

## UNITED KINGDOM

<b>LEGISLATION</b>	
<b>Existence of Transfer Pricing Laws/Guidelines</b>	<p>The UK transfer pricing legislation is contained in Schedule 28AA of ICTA 1988. Two key statutory requirements of schedule 28AA are:</p> <ul style="list-style-type: none"> <li>• Taxpayers are required to use arm's length transfer prices in making their own assessment of their taxable profits;</li> <li>• The rules, as matters of law have to be construed consistently with Art. 9 of the OECD Model Tax Convention and the OECD's Transfer Pricing Guidelines.</li> </ul> <p>HMRC (UK tax authority) issued a consultation paper on 20 June 2007 for a new approach to transfer pricing enquiries. This consultation is part of the 2006 Review of Links with Large Business, published in November 2006. In October 2007, responses to the consultation were published as part of the Making a Difference: Clarity and Certainty publication. However, HMRC has not introduced a new approach to Transfer Pricing yet, which will involve a greater specialization and team work, a focus on issues of higher risk, action plans for enquiries agreed where possible with companies, and active monitoring of progress.</p>
<b>Transfer Pricing Scrutiny</b>	<p>HMRC has issued guidance on when they will conduct a transfer pricing audit. The most recent guidance titled 'HMRC approach to compliance risk management for large business' was published March 2007 as part of the 2006 Review of Links with Large Businesses. In it, HMRC sets out its approach stating that it will vary its activities more clearly in response to risk, thereby reducing significantly the number of checks and enquiries for low risk customers and increasing the intensity and effectiveness of interventions for high risk customers.</p> <p>For low risk businesses, HMRC expects that the majority of its engagement take place in real-time, as issues arise. If a customer is low risk, HMRC will not expect to repeat the full risk process for two to three years, or even longer.</p> <p>For the highest risk businesses it is likely that several meetings will be necessary each year, with annual risk reviews. HMRC expects that regular intervention will be necessary, while striving to engage in real-time and to target its resources on the most significant issues in order to get to the heart of the matter more quickly.</p> <p>Initial guidance listed the following factors as reasons for initiating an audit:</p> <ul style="list-style-type: none"> <li>• The existence of tax haven entities in the group but outside the controlled foreign corporation rules, which are profitable despite the absence of significant activities carried out in their locations; Instances of mismatches between the likely scale of tax haven operations and the level of profits allocated to them;</li> <li>• Profit margins in the United Kingdom are lower than in the group generally and there are reasons to believe that this should not be the case;</li> <li>• The UK company possesses the resources to generate high-margin profits yet produces only a routine low-margin profit. In this context, the Inland Revenue will look for the presence of, for example, heavy investment, highly skilled and remunerated technical or R&amp;D workforce, and intangibles such as trade names, know-how, and patents;</li> </ul>

	<ul style="list-style-type: none"> <li>• Royalty or management fee payments that do not appear to make commercial sense and which substantially impact on the UK bottom line, such as payments for a brand name unknown in the United Kingdom, technology to which significant value has been added by complex processes carried out in the United Kingdom, and nebulous bundles of intangibles;</li> <li>• Poor performance over a number of years when there is no obvious prospect of super-profits in later years to justify the risk of continuing losses;</li> <li>• Any period in which changes in intra-group contractual arrangements purport to adjust the risk profile, and hence the reward, of the UK group, such as where a distributor becomes a commissionaire (and net profits fall away), or where a full manufacturer becomes a contract manufacturer and R&amp;D activities that once generated royalties move to a contract basis; and</li> <li>• Cost-sharing arrangements have been introduced.</li> </ul>
<p><b>Definition of Related Party</b></p>	<p>The concept of control is based on ICTA 88, s. 840: “Control”, in relation to a body corporate, means the power of a person to secure –</p> <ul style="list-style-type: none"> <li>• by means of the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or</li> <li>• by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate,</li> </ul> <p>that the affairs of the first-mentioned body corporate are conducted in accordance with the wishes of that person, and, in relation to a partnership, means the right to a share of more than one-half of the assets, or of more than one-half of the income, of the partnership.</p> <p>There are two important additions to this definition:</p> <ul style="list-style-type: none"> <li>• The 40% test (ICTA88/S747(1A)) which applies to joint venture companies with a UK and non-UK party where the UK party has an interest of at least 40 per cent; and</li> <li>• Attribution rules (ICTA88/S755D (5) – (9)) to trace control relationships through a number of levels in determining whether parties are controlled.</li> </ul>
<p><b>Transfer Pricing Penalties</b></p>	<p>A tax related penalty can be imposed under schedule 20 para20 of FA1998 on a company of up to the amount of the tax understated; where:</p> <ul style="list-style-type: none"> <li>• A return is made which is not in accordance with the arm's length principle;</li> <li>• It can be shown that the return was submitted fraudulently or negligently by the taxpayer; and</li> <li>• United Kingdom tax is lost as a result.</li> </ul> <p>In addition, all other corporate tax penalties can apply and in particular:</p> <ul style="list-style-type: none"> <li>• Failure to keep and preserve records. Para. 23 of Schedule 18 of the FA 1998 imposes a penalty on a company of up to £3,000;</li> <li>• Failure to produce documents and other information. Para. 29 of Schedule 18 of the FA 1998 imposes a penalty of £50 plus £30 for each day during which the failure continues (£150 a day if the penalty is determined by appeal Commissioners); and</li> </ul>

	<ul style="list-style-type: none"> <li>The making of fraudulent or negligent returns or statements in connection with a claim for a tax allowance, deduction or relief or the submission of fraudulent or negligent accounts. Para. 89 of Schedule 18 of the FA 1998 imposes a penalty on a company of up to the amount of the tax understated.</li> </ul>
<p><b>Advance Pricing Agreement (APA)</b></p>	<p>The legislation essentially provides for legally binding written agreements between taxpayers and the UK tax authorities. These are available for accounting periods ending after 27<sup>th</sup> July 1999.</p> <p>Two kinds of APA are outlined in the legislation:</p> <ul style="list-style-type: none"> <li>The "unilateral" type, in which only the taxpayer and HMRC are involved (including UK to UK transactions);</li> <li>The "bilateral" type, where there is a double taxation treaty and the tax authorities of the relevant treaty partner country are also involved.</li> </ul> <p>HMRC encourages applications for bilateral APAs wherever this is possible. HMRC see APAs as resolving complex transfer pricing issues and can decline to consider an APA if the situation does not seem to them complex enough to justify their use of the resource.</p> <p>Advance Thin Capitalisation Agreements (ATCAs) can be used to resolve potential thin capitalization issues. Unilateral ACTAs could allow taxpayers to gain certainty without having to seek relief through double taxation treaties.</p>

**DOCUMENTATION AND DISCLOSURE REQUIREMENTS**

<p><b>Tax Return Disclosures</b></p>	<p>The tax return must be adjusted for non-arms length transactions.</p>
<p><b>Level of Documentation</b></p>	<p>The HMRC guidance recommends a business:</p> <ul style="list-style-type: none"> <li>Should make documentation available and accessible to the Inland Revenue (including, where appropriate, translation from another language), but the form in which the documentation is stored should be at the discretion of the business;</li> <li>Should make documentation available in relation to a permanent establishment on the same basis as for a legal entity;</li> <li>Should identify the associated businesses with which the relevant transactions took place and the nature of the association;</li> <li>Should describe the nature of the business in the course of which the relevant transactions took place, and the property (tangible and intangible) used in that business;</li> <li>Should set out the contractual or other understandings between the associated businesses and the risk assumed by each party;</li> <li>Should describe the method used to establish an "arm's length" result and explain why that method was chosen;</li> <li>Need not provide evidence about associations or transactions between businesses where those associations or transactions are not within the scope of UK transfer pricing rules;</li> <li>Need not provide evidence related to each relevant transaction, but may provide aggregated evidence related to a class of similar transactions;</li> </ul>

	<ul style="list-style-type: none"> <li>• Need not create new evidence in relation to transactions that occur after evidence has been created in relation to transactions that are similar and there have been no material changes in the circumstances for determining an “arm’s length” result;</li> <li>• Need not commission the production of evidence from a professional adviser if the business is able to produce appropriate evidence itself;</li> <li>• May choose to explain its general commercial and management strategy, or that of the group of businesses and technological environment, competitive conditions, and regulatory framework; and</li> <li>• May choose to make documentation in relation to relevant transactions available to the Inland Revenue before the tax return in which those transactions are reflected is due to be made.</li> </ul>
<b>Record keeping</b>	Documentation must in general be kept for a period of 6 years from the end of the chargeable period to which it relates.
<b>Language for documentation</b>	It is expected that the documentation is in English.
<b>Small and medium sized enterprises (SMEs)</b>	<p>Small and medium sized enterprises are generally exempted from the transfer pricing rules. Small businesses are ones with fewer than 50 employees and either turnover or assets of less than €10 (about £7 million). Medium-sized businesses are ones that are not small businesses but which have fewer than 250 employees and either turnover of less than €50 (about £35 million) or assets of less than €43 (about £30 million). (These numbers are calculated on a group basis). For medium sized businesses only, HMRC have a reserve power to apply the rules in exceptional cases justified by significant tax at risk.</p> <p>To protect tax revenue, the rules are retained for transactions with certain overseas territories (countries with which the UK does not have a double tax treaty containing a suitable non-discrimination article).</p>
<b>Deadline to Prepare Documentation</b>	Documentation must be in place at the time of submission of the tax return.
<b>Deadline to Submit Documentation</b>	Must be made available upon request by tax authorities. There is a minimum time limit of 30 days.
<b>STATUTE OF LIMITATIONS</b>	
<p>Generally, HMRC must open an enquiry 2 years from the end of the accounting period in which the transfer pricing issue arose. In certain circumstances, HMRC can make a discovery assessment six years after the end of an accounting period. In cases of fraud or negligence, this can be extended to 21 years from the end of an accounting period.</p>	

**TRANSFER PRICING METHODS**

The OECD Guidelines are applied by the UK legislation. Therefore, all methods outlined in the OECD guidelines may be accepted.

**COMPARABLES**

Where the tested party is located in the UK, there is a preference for UK comparables. However, the use of pan-European databases has been accepted in the European Joint Transfer Pricing Forum.

*Date: 6 February 2008*