The Transfer Pricing Law Review

Fourth Edition

Editors
Steve Edge and Dominic Robertson

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THE TRANSFER PRICING LAW REVIEW

Fourth Edition

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Steve Edge and Dominic Robertson

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PREFACE

It has been a great pleasure to edit this fourth edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself has recently launched a project to align its transfer pricing rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed, and the availability of APAs). Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

As we have said in earlier editions of the *Review*, transfer pricing rules will be high on the corporate tax agenda for many years to come, and they are continuing to evolve at a rapid pace. Over the next year or so, we expect the following to be among the main areas of focus.

First, as in so many other areas of endeavour, the covid-19 pandemic raises new challenges for transfer pricing, and may in some cases invert the 'normal' argument between taxpayers and tax authorities. For example, will tax authorities which have previously argued that a company is not a routine service provider, and should be rewarded through a profit split, now accept that the company therefore needs to bear a share of the group's covid-19 losses? Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts held last year that transfer pricing rules are not limited to pricing adjustments alone; and Ireland introduced rules that enable the Irish Revenue to impose a 'substance over form' principle.

Third, the long-awaited OECD Transfer Pricing Guidance on Financial Transactions was published in February 2020. Although its immediate impact has been rather overshadowed

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by the covid-19 situation, many taxpayers, and tax authorities, will need to get to grips with the potential impact of this guidance on them.

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards its target of presenting an agreed solution by the end of 2020. The current Pillar One and Pillar Two proposals would, if enacted, be the most far-reaching change to transfer pricing principles in close to 100 years, and would mark a significant shift away from the arm's-length principle. The desire to shore up tax revenues in light of covid-19 may well encourage the countries that expect to be 'winners' from the proposals to push for an agreed outcome. It is worth noting, however, that the reforms will not be a silver bullet for public finances. The OECD expects the reform to increase corporate tax revenues by 4 per cent; in the UK, for example, that would raise enough money to fund the National Health Service for only one week.

We would like to thank the authors of all of the country chapters for their comprehensive and illuminating analysis of each country's transfer pricing rules; and the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this *Review*.

Steve Edge and Dominic Robertson
Slaughter and May
London
June 2020

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Chapter 22

UNITED KINGDOM

Steve Edge, Dominic Robertson and Tom Gilliver[1]

I OVERVIEW

Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) contain the main UK transfer pricing legislation that applies for corporation tax and income tax purposes. These rules apply the arm's-length principle and are intended to counter transactions where a potential tax loss or reduction in taxable profits is created as a result of non-arm's-length pricing between related parties.

If certain conditions are met, the rules require that a person's profits and losses are calculated for tax purposes by substituting an arm's-length provision for an actual one. In broad terms, the conditions can be summarised as follows:

a an actual provision has been made or imposed between two persons by means of a transaction or series of transactions;

b one of these persons was directly or indirectly participating in the management, control or capital of the other, or the same person or persons were directly or indirectly participating in the management or control of the two parties to the provision;

c the actual provision differs from the arm's-length provision that would have been made between independent enterprises; and

d the actual provision confers a potential UK tax advantage on one or both of the parties to it.

The main elements of these conditions are considered below.

i Meaning of 'provision'

A 'provision' must be made or imposed for the UK rules to apply. While the term 'provision' is not defined in the legislation, Her Majesty's Revenue and Customs (HMRC) guidance suggests that it embraces all the terms and conditions attaching to a transaction or series of transactions and should be given a wide meaning. The guidance also provides that the term is broadly equivalent to the phrase 'conditions made or imposed' in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (the Model Convention) and so should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines).[2] The UK's Upper Tribunal has held that a share issue could be treated as a provision for transfer pricing purposes, although the point has been

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1 Steve Edge and Dominic Robertson are partners and Tom Gilliver is an associate at Slaughter and May. The authors wish to thank Sam Cadd for research assistance on this chapter.

2 HMRC International Manual (INTM412050).

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appealed to the Court of Appeal.[3] This interpretation suggests that the term is not confined to commercial transactions between companies and that the transfer pricing legislation can also impact shareholder transactions.

The rules operate in only one direction so that it is not possible to substitute an arm's-length provision for the actual provision where to do so would result in a reduction in taxable profits or an increase in allowable losses.

ii Degree of relationship

The participation condition sets out the required degree of relationship between the parties and can be satisfied by way of direct or indirect control. In relation to a body corporate, 'control' means the power of a person to ensure that the affairs of the body corporate are conducted in accordance with the wishes of that person by means of holding shares, possessing voting power, or powers conferred by a document regulating the body corporate. In relation to a partnership, 'control' means the right to a share of more than half the assets, or of more than half the income, of the partnership.[4]

'Direct' control is most commonly satisfied where a person has voting control over a body corporate. Certain additional rules apply, however, for the purposes of determining whether a person has 'indirect' control.[5] Indirect control will arise in any of the following scenarios:

a where a person would have direct control if certain additional rights and powers were attributed to that person, including, by way of example, entitlements to rights and powers of connected persons, and future rights and powers;

b where a person is a 40 per cent participant in a joint venture and there is one other participant who holds at least 40 per cent of the venture; and

c where a person acts together with other persons in relation to a financing arrangement, and that person would have direct control if the rights and powers of those other persons were attributed to it.

iii Scope

The UK rules apply where an actual provision has been made or imposed between two 'persons'. There is no definition of 'person' in UK tax legislation but HMRC will apply the term to include bodies corporate, partnerships and individuals. The effect of the participation condition (see above), however, is that one of the parties to the actual provision must be a body corporate or a partnership. It is not yet clear whether the rules can apply to a provision between a company and an individual acting in her personal capacity rather than as an 'enterprise', which may be clarified by a First Tier Tribunal decision expected later in 2020.

Both cross-border transactions and domestic transactions fall within the scope of these rules.

Where an adjustment is required by the transfer pricing rules to increase the profits (or reduce the losses) of one party (the advantaged party), the connected UK party (the

3 *Union Castle Mail Steamship v. HMRC* [2018] UKUT 316 (TCC).

4 Section 1124 of the Corporation Tax Act 2010.

5 Sections 157 to 163 of TIOPA.

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disadvantaged party) may, in turn, claim a compensating adjustment to its taxable profits. The rules also allow for a balancing payment to be made by the disadvantaged party to the advantaged party tax-free up to the amount of the compensating adjustment.[6]

Exemptions apply for small and medium-sized enterprises and dormant companies where certain conditions are met.

The UK transfer pricing rules do not apply to the calculation of a chargeable gain (or allowable loss) except to facilitate a claim for a compensating adjustment where there has been a transfer pricing adjustment.[7] Notwithstanding this, a market value rule may be imposed on related-party transactions under the Taxation of Chargeable Gains Act 1992, which should, in the majority of cases, produce a similar result.

iv OECD principles

The UK rules contain an express provision that Part 4 of TIOPA should be construed in a manner that best secures consistency with the arm's-length principle in Article 9 of the Model Convention and the 2017 OECD Guidelines.[8] The definition of the OECD Guidelines has been updated to include the Base Erosion and Profit Shifting (BEPS) Actions 8–10 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation. Although additional transfer pricing guidance on BEPS Actions 4, 8–10 was released by the OECD in February 2020, at the time of writing this guidance had not yet been incorporated into the definition of the OECD Guidelines for the purposes of TIOPA. While the strict statutory position is that these updates to the OECD Guidelines should apply only in relation to accounting periods beginning on or after 1 April 2016 for corporation tax purposes, HMRC views the updates as merely clarifications. Therefore, HMRC contends that pre-April 2016 transactions should also be tested under the current, post-BEPS version of the OECD Guidelines.

II FILING REQUIREMENTS

There is no specific requirement under the UK rules to prepare a transfer pricing report. However, given transfer pricing forms part of the UK self-assessment system, a taxpayer must keep and retain appropriate records and documentation so that it can submit a correct and complete tax return.

HMRC guidance refers to four classes of records or evidence that it would have to consider to assess whether a taxpayer's transfer pricing accords with the arm's-length standard, as follows:

a primary accounting records;
b tax adjustment records;
c records of transactions with associated businesses; and
d evidence to demonstrate an arm's-length result.[9]

While HMRC would expect the first three categories to be prepared in advance of submitting a tax return for the relevant accounting period, evidence to demonstrate an arm's-length result may be required only in response to an information request from HMRC as part of

6 Section 196(2) of TIOPA.
7 HMRC International Manual (INTM412040).
8 Section 164 of TIOPA.
9 HMRC International Manual (INTM483030).

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an enquiry into a taxpayer's return. However, where HMRC makes any adjustments to a taxpayer's transfer pricing position in its tax return, HMRC will in practice require some evidence that the company had carefully considered the arm's-length position, to be satisfied that no 'careless error' penalty is due. Traditionally, this would be done by preparing a formal transfer pricing report; however, the company should still verify that the comparables identified in the report are genuinely functionally similar to the company itself.

Recommendations about transfer pricing documentation can also be found in the OECD Guidelines. In addition, HMRC will also accept documents prepared in accordance with the EU's Code of Conduct on transfer pricing documentation.[10]

III PRESENTING THE CASE

i Pricing methods

Since the UK's domestic transfer pricing legislation must be construed in a manner consistent with the OECD Guidelines, any of the five transfer pricing methods provided for in the OECD Guidelines may be adopted in the UK, provided the relevant method establishes pricing that satisfies the arm's-length standard.

The OECD Guidelines do permit taxpayers to adopt 'other methods' outside the five OECD-recognised methods where the latter are regarded as less appropriate or unworkable having regard to the particular facts and circumstances of the case. Under most of the methods, it is necessary to carry out a comparison of the controlled (i.e., related party) transaction against an uncontrolled (i.e., independent party) transaction.

Factors influencing the selection of the most appropriate method include the nature of the controlled transaction in issue (having regard, in particular, to the functional analysis), the availability of information, the degree of comparability and the reliability of comparability adjustments. HMRC endorses the OECD's preference for traditional transaction methods over transaction profit methods where both can be applied in an equally reliable manner and, similarly, it is generally accepted that a comparable uncontrolled price (CUP) is the most effective way of assessing the arm's-length price.

Comparability

HMRC emphasises the importance of carrying out a robust comparability analysis as this may have a considerable impact on the acceptable range of arm's-length pricing. However, it is difficult for a CUP to be entirely robust given that access to information on a third party's actual position is limited. A determination as to whether any given comparable is reliable must be made case by case having regard to the extent to which they satisfy the five comparability factors identified in the OECD Guidelines (i.e., the characteristics of the property or services transferred, the functions performed (taking into account the assets used and risks assumed), the contractual terms, the economic circumstances of the parties and the business strategies pursued by the parties).

In practice, both quantitative and qualitative data will be used to include or exclude potential comparables. HMRC acknowledges that a small number of strong comparables is likely to give a more accurate result than a large number of weak comparables.

10 HMRC International Manual (INTM483030).

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The feasibility of carrying out reasonably accurate comparability adjustments is equally important when performing a comparability analysis. Examples of comparability adjustments include adjustments for accounting consistency and adjustments for differences in functions, assets and risks. However, in line with the OECD Guidelines, the only adjustments that should be made are those for differences that will have a material effect on the comparison and that are expected to improve comparability. If numerous or substantive adjustments to important comparability factors are required, this may be an indication that the comparability of the independent transaction is not, in fact, sufficiently reliable.

Cost-plus

The cost-plus method is typically applied in the UK for routine low-risk activity (e.g., administrative business support functions or services that a multinational group would be prepared to outsource). A key consideration in applying this method is to ensure that all relevant costs have been included in the tested party's cost base. HMRC now considers that cost-plus is rarely appropriate for regional headquarter functions.

Profit split

In contrast, the profit split method is often applied for highly integrated operations or where both parties make unique and valuable contributions (e.g., contribute unique intangibles) to the transaction. This method is more commonly applied where the level of integration or contribution made by the relevant parties is akin to a joint venture. A search for reliable comparables must have been suitably exhausted before taking recourse to this method.

Cost sharing

The guidance contained in the OECD Guidelines on cost-sharing arrangements applies in the UK. In applying this guidance, HMRC emphasises that there is no difference in the approach for analysing transfer pricing for cost-sharing arrangements than for any other transactions, and that parties performing activities under similar economic circumstances should receive the same expected return, irrespective of whether those activities are performed within the framework of a cost-sharing arrangement or not.

The BEPS Actions 8–10 Final Reports make clear that contributions made to such an arrangement should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of the participants. While cost share methods are acceptable in the UK, it is expected that arrangements of this kind will be less commonly used for IP in the future because of this general requirement to measure contributions at fair value (rather than cost).

ii Authority scrutiny and evidence gathering

Cross-checks

While one particular method may be selected and applied for the purposes of determining the arm's-length pricing of the transaction, HMRC also emphasises the importance of cross-checking this result against other methods and applying 'sense checks'. In light of the increased public interest in the tax affairs of multinational companies, HMRC is interested in how the 'man on the street' would perceive the result. While this is, of course, a valid

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consideration, it must be balanced with the need to arrive at a principled arm's-length price having due regard to the established rules and OECD guidance. This can involve exercising judgement as to the reasonableness of the result from a business and economic perspective.

One sense check that HMRC is particularly keen to examine is the global tax position for multinational groups and the profit share in each jurisdiction in the value chain. This enables it to form a view on whether the UK is getting its 'fair share' of the profits. Major difficulties can arise in trying to value the rate of return on IP across a multinational group. In a financial services context, however, it is generally easier to value the return on capital employed.

Following the introduction of diverted profits tax (DPT) (see Section IX, below), HMRC now expects to be provided with information on a group's full value chain, and the profits earned in each entity. Details of the transactions between UK and non-UK affiliates are unlikely to be sufficient, so taxpayers should expect to be required to provide information on pricing or profit allocation between non-UK members of the group also.

Country-by-country reporting

The UK has adopted country-by-country reporting (CbCR). The rules require any UK-headed multinational enterprises or, in certain circumstances, UK sub-groups of multinational enterprises, with a consolidated group turnover of €750 million or more to file an annual report containing information about global activities, profits and taxes with HMRC. The Finance Act 2016 afforded Her Majesty's Treasury the power to make regulations requiring CbCRs to be included in a group's published tax strategy. The UK government has confirmed that it is keen to achieve an international consensus for a public model of this kind before exercising its powers to make such regulations, and the OECD remains in the process of international public consultation on its CbCR and BEPS Action 13 guidelines.

Evidence gathering

HMRC's governance process plays a key role in shaping how transfer pricing investigations are conducted. For any settlement to be approved by HMRC's governance process, the HMRC case team must conduct a comprehensive fact-finding exercise.

Interviews

In addition to carrying out a review of documentary evidence (including email reviews), witness interviews may also be required. Interviews with key business personnel can serve as a useful tool to address any gaps in HMRC's knowledge following a review of the documentary evidence, to verify HMRC's analysis of the material functions and risks in the business, and to assess whether there is any divergence between the related parties' conduct and the terms of the written contracts between them. In addition to speaking with the tax personnel in the business, HMRC is keen to meet with those working at the coalface to get a proper understanding of where they perceive the real value-generating activities of the business to be located. It is fairly unusual for expert witnesses, such as economists, to be engaged by the taxpayer prior to an appeal, but in some cases HMRC may consult its in-house economists.

Depending on the facts and circumstances of a particular enquiry, HMRC may request interviews with third parties outside the taxpayer group, including customers. To avoid any undue business disruption, it is generally accepted that HMRC should try, where practical, to obtain information and documents from the taxpayer concerned before approaching

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third parties. That said, third-party witness interviews can enable HMRC to independently check information provided by a taxpayer and to gain a more holistic picture of the business concerned.

In the case of customers, HMRC will liaise in the first instance with the taxpayer concerned to coordinate the interviews. If the taxpayer or the third party refuses to comply with this informal request, HMRC may decide to issue a third-party information notice that would legally require the customer to give HMRC certain information or documents to help it check the relevant taxpayer's position. Before making a decision, HMRC case teams are advised to consider carefully whether they can be satisfied in any way other than by issuing a third-party information notice. In addition, the approval of the tribunal, or taxpayer consent, is required to issue such a third-party information notice. HMRC cannot require the third party to produce a document that is not in its possession or power or that is subject to legal professional privilege.

Information exchange powers

If information essential to a transfer pricing enquiry is not within the power or possession of a UK business or its officers, HMRC may consider invoking formal information powers, such as the exchange of information facility with other tax authorities. However, HMRC is expected to exhaust all other sources before invoking such powers. HMRC may use these facilities pursuant to a double tax treaty that contains an exchange of information article, the Joint Council of Europe and OECD Convention on Mutual Administrative Assistance in Tax Matters, various EU directives and regulations (during the Brexit transitional period) and exchange of information agreements.

Exchange of information articles typically restrict HMRC in the specific uses to which it may put the exchanged information it receives and the onward disclosure of that information. The usual rule is that the information can be used only for the purposes of the assessment and enforcement of the taxes covered by the relevant treaty.[11] While transfer pricing will fall within the scope of most double-tax treaties, this may not be the case for DPT since HMRC views DPT as a tax 'in its own right' and not as corporation tax.[12]

IV INTANGIBLE ASSETS

HMRC recognises that the use and transfer of intangible assets represent a material risk area for transfer pricing, particularly in the context of multinationals.

The BEPS Actions 8–10 Final Reports provide revised guidance specifically tailored to determining arm's-length conditions for intangible asset transactions. The revised guidance provides a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles based on the value they create through functions performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (DEMPE). In 2018, the OECD issued guidance for tax administrations on hard-to-value intangible assets.

11 HMRC International Manual (INTM156050).

12 HMRC DPT Guidance (DPT1040).

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Based on recent transfer pricing enquiries involving multinationals in the technology area, it is expected that HMRC will carry out a DEMPE analysis across the global value chain of these multinationals so as to ensure that the transfer pricing resolution accords with the guidance in the BEPS Actions 8–10 Final Reports.

The framework for analysing DEMPE associated risks builds upon existing OECD guidance, which requires one to take into account both the capability to perform relevant 'day-to-day' decision-making functions together with the actual performance of those functions. Legal ownership of intangibles alone does not determine entitlement to returns, so if a member of a multinational group contractually assumes a specific risk but neither exercises control over that risk nor has the financial capacity to assume the risk, the risk should be allocated to another multinational group member that satisfies those requirements. To justify a higher than passive return for a member of a multinational group, it would be necessary to evidence that the member in question has appropriately skilled and qualified employees and resources to manage the economically significant risks associated with the relevant DEMPE functions.

V SETTLEMENTS

The settlement of a transfer pricing enquiry must be approved by the Transfer Pricing Panel or the Transfer Pricing Board, following the submission by the HMRC case team of a resolution report. However, if arrangements have been identified as meeting the conditions for a potential DPT charge, the Diverted Profits Board will consider both the transfer pricing and DPT issues in point. A resolution report will include a summary of the case, a recommendation as to how the case should be settled and a 'statement about culpability'.[13] The statement about culpability is intended to assist the relevant panel or board in assessing whether penalties should be imposed.

The Transfer Pricing Board makes decisions on high-profile or contentious transfer pricing enquiries. It also makes recommendations to the Tax Disputes Resolution Board (TDRB) about transfer pricing risks that fall within the TDRB's remit. In 2018–2019, it considered 29 cases (27 in 2017–2018).[14] The Diverted Profits Board similarly makes recommendations to the TDRB on HMRC's largest and most sensitive cases. In 2018–2019, the Diverted Profits Board considered 41 proposals to resolve DPT issues (16 in 2017–2018).[15]

This governance framework is intended to ensure consistency across taxpayers and provide assurance to taxpayers that HMRC treats taxpayers fairly and even-handedly, irrespective of the size or complexity of the taxpayer or its affairs.

The relevant panel or board will examine the recommendations made in the case team's resolution report. If the settlement is authorised, HMRC will confirm the agreement and its terms in writing to the taxpayer and its advisers. The taxpayer is then afforded a 30-day cooling-off period in which it may withdraw from the agreement before a closure notice or assessment is issued.[16]

13 HMRC International Manual (INTM481060).

14 Tax Assurance Commissioner's Report, pages 100–110 of HMRC's Annual Report and Accounts 2018–2019.

15 ibid.

16 Sections 208 and 209 of TIOPA.

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If the resolution report is not approved, the relevant panel or board will set out the reasons why and the basis upon which the case team should revisit the negotiation or proceed to litigation.[17]

In cases where a settlement has resulted in an adjustment to a taxpayer's returned profits, this may be relied upon to inform the future returning position provided there has been no material change in the circumstances of the business or in the market conditions in those future periods. In such cases, HMRC may provide comfort that the enquiry period will be regarded as low risk. However, HMRC emphasises in its guidance that it cannot provide any assurances that a future return will not be subject to a transfer pricing enquiry. Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process.[18] Certainty will only be achieved, of course, if the critical assumptions arrived at in the APA process remain true. Negotiating these assumptions will often require significant work in any APA discussions.

In certain cases, HMRC will recommend an APA either following a transfer pricing enquiry or during the process. This has the obvious advantage of increasing certainty that the transfer pricing method agreed upon will not be challenged and enables a taxpayer to realise more long-term benefits from the cost, time and effort involved in resolving the enquiry itself – though the critical assumptions on which the APA is based can, of course, mean that the APA falls away whenever the critical assumptions are breached.

VI INVESTIGATIONS

i Process

The way in which a transfer pricing enquiry is conducted will vary from case to case, although once an enquiry has been opened the process generally involves HMRC: making and agreeing an action plan and timeline with the taxpayer; carrying out a fact-finding exercise; assessing the evidence and engaging in technical discussions with the taxpayer; and resolving the enquiry.

A transfer pricing enquiry is undertaken by Large Business Service or Local Compliance case teams headed by their respective Customer Compliance Managers (CCMs). A transfer pricing specialist is allocated to each enquiry. The CCM is responsible for HMRC's relationship with the customer and for the planning and direction of the work of the case team.[19]

Because of the punitive rate of DPT and for the other reasons outlined in Section IX, below, DPT can represent a strong incentive for taxpayers to be open and cooperative with transfer pricing enquiries.

ii Time limits

In most cases, HMRC may open an enquiry into a taxpayer's return within 12 months of the date on which a tax return is filed. Once opened, there is no specified time limit for completing the enquiry, although HMRC's 'Review of Links with Large Business' commits HMRC to resolving transfer pricing enquiries within 18 months for the large majority of

17 HMRC International Manual (INTM483070).

18 HMRC International Manual (INTM483130).

19 HMRC International Manual (INTM481080).

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cases, and 36 months for those that are particularly complex and high risk. In its guidance, HMRC comments that a transfer pricing enquiry should not be opened without the approval of the Transfer Pricing Panel or Transfer Pricing Board. The taxpayer may request HMRC (or the tax tribunal) to close an enquiry if there appears to be an unnecessary delay by HMRC in progressing the case.[20]

Where the 12-month period within which an enquiry must be opened has passed, HMRC has the power to raise a discovery assessment where there has been incomplete disclosure or careless or deliberate conduct by the taxpayer. The time limit for raising a discovery assessment is generally four years from the end of the relevant accounting period to which the assessment relates. This may be extended to six years where the assessment is made to recover an underpayment of tax due to carelessness by the taxpayer (or 20 years where the error in the taxpayer's transfer pricing position was deliberate).[21] The 12-year time limit for assessing offshore cases does not apply to corporate tax.

To conclude a formal enquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend its return.[22] If a taxpayer fails to comply with the contents of the closure notice, HMRC may make a determination as to the amount of tax that it considers is payable by the company.[23] Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.[24]

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days of the notice or assessment being issued.[25]

iii Profit Diversion Compliance Facility

In January 2019, HMRC launched a Profit Diversion Compliance Facility (PDCF) intended to enable multinational enterprises to correct transfer pricing irregularities. The PDCF is targeted at situations in which a multinational enterprise has adopted cross-border pricing arrangements that might trigger a DPT investigation because the arrangements either do not reflect what is happening on the ground or are inconsistent with the OECD Guidelines. An enterprise wishing to use the PDCF must submit a detailed disclosure report of its transfer pricing affairs, including a proposal for the amount of tax, interest and penalties payable to remedy the identified irregularities. By using the PDCF, an enterprise may obtain more control over its interactions with HMRC regarding transfer pricing, avert a future DPT investigation or benefit from lower penalties for profit diversion that has already occurred. HMRC will aim to respond to proposals submitted through the PDCF on an accelerated three-month timescale, though this may be optimistic given the time taken to investigate and resolve recent transfer pricing cases in the UK.[26]

20 Paragraph 33 of Schedule 18 to the Finance Act 1998.
21 Paragraph 46, ibid.
22 Paragraph 32, ibid.
23 Paragraph 36, ibid.
24 Paragraph 39, ibid.
25 Paragraph 48, ibid.
26 HMRC Profit Diversion Compliance Facility Guidance dated 10 January 2019.

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VII LITIGATION

i Procedure

If a transfer pricing enquiry cannot be resolved by agreement, the taxpayer may appeal any final decision by HMRC to the UK's First Tier Tribunal (FTT). The time limit for taxpayers to make an appeal is generally 30 days from the date of such a final decision.

Most appeals will, in the first instance, be considered by the FTT. Where an appeal turns on a particularly complex point of law, without any disputed facts, it may exceptionally be heard by the Upper Tribunal at first instance. Decisions by the FTT may be appealed to the Upper Tribunal on a point of law. Upper Tribunal decisions create legally binding precedents.

As a public body, a taxpayer may seek judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if, for example, it believes an HMRC officer has failed to properly carry out his or her duties or misdirected the taxpayer, and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims. In *R (Glencore Energy UK Ltd) v. HMRC*,[27] the taxpayer received a DPT charging notice and sought judicial review of the notice, arguing that the statutory appeal process was 'slow, inappropriate and ineffective'. Unsurprisingly, given the very high threshold required for a judicial review case to succeed, the High Court refused this application and the Court of Appeal reached the same conclusion, going on to determine that none of taxpayer's grounds for judicial review would have succeeded in any event.

The process to prepare for a transfer pricing hearing is the same as for any other tax litigation. The timeline for any given tax trial will vary according to the complexity of the dispute in question. Economists or businesspeople may give expert evidence, though there is little established practice in this regard due to the dearth of transfer pricing cases in the UK (see below).

A court decision may be appealed where permission has been granted. Appeals from the FTT must be applied for within 56 days of the tribunal decision. Appeals from the Upper Tribunal and the Court of Appeal must be applied for within one month and 28 days, respectively. Appeals against the decisions of lower tribunals or courts can generally be made only on a point of law. However, if a party believes that the findings of fact made by the lower court or tribunal are such that no judge properly could have come to that determination, an appeal may be permitted on those wider grounds.

ii Recent cases

Very few transfer pricing cases have been litigated in the UK.

DSG Retail Ltd v. HMRC[28] is one of the few substantive transfer pricing cases to have reached the tribunal. This case concerned a UK company that sold electrical goods. It encouraged customers to purchase extended warranty agreements. The liability to customers under those warranty agreements was insured or reinsured by an associated Isle of Man company via a third-party insurer. The tribunal considered the extent to which transfer pricing

27 [2017] EWHC 1476 (Admin); [2017] EWCA Civ 1716.

28 SpC [2009] SSCD 397.

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rules apply to the indirect provision of a business facility between connected companies where there is no contractual relationship between those companies, and the appropriate transfer pricing methodology for an adjustment.

The tribunal held that the UK company had provided an indirect business facility to its Isle of Man subsidiary, by enabling the subsidiary to enter into commercially advantageous insurance contracts with a third-party insurer. The tribunal further held that, if the UK company and its Isle of Man subsidiary had been dealing at arm's length, the subsidiary would have remunerated its parent for the provision of that business facility, thereby increasing the UK company's taxable profits.

More recently, several cases, especially *Union Castle Mail Steamship v. HMRC*, have considered whether shareholder transactions such as bonus issues are subject to adjustment on transfer pricing groups (see Section I.i, above).

VIII SECONDARY ADJUSTMENT AND PENALTIES

i Secondary adjustments

The UK government launched a consultation in 2016 on whether a secondary adjustment rule should be introduced into the UK's transfer pricing legislation and how that rule would be designed. These proposals have not been taken forward, though no response to the consultation has ever been published.

ii Penalties

HMRC may impose penalties if an incorrect return is made and a taxpayer has been careless or negligent in establishing an arm's-length basis for the return; or a taxpayer does not maintain adequate records.[29] Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an enquiry.[30]

Tax-geared penalties apply for inaccuracies in tax returns and documents submitted to HMRC. This means that they are calculated as a percentage of the tax that is due. The percentage will depend on a number of factors, including, among others, whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed; whether the disclosure was prompted or unprompted; and the quality of disclosure.

Given that transfer pricing is more of an art than a science and identifying an arm's-length price is a matter of judgement, it can be difficult to determine what is meant by 'careless' or 'negligent' in a transfer pricing context. While each case must be judged on its own merits and facts, HMRC provides some examples in its guidance on how it interprets these concepts. For example, where HMRC is satisfied that the taxpayer has made an honest and reasonable attempt to comply with the arm's-length principle, no penalty should apply.[31]

29 HMRC International Manual (INTM483110).
30 Part 7 of Schedule 36 to the Finance Act 2008.
31 HMRC International Manual (INTM483120).

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IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

DPT was introduced from 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements.[32] It is intended to provide the transfer pricing legislation with a little more steel to support HMRC enquiries in high-risk transfer pricing areas (such as the digital economy and IT). The expectation is that this, in turn, will encourage better transfer pricing compliance, and greater transparency with HMRC in dealing with transfer pricing enquiries.

Broadly speaking, a DPT charge can arise in two scenarios: first, where a UK subsidiary or permanent establishment enters into arrangements with a related person where that person or the arrangements lack economic substance, resulting in a reduction in taxable profits; or second, where a person carries on an activity in the UK connected to the supply of goods, services or other property made by a non-UK resident company in the course of its trade in a way that avoids creating a UK permanent establishment. The amount of DPT payable is 25 per cent of the amount of 'taxable diverted profits'.[33] (An error in the DPT legislation meaning that both DPT and corporation tax were technically payable on the amount of taxable diverted profits was corrected in 2019, such that profits charged to DPT are excluded from corporation tax to avoid double taxation.)

In most cases, any DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can accelerate resolution of a transfer pricing enquiry for the following reasons: the DPT rate is considerably higher than the UK corporation tax rate; it is not possible to postpone any DPT payment once a charging notice has been issued; and DPT gives credit for transfer pricing adjustments only if they are made before DPT is assessed.

In 2018–2019, HMRC issued 203 DPT preliminary notices to 11 businesses and 204 DPT charging notices to 13 businesses. HMRC reported that the amount raised from DPT charging notices themselves during the 2018–2019 financial year was only £12 million, though most of the DPT revenue impact comes through transfer pricing adjustments and changes in taxpayer behaviour.[34]

ii Double taxation

Most of the UK's tax treaties have effective mutual agreement procedures (MAPs). These provisions typically permit HMRC to engage in MAP but do not require the case in question to be resolved. Consequently, there is no guarantee of relief from double taxation under MAP. That said, the UK is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments. HMRC resolved 95 MAP cases in the 2018–2019 financial year.[35]

EU Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises may provide an alternative to the MAP procedure where residents of EU Member States are potentially subject to double taxation. MAP may be invoked under a treaty, under the EU Convention or under both simultaneously. While the UK will not cease to be a party to the EU Convention by virtue of

32 HMRC DPT Guidance (DPT1000).

33 Section 79 of the Finance Act 2015.

34 Transfer Pricing and Diverted Profits Tax Statistics, to 2018–2019.

35 ibid.

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Brexit, the territorial scope of the EU Convention is defined by reference to EU membership. Therefore, the UK will fall outside the territorial scope of the EU Convention following the end of the Brexit transitional period. Until then, however, the UK continues to implement EU arbitration provisions, implementing the Double Taxation Dispute Resolution (EU) Regulations in February 2020. It is not clear what (if any) new arrangements the UK will seek to put in place with the EU27 post-Brexit.

MAP is not an alternative to the normal transfer pricing enquiry process. An enquiry will not be conducted as part of MAP and, equally, MAP will not suspend or replace an enquiry. A taxpayer cannot pursue domestic legal remedies and MAP concurrently. If a case is accepted for MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay MAP until these remedies are exhausted.[36]

Part VI of the OECD multilateral instrument enables countries to include mandatory binding arbitration (MBA) in their double tax treaties. MBA applies only between countries that expressly choose to apply it to their double tax treaties. Twenty countries (including the UK) have committed to adopt and implement MBA. These provisions will provide taxpayers with certainty that a case submitted to MAP will be resolved.

HMRC is of the view that DPT is a separate, stand-alone charge on diverted profits and is not income tax, capital gains tax or corporation tax. Consequently, HMRC would not make it the subject of a bilateral APA or enter into MAP discussions concerning it. This is another reason why it is important to agree transfer pricing disputes before disputing DPT.

iii Consequential impact for other taxes

VAT

Where a business records its transactions with related parties on arm's-length terms, no transfer pricing issues should typically arise in respect of those transactions for VAT purposes. Further, HMRC is of the view that balancing payments do not in themselves create taxable supplies for VAT purposes. However, the existence of a transfer pricing adjustment or the payment or receipt of a balancing payment may indicate that the value of a previous VATable supply has been understated so that a VAT correction may be required.[37]

Where the advantaged party and the disadvantaged party are within the same VAT group at the time of the original supply and subsequent adjustment, no VAT liability would normally arise.[38]

If a balancing payment is made conditional by one party in return for another VATable supply, it may, depending on the particular circumstances, be considered (in whole or in part) as non-monetary consideration so that an open market value direction under Schedule 6 of the Value Added Tax Act 1994 may be appropriate.[39]

36 HMRC Statement of Practice 1/2018.

37 HMRC VAT Valuation Manual (VATVAL 15700).

38 ibid.

39 HMRC VAT Valuation Manual (VATVAL 15800).

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Import and customs duties

Similar issues arise in relation to the interaction of the transfer pricing rules with import and customs duties. Balancing payments may have to be considered in ascertaining whether there has been an under- or overvaluation of the import price of a particular transaction and, therefore, in determining whether an adjustment is required.[40]

iv Income tax in respect of intangible property

With effect from April 2019, income tax is charged on income from intangible property received by non-UK residents in low-tax jurisdictions which do not have tax treaties with the UK, to the extent that such income is referable to the sale of goods or services in the UK.[41] Tax is charged on the gross amount of income, rather than on profits.

If the non-UK resident subject to the income tax charge fails to pay, the tax will be recoverable from other entities in the same corporate group (whether or not the other entity is resident or taxable in the UK).[42]

This new income tax charge does not include any arm's-length concept, and applies even if the income is subject to a CFC or GILTI charge higher up the corporate structure. In practice, it is intended to encourage businesses to move intangible property out of low-tax jurisdictions – as most of these countries have recently adopted 'economic substance' requirements, this shift was largely happening anyway.

While this new income tax charge does not fall directly within the scope of the BEPS project, it provides another mechanism to counter circumstances in which multinational enterprises generate significant income from intangible assets through activities in the UK but receive that income in low-tax jurisdictions.

v Digital services tax

From April 2020, the UK has levied a digital services tax on large search engines, social media platforms and online marketplaces. The tax is levied at 2 per cent of the gross revenues attributable to UK users. The Government has said that this will be a temporary measure, which will be removed if and when international agreement is reached on reforming transfer pricing principles to reflect the growing digitalisation of the economy.

X OUTLOOK AND CONCLUSIONS

The chilly atmosphere that seems to have pervaded many UK transfer pricing disputes lately can be attributed to the spectre of DPT, which has emboldened HMRC to adopt an increasingly assertive approach to policing the transfer pricing of what might be considered commercially conventional licencing arrangements or above-market functions, even in cases which taxpayers and advisers (and perhaps also HMRC) would not have imagined to fall within the intended scope of DPT at the time when it was being designed and consulted upon. In transfer pricing enquiries where DPT is arguably at issue, taxpayers will generally aim to achieve resolution on the basis of a transfer pricing adjustment that eliminates any potential charge to DPT, though such an adjustment is still subject to approval by the

40 HMRC VAT Valuation Manual (VATVAL 15900).

41 Chapter 2A of Part 5 of the Income Tax (Trading and Other Income) Act 2005.

42 Sections 608O–608V of the above Act.

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Diverted Profits Board. If (or when) any cases of this kind come before the courts, the judicial approach to interpreting and applying the DPT rules, which is not a straightforward task, will be closely watched.

Taking a wider view, the UK transfer pricing landscape continues to be reshaped by international tax reform efforts led by the OECD. The original BEPS project increased focus on the functional analysis in applying the transfer pricing rules in the UK, to ensure that transfer pricing outcomes are aligned with the individuals involved in value creation. The much-anticipated OECD Transfer Pricing Guidance on Financial Transactions, published in February 2020, may influence HMRC's approach in subtler ways.

More profound change is potentially around the corner, in the form of the OECD's Pillar One and Pillar Two proposals. It is already clear that the challenge of integrating the conceptual and practical framework of Pillar One (and, to a lesser extent, Pillar Two) with conventional approaches to transfer pricing, and navigating the areas of overlap, will open up new perspectives on fundamental tenets of transfer pricing, in the UK no less than elsewhere.

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Appendix 1

ABOUT THE AUTHORS

STEVE EDGE

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Steve Edge, who qualified with Slaughter and May in 1975, acts for clients across the full range of the firm's practice.

Steve advises on the tax aspects of private and public mergers, acquisitions, disposals and joint ventures and on business and transaction structuring (including transfer pricing in all its aspects) more generally. He also advises many banks, insurance companies, hedge funds and others in the financial services sector in a wide range of areas.

In recent years, Steve has been heavily involved in several large-scale interventions under HMRC's high-risk corporates programme and in many in-depth tax investigations of specific domestic or international issues including transfer pricing in particular. He thus has considerable experience of negotiating and dealing with HMRC at all levels.

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Dominic Robertson advises a wide range of clients on all areas of UK corporate tax law. He is co-head of the firm's tax disputes practice.

Dominic's expertise covers structuring and other tax aspects of M&A, joint ventures and other corporate finance transactions; tax enquiries and disputes, including EU tax state aid investigations; and standalone tax advisory work, including group reorganisations, CFCs, transfer pricing and the tax treatment of IP.

TOM GILLIVER

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Tom Gilliver is an associate at Slaughter and May. His practice covers all direct taxes, stamp duties and value added tax, with a strong focus on corporation tax. In addition to advising on corporate transactions (including mergers, acquisitions and group reorganisations), Tom has experience of advising on transfer pricing and diverted profits tax disputes with HMRC.

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