Transfer Pricing Country Summary
United Kingdom

April 2018

Legislation

Existence of Transfer Pricing Laws/Guidelines

The UK transfer pricing legislation is contained in Part 4 of Taxation (International and Other Provisions) Act (TIOPA) 2010. All legislative references herein are to TIOPA unless specified otherwise. Two key statutory requirements of the legislation are:

1. taxpayers are required to use arm's length transfer prices in making their own assessment of their taxable profits; and
2. the rules, as matters of law have to be construed consistently with Article 9 of the OECD Model Tax Convention and the OECD's Transfer Pricing Guidelines. HM Revenue & Customs (HMRC), the UK tax authority, has also published detailed guidelines on transfer pricing notably within the International Tax Manual INTM410000 to INTM539000 and the Tax Compliance Risk Management Manual.

It is also important to note whether an entity is within the scope of the UK's transfer pricing legislation depends on the size of the Group. The size is determined in line with the EU definition set out in the Annex to the Commission Recommendation of 6 May 2003 (2003/361/EC) concerning the definition of micro, small and medium-sized enterprises.

All large enterprises are within the legislation. Medium sized enterprises are within the legislation if HMRC issues them with a Transfer Pricing Notice or if the other party to the relevant transaction is resident in a territory with which the UK does not have a Double Taxation Convention or if the UK does have a Double Taxation Convention (DTC), the convention does not have a non-discrimination article or the territory is on a list published by the UK Treasury.

Small enterprises are only within the scope of the legislation if the other party is in a similar territory to that which brings a medium sized entity within scope or if the transaction is taken into account by anyone for the UK Patent Box purposes and HMRC issues a Transfer Pricing Notice.

HMRC has also published a number of Statements of Practice that set out how they will apply the rules in certain circumstances. For instance SoP 1(2012) sets out how HMRC will deal with applications for Advance Thin Capitalisation Agreements and SoP 2 (2010) deals with HMRC's interpretation of the Advance Pricing Agreements legislation. Taxpayers are allowed to reply upon Statements of Practice when making their tax returns.

As the OECD's Transfer Pricing Guidelines are imported directly into UK law by s164 the changes to them as a result of the OECD Base Erosion and Profit Shifting (BEPS) project have been implemented in UK law. Any further changes will be implemented by way or an order issued by HM Treasury. It is important to note however that the OECD 2010 Report On The Attribution Of Profits To Permanent Establishments is not part of the OECD Transfer Pricing Guidelines for these purposes, although HMRC will consider the Report to be highly persuasive.

There has been little transfer pricing case law in the UK with many taxpayers preferring to settle. The most notable case was DSG Retail Ltd & Others v HMRC [2009], which was the first case to move away from the old OECD hierarchy of transfer pricing methodologies. Whilst there is no longer a hierarchy as to which methodology to apply within the OECD Transfer Pricing Guidelines, this is still an important case as it examines how to apply the profit split method, a method that we expect to be more commonly used in light of the UK's new Diverted Profits Tax and the OECD BEPS initiative.

Finance (No.2) Act 2015 brought in the new Diverted Profits Tax (DPT), effective 1 April 2015 levied at 25% on profits that are assessed as having been diverted from the UK.

This legislation has been born out of the UK government's frustration that transfer pricing rules do not go far enough in protecting the UK tax base, with taxpayers taking steps to artificially avoid creating a UK taxable presence or charging for the use of royalties or other services that result in such income flowing through convoluted structures to entities and territories lacking economic substance. The key point to note is that the legislation looks beyond the UK/foreign transaction at hand and to the substance of an onward transaction and wider group supply chain structure.

The DPT effectively overrides UK transfer pricing rules (and permanent establishment definition) by seeking to arbitrarily restrict fees paid to non-UK connected parties as well as seeking to allocate profits to artificially avoided UK PEs on a 'just and reasonable' basis as opposed to an arm's length basis. The concept of 'just and reasonable' is not defined. The DPT is deliberately outside of the UK's DTC network. No protection is therefore available under those DTCs in the UK to any non-UK entity charged to DPT.

The DPT will apply if one of two Charging Provisions is met:

1. where a UK resident company (or the UK permanent establishment (PE) of a non-UK resident company) has entered into transactions with entities lacking economic substance (Charging Provision 1); or
2. where a non-UK resident company has taken steps designed to avoid creating a UK PE (Charging Provision 2).

The legislation is complex and groups must undertake a full assessment as to the application of the rules. If a group considers the rules do not apply it should retain documentation evidencing how this conclusion was drawn. It might be helpful to retain such evidence within the UK country-file transfer pricing documentation.

<u>Assessment and reporting</u>

The taxpayer must assess whether one of the charging provisions apply and the following should be noted:

- There are tax geared penalties where the taxpayer does not report to HMRC within 3 months of the accounting period end (6 months for first year). The only time that you are not required to notify is if Charging Provisions 1 or 2 do not apply;
- It is also possible that the provisions apply but that in calculating the DPT charge no further profits are allocated to the UK – where this is the case you must still notify HMRC;
- Once notified, HMRC must then determine a 'best estimate' of the profits subject to the DPT charge, with the final tax charge being agreed over the following 12 months. It is strongly recommended that the taxpayer considers providing HMRC with any analysis as to how the

quantum profits subject to DPT charge (if any) has been determined;
- Failure to notify may result in penalties between 30%-200% of the DPT due.

Definition of Related Party

The related party requirement is applied by reference to body corporates or partnerships which are controlled by a person.
The term “Person” can cover individuals as well as corporates or other legal entities.

“Control”, in relation to a body corporate, means the power of a person to secure:
- 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
- by virtue of any powers conferred by the articles of association or other document regulating that or any other body corporate, 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.

There are two important additions to the control definition:
- the 40% test (section 160(3) TIOPA) that applies to joint venture companies where each party has an interest of at least 40 per cent; and
- attribution rules (section 160(5) TIOPA) that trace control relationships through a number of levels in determining whether parties are controlled.

Transfer Pricing Scrutiny

HMRC’s application of the UK’s Transfer Pricing legislation is set out in the International Manual. This guidance is not binding, but does provide for key insight into how HMRC interprets the law. Taxpayers are though entitled to reply upon the guidance where HMRC have made a completely unambiguous statement and for HMRC to not apply the guidance would be conspicuously unfair. The guidance provides that HMRC will vary its enquiry activities depending on the risks rating awarded to a taxpayer. In recent years HMRC has undertaken a risk review of taxpayers dealt with by their Large Business Directorate awarding either a ‘low risk’ or ‘not low risk’ status. This process involves HMRC allocating the taxpayer with a Customer Compliance Manager (CCM). The CCM will consequently introduce corporate tax (including International Tax Specialists with Transfer Pricing experience), employer tax and VAT specialists to undertake the risk assessment.

HMRC thereby reduce significantly the number of checks and enquiries for low risk taxpayers and increase the intensity and effectiveness of interventions for higher risk taxpayers within their Large Business Directorate.

For low risk businesses, HMRC expects that the majority of its engagement will take place in real-time, as issues arise. If a taxpayer is low risk, HMRC will generally review whether the customer continues to meet the low risk criteria on a three-year cycle.

For non-low 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, at the same time, striving to engage in real-time discussions and to target its resources on the most significant issues in order to get to the heart of the matter more quickly.

HMRC guidance states that the following factors will be taken into account, both in determining the risk profile of a business and as reasons for initiating an audit:

- the existence of tax haven entities in the group but outside the controlled foreign corporation rules (UK anti-avoidance provisions that prevent the retention of income in low tax jurisdictions), which are profitable despite the absence of significant activities carried out in their locations;
- profit margins in the United Kingdom are lower than in the group generally or inconsistent with its business activities over a cycle of, say, 5 years;
- the UK company possesses the resources to generate high-margin profits yet produces only a routine low- margin profit. In this context, HMRC will look for the presence of, for example, heavy investment, highly skilled and remunerated technical or R&D workforce and intangibles such as trade names, know-how, and patents;
- royalty or management fee payments that do not appear to make commercial sense and which substantially impact the UK taxable profit, 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;
- 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;
- notes on UK accounts, or other forms of information such as press or internet articles, which mention restructuring, acquisition / merger activity; transfer of UK activities to related parties and / or changes to the way in which the company is rewarded;
- disappearance of / significant decline in stock;
- borrowing appears disproportionately high in relation to shareholders' funds, bearing in mind the type business involved;
- any period in which changes in intra- group contractual arrangements purport to adjust the risk profile and, hence the reward, of the UK group. Examples include where a distributor becomes a commissionaire (and net profits fall away), or where a fully-fledged manufacturer becomes a contract manufacturer and R&D activities that once generated royalties move to a contract basis; and
- cost-sharing arrangements have been introduced.

Companies dealt with outside of the Large Business Directorate are risk assessed on a project basis and transfer pricing or aspects of transfer pricing may be selected as a project. These enquiries are likely to be led by an International Tax Specialist with Transfer Pricing experience.

Transfer Pricing Penalties

A tax related penalty can be imposed under Schedule 24 of Finance Act (FA) 2007 on a company of up to the amount of the tax understated, where:

- a return is made that is not in accordance with the arm's length principle;
- the inaccuracy was either careless or deliberate; and
- United Kingdom tax is lost as a result.

Where the inaccuracy was deliberate the level of penalty will depend on whether the inaccuracy was concealed or not. The penalty may be reduced if the taxpayer brings the error to HMRC's attention and also for the amount the taxpayer assists HMRC during the enquiry.

In addition, where a transfer pricing assessment is raised on an individual (for example where an individual is providing services to a related company and the service fee is not arm's length), FA 2010 introduced paragraph 4A of Schedule 24 FA 2007 under which the penalty for understated tax can be up to twice the amount of the tax where:

- the inaccuracy was deliberate and concealed;
- it involves an "offshore matter"; and
- the offshore territory in question falls within a list of designated offshore jurisdictions (so called
    - Category 3 territories).

In determining whether a jurisdiction is a Category 3 territory the UK Treasury considers the existence and quality of information exchange agreements. A list of Category 3 territories is published on the HMRC website [1] and includes jurisdictions such as Brazil and United Arab Emirates.

In addition, all other corporate tax penalties can apply and in particular:

- Paragraph 23 of Schedule 18 of the FA 1998 imposes a penalty on a company of up to £3,000 for a failure to keep and preserve records;
- Paragraph 39 of Schedule 36 of the FA 2008 imposes a penalty of £300 for a failure to produce documents and other information plus £60 for each day during which the failure continues.

Advance Pricing Agreement (APA)

The legislation provides for legally binding written agreements between taxpayers and HMRC. These are available for accounting periods ending after 27 July 1999.

Two kinds of APA are outlined in HMRC guidance:

- the "unilateral" type, in which only the taxpayer and HMRC are involved (including UK to UK transactions); and
- the "bilateral" type, where there is a double taxation treaty and the tax authorities of the relevant treaty partner country are also involved.

HMRC encourages applications for bilateral APAs wherever this is possible and will now not normally enter into unilateral APAs. HMRC consider APAs apply only where there are complex transfer pricing issues and can decline to consider an APA if the situation does not seem complex enough to justify their use of the resource. The quantum of the transaction is also very relevant. Unless the figures involved are significant (hundreds rather than tens of millions) it is unlikely HMRC will agree to issue an APA.

Advance Thin Capitalisation Agreements (ATCAs) are also available to resolve potential thin capitalization issues. Unilateral ACTAs allow taxpayers to gain certainty without having to seek relief

[1] see https://www.gov.uk/government/publications/territory-categorisation-for- offshore-penalties/territory-categorisation-for-offshore-penalties-from-24-july-2013)

through double taxation treaties. Note that HMRC will still enter into unilateral ATCA's while looking to discourage unilateral APAs.

Documentation And Disclosure Requirements

Tax Return Disclosures

The annual tax return must be adjusted for non-arm's length transactions.

Level of Documentation

The UK's transfer pricing legislation does not require that specific documentation be kept to support the positions taken. Instead the normal record–keeping requirements apply. These are that the person must keep sufficient records to enable them to deliver a correct and complete Return. The HMRC guidance recommends a business:

- should, on request, make documentation available and accessible to HMRC (including, where appropriate, translation from another language). The form in which the documentation is stored should be at the discretion of the business;
- should maintain documentation for a permanent establishment on the same basis as for a legal entity;
- should identify the associated businesses with which the relevant transactions took place and the nature of the association;
- 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;
- should set out the contractual or other understandings between the associated businesses and the risk assumed by each party;
- should describe the method used to establish an "arm's length"result and explain why that method was chosen;
- 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;
- need not provide evidence related to each relevant transaction, but may provide aggregated evidence related to a class of similar transactions;
- need not create new evidence for transactions that occur after evidence has been created in respect of transactions that are similar and there have been no material changes in the circumstances for determining an "arm's length"result;
- need not commission the production of evidence from a professional adviser if the business is able to produce appropriate evidence itself;
- 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
- may choose to make documentation on relevant transactions available to HMRC before the tax return in which those transactions are reflected is due to be made.

Record Keeping

Transfer pricing falls within the UK self-assessment rules. As such, the records kept must be sufficient to enable the taxpayer to deliver the correct tax return.

Documentation must, in general, be kept for a period of 6 years from the end of the chargeable period to which it relates.

HMRC guidance set out that the following documentation must be kept:

1. primary accounting records;
2. tax adjustment records; and
3. records to demonstrate an arm's length result, as is reasonable to the size of the business (HMRC INTM483030).

HMRC will also accept documents prepared in accordance with the EU's Code of Conduct on transfer pricing documentation. Businesses who intend using the Code are asked to notify HMRC of this although there is no legal requirement to do so.

Country-by-Country Reporting (CbCR)

The UK has implemented Action 13 of the OECD's work on countering Base Erosion & Profit Shifting (BEPS) and Multi-National Enterprises with group revenue of over €750m must now make an annual report to HMRC where the Ultimate Parent Entity (UPE) is in the UK or where a group member is in the UK and its UPE is in a country that doesn't require CbCR. Also a UK headed sub-group must file a sub-group CbCR if its UPE has not filed a CbCR elsewhere or it has filed and it is in a country that doesn't not exchange information with the UK.

The report sets out details of the income and profits a Group has in each territory together with details that allow a Revenue Authorities to assess the likely substance an entity has in each jurisdiction and the activities it carries on there.

The UK now requires businesses obliged to file a CbCR to keep the documentation set out in Annexes I & II of the final report for the OECD BEPS Action 13 "Transfer Pricing Documentation and Country-by-Country Reporting" to back up its CbCR. These are the Master file and Local files. The UK does not require these to be filed alongside the CbCR. The documentation underlying the CbCR, Master and Local files is still subject to the general UK rule relating to being able to deliver a correct Tax Return.

Language for Documentation

Documentation should be maintained in English.

Small and Medium Sized Enterprises (SMEs)

At section 166, the legislation also provides for an exemption from transacting at arm's length and maintaining transfer pricing documentation for those companies that qualify as an SME.

The criterion for an SME is taken from European recommendation at 2003/361/EC and is determined on a group basis. An SME is defined as one that has:

1. up to 250 staff (50 for a small enterprise); and
2. annual balance sheet not exceeding €43mn (€10mn for a small enterprise); or
3. annual turnover not exceeding €50mn (€10mn for a small enterprise).

For the SME exemption to apply, the transaction must take place with a 'qualifying territory'. To be a qualifying territory it must have:

- concluded a Double Tax Treaty (DTA) with the UK containing a non-discrimination article; and
- not been specifically designated by the UK Treasury as non-qualifying (a list of non-qualifying territories can be found at INTM412090).

Exceptions to the SME exemption:

1. HMRC may issue a Transfer Pricing Notice (section 167) to a medium sized enterprise that requires the person to apply transfer pricing to the provision specified in the notice when calculating its taxable profits.
2. A business can apply the transfer pricing rules even if it would ordinarily qualify for the SME exemption. Such election can be made for a chargeable period and will cover all transactions made within that period.
3. If the SME is party to a transaction that is relevant to a patent box claim (Part 8A Corporation Tax Act 2010), HMRC may issue a notice that requires the person to compute their profits in accordance with transfer pricing in respect of that provision for the period.

Deadline to Prepare Documentation

Documentation must be in place at the time a tax return is submitted.

Deadline to Submit Documentation

Must be made available upon request by tax authorities within such time as is "reasonably specified" in the information notice. There is no minimum response / disclosure period, although such period must be "reasonable". HMRC has indicated that it might be reasonable to expect that most information could be provided within 30 days of any notice.

Statute Of Limitations

Generally, where HMRC consider an enquiry should be made, it must do so within 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 four years after the end of an accounting period. In cases involving a loss of tax brought about carelessly this can be extended to six years from the end of the accounting period and if the loss of tax was brought about deliberately, this can be extended to 20 years.

Where the extended time limits are used to issue assessments to recover any loss of tax then HMRC are very likely to look to charge tax geared penalties.

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.

Secret comparables are not used by HMRC.

This document was updated in cooperation with Milestone Tax, TPA Global Partner, United Kingdom.