exemption.

If there is a risk of a transfer pricing notice, then the second question to ask is whether the transfer pricing analysis could in practice be done within 90 days. Three months may sounds like a long time, but conducting anything other than a very simple transfer pricing analysis this quickly will be a tall order, especially because, in the real world, most tax departments are perpetually busy and resource constrained. Perhaps, though, the Revenue will only issue the transfer pricing notice after discussing transfer pricing concerns with the taxpayer, so the taxpayer will already be well aware of the issues, and may already have carried out analysis, to try to convince the Inspector that a transfer pricing notice is not warranted. This is what commonly used to happen under a section 770 direction, though the penalty rules were different back then.

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Thirdly, taxpayers should consider what the consequences will be if they do receive a transfer pricing notice and they suffer transfer pricing adjustments to cross-border transactions. If the group's United Kingdom taxable profits are increased, it will want to reduce its overseas profits by a corresponding amount, so that it is not effectively taxed twice on the same profits. However, by the time the United Kingdom taxpayer has filed its tax return, received a transfer pricing notice, and refiled its return, two years or more may have gone by since the end of the relevant accounting period. The other (overseas) party to the transaction will have closed its accounts long ago, and will very probably have filed its tax return. In practice, the only way to avoid double taxation is likely to involve making a claim to the relevant overseas competent authority under the mutual agreement procedures of the relevant double tax treaty (or under the European Union Arbitration Convention). This is, at best, costly and lengthy. At worst, in the case of mutual agreement procedures, tax authorities are not always able to agree, so double taxation cannot always be avoided.

After considering these three questions, a few unlucky taxpayers may be astonished to find themselves concluding that it would be safer and simpler to disregard the exemption and apply the transfer pricing rules from the start. Perhaps this is an answer to the apparent puzzle of who would wish to take advantage of the provision in the new legislation permitting a small or medium-sized enterprise to elect not to be exempt from the transfer pricing rules. (Note, however, that overseas authorities may not be willing to allow a deduction to correspond with a United Kingdom transfer pricing adjustment that could have been avoided had the taxpayer not elected voluntarily to waive the exemption.)

Entities caught by the rules

The draft guidance notes that have been released are worth reading for a number of reasons, one of which is that a number of them appear to set out deliberately to assist taxpayers. An example is the draft guidance note entitled 'Scope of Schedule 28AA – Enterprises'.

This note appears to be intended to restrict the scope of the entities caught by the new rules. Indeed, the rationale advanced in the note is based on wording that was unchanged by the Finance Bill 2004, so the note presumably applies equally to the last six years.

The note infers from two parts of Schedule 28AA that the transfer pricing rules should be applied only to 'enterprises'. First, the note observes that the legislation requires the terms of the controlled transaction to be compared with the terms that would have been made between 'independent enterprises'. It would appear that the Revenue is suggesting it is therefore implicit that, as the comparison must be with transactions between enterprises, the legislation must only apply where both parties to the controlled transactions are themselves enterprises. This is a somewhat heroic leap, although one that taxpayers who will benefit from it will be happy to go along with.

The second basis advanced in the note is more compelling. It points out that Schedule 28AA states that it must be construed in accordance with Article 9 of the Organisation for Economic Co-operation and Development Model Tax Convention, which is the origin of the arm's length principle. That article is couched only in terms of 'enterprises'. As Article 9 only applies the arm's length principle to enterprises, it would seem to follow that Schedule 28AA should be considered to be similarly restricted.

Unfortunately, what constitutes an enterprise is not entirely clear. Article 3 of the Model Convention defines enterprise, but not in an exhaustive fashion. It merely specifies that the term 'applies to the carrying on of any business', which arguably leaves open the possibility that the term is wider than that. This seems to be the Revenue's view. It suggests that the term encompasses not only trading activities, but 'any activity carried on with an intention to make a profit or gain or undertaken in a businesslike or commercial way'.

This reasoning appears to be intended to allow the Revenue to draw the conclusion that individuals and charities will not always be subject to the transfer pricing rules on transactions with companies and partnerships that they control. The Revenue argues that it is necessary to consider in what capacity the parties to a transaction are carrying it out. Thus, it suggests that acting as a director or employee does not normally constitute being an enterprise, so it would not normally be necessary to apply transfer pricing principles to a salary paid by a company to an individual who controls the company.

On the other hand, it appears the Revenue will normally expect arm's length rent on letting of property between individuals and companies they control. On loans, the Revenue sees a distinction between, on the one hand, 'loans undertaken in a businesslike way with a view to generating gains on shares in the company', and on the other hand, 'isolated loans where the intention is to provide long term funding for a family business'.

It is good news that the Revenue has adopted an interpretation that narrows the scope of the rules a little, but it seems a pity that this was not done by way of a specific, clearly defined statutory provision. Some of these distinctions seem subjective, even bordering on arbitrary. In practice, whether a transaction is caught will probably often come down to the goodwill of individual tax Inspectors.

Thin capitalisation grouping

Another example of the Revenue going out of its way to be helpful arises in the guidance note 'Thin Capitalisation'. A combination of some new wording in the legislation and a willingness by the Revenue to apply it in a favourable manner, means that it will, for the first time, be possible to group United Kingdom companies for thin capitalisation purposes, where they are not under the same United Kingdom holding company. However, the grouping mechanism has completely changed.

The old thin capitalisation rules in section 209(2)(*da*), Taxes Act 1988, contained extensive provisions to govern the extent to which other group companies could be taken into account in determining the quantum of debt that a particular group company would have borrowed, were it not for its relationship with the lender. The basic rule was that in determining the creditworthiness of the borrower, it was not possible to take into account any comfort that an arm's length lender might derive from the borrower's relationship with other group companies, with the exception of companies in what was called the United Kingdom grouping.

The rules for determining the United Kingdom grouping were not easy to follow, but in practice they boiled down to the following in most cases. Starting with the borrower, one traced up the ownership chain until one reached a United Kingdom company that had a direct overseas parent. That United Kingdom holding company and all companies (United Kingdom or overseas) below it counted as the United Kingdom grouping. The arm's length borrowing capacity of the borrower would therefore be determined on the basis of the consolidated accounts of the borrower's United Kingdom holding company. If, however, the multinational had other United Kingdom subsidiaries that it owned through a separate United Kingdom holding company, these could not be taken into account.

Section 209(2)(*da*) has been repealed with effect from 1 April 2004, as have the United Kingdom grouping rules. Thin capitalisation is now countered solely by the transfer pricing rules in Schedule 28AA. The United Kingdom grouping concept is not carried over, however. Instead, it is replaced by one of the new compensating adjustment mechanisms which are a key part of the way the new transfer pricing rules function.

The way it will work is that the borrower company will lose interest deductions if its borrowings are in excess of its own arm's length borrowing capacity. Unlike the old rules, no other companies (other than the borrower's own subsidiaries) may be taken into account for this purpose.

The role of the compensating adjustment is to allow other United Kingdom group companies to claim deductions for the excess interest if they have given guarantees that support the borrower's debt. A very broadly worded definition of 'guarantee' has been incorporated into the legislation, covering any situation where an arm's length lender might have derived any comfort from other group companies, whether or not they have given a formal or explicit guarantee.

The Revenue's draft guidance note on thin capitalisation seems to hint strongly that it is prepared to consider there to be a guarantee in almost any situation. However, rather than rely on this, it may be sensible to consider putting in place formal cross-guarantees between all United Kingdom members of a multinational group.

Any United Kingdom company that is sufficiently related to the borrower is entitled to claim a compensating adjustment. Unlike the old United Kingdom grouping rules, it is not necessary for the borrower and guarantor to have a common United Kingdom parent, or for one to be the parent of the other. One imagines that this is an intended by-product of using the compensating adjustment mechanism, so as to remove what was arguably a discriminatory restriction that was likely eventually to be challenged in the European Court of Justice.

The guidance note contains further statements that will be helpful to taxpayers. They will have almost complete freedom to allocate the compensating adjustment to whichever United Kingdom group companies they wish. The note says that 'any reasonable allocation … between guarantors should be accepted …, provided it is reasonable to suppose that the loan would have been made with the support of just those guarantees and no others'. Thankfully, the Revenue confirms that it is not necessary to allocate a notional amount to non-United Kingdom group members. The same, presumably, applies to loss-making group members in the United Kingdom, though most loss-makers would not, in any case, be creditworthy.

If this wording means what it appears to say, it could introduce some flexibility that may sometimes be useful. Consider the following example. A borrower company is thinly capitalised and is denied interest deductions of £10 million. There are three other United Kingdom companies in the same group. Company A has sufficient creditworthiness that a guarantee from it would, alone, have supported debt on which the interest would have been £15 million. The

corresponding figures for Company B and Company C are £10 million and £5 million.

Despite the wide variance in proportionate creditworthiness, it does not seem that the Revenue will require the compensating adjustment to be allocated on a pro-rata basis, *i.e.* 1/2 to A, 1/3 to B and 1/6 to C. Indeed, as A or B could each have supported the entire excess debt on their own, the compensating adjustment could be allocated entirely to A or entirely to B if desired. In fact, it would seem that the adjustment could be allocated in virtually any way that the group wished. The only allocation that is not possible, is for C to claim 100 per cent of the adjustment, because it could only have supported half the additional £10 million interest by itself. Strangely, though, as B and C could, together, have supported the full £10 million of interest it would appear possible to allocate, say, £9 million of the deduction to C, and £1 million to B. However, one wonders if the Revenue will clarify that C cannot claim an adjustment of more than £5 million.

Centrally provided services

The final guidance note that we have space to cover in this article is the one entitled 'Centrally Provided Services'. Most of the note seems consistent with former (unwritten) practice, but there are two elements of the note that are worth highlighting.

The first is that it is implicit in the note that the Revenue generally expects a service fee to include a profit mark up. This may be unsurprising to most United Kingdom tax practitioners, but it may raise eyebrows overseas, as there are a number of countries, particularly in Europe, that are resistant to any profit mark-up on head office service fees and the like.

It may be objected that this misrepresents the guidance note, as it does not explicitly address the issue. Certainly it does not specifically state that there must be a mark-up. However, it does seem to proceed on this basis, and it does not seem to contemplate that there may be circumstances in which a mark-up is inappropriate (other than a passing reference to cost contribution arrangements).

The second noteworthy point is that although the guidance note otherwise confines itself to entirely generic comments, there is one paragraph where the note gets very specific. It singles out two types of service for which the Revenue feel compelled to make clear its view that the cost plus method is 'most unlikely to give an arm's length result'. These are:

- 'financial services, such as Treasury services;
- 'services creating, enhancing, or using intellectual property (including research and development, product design, brand development and management).'

Unfortunately, that is all the note says. There is no detail about what those words mean, nor any explanation why cost plus is inappropriate for these services. It is easy to see why cost plus would be inappropriate for certain services fitting these descriptions. For instance, the key factor affecting the arm's length price of loans and other financial instruments is risk. A simple mark-up on costs will rarely adequately reflect the risk inherent in the service of making loans or issuing other financial instruments. However, it is not clear if this is what the Revenue means by financial services.

In fact, it is not clear what the Revenue does mean. Are book-keeping and drawing up accounts financial services? Are the advice and activities of a group treasury manager financial services? If they are, it is not immediately obvious why cost plus is inappropriate, nor what other method would be more appropriate. Abandoning cost plus for such services would be a reversal of widespread United Kingdom practice, long accepted by the Revenue.

Similarly, with the second category, few would argue that a royalty rate can usually be set reliably on a cost plus basis, because again this would not necessarily reward the owner of the intellectual property for the risks borne in developing the intellectual property or for its value. If that is what the note is trying to say, it could be said with a lot less ambiguity.

However, it seems more likely that the Revenue is primarily trying to prohibit the use of cost plus for activities such as contract research and development. If so, it needs to make itself clear and advance a compelling rationale. If a company signs an agreement to provide services such as contract research and development or brand management on terms that mean it will be paid whether or not the activity successfully produces valuable intellectual property, then risk is not a significant factor. It is widely considered to be appropriate to reward such companies on a cost plus basis. There are ample examples of independent service companies that behave broadly in this manner. India, for example, is full of them.

It is no secret that the Revenue suspects that concepts like contract research and development are sometimes abused in transfer pricing tax planning. If so, it should explain the circumstances it considers to be abusive. The authors of the Revenue guidance are probably well aware that the position is more complex than the current wording suggests, but many tax Inspectors will not have had enough experience of transfer pricing to read down these sweeping statements. The result may be that some taxpayers will have to waste resources resisting spurious objections to their transfer pricing.

As we went to press, a revised version of the draft guidance note was issued, but unfortunately it seems not to address these concerns. Although it removes the wording that said '(including research and development, product design, brand development and management)', those activities would still seem to be covered by the remaining wording: 'Services creating, enhancing, or using intellectual property'. Perhaps the change can be interpreted as tacit confirmation that not all research and development, product design, brand development and management services are inappropriate for cost plus, but more clarity is needed if this note is to be of any real guidance to taxpayers on this point.

Interesting times

These are interesting times in the world of transfer pricing. This article has outlined some of the more important developments that taxpayers should be aware of. Study of the legislation and guidance notes will reveal many more. ■

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