THE UK's TRANSFER PRICING REGIME

Recent Developments

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- Current legislation introduced in 1999 to coincide with the introduction of corporation tax self-assessment:
  - ➢ Shifted the burden of compliance from HMRC to companies
- 2004 rules revised to include UK to UK transactions and to incorporate thin capitalisation rules
- The UK's transfer pricing rules are based on the OECD model Tax Convention and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

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Summary of Rules

- Apply to transactions between persons (companies, partnerships, individuals in business, trusts) where one person has direct or indirect participation in management and control or in the capital of the other
- Recent new rules have extended the "control test" to cover persons acting together in relation to certain finance agreements
- Exemption for small and medium sized companies (as defined by the Annexe to the 2003 EC recommendations 2003/361/EC

Size	Headcount	Turnover	Balance sheet (gross)
Medium	Not more than 250	Not exceeding €50m	Not exceeding €43m
Small	Not more than 50	Not exceeding €10m	Not exceeding €10m

- Test looks at headcount and one of the two other thresholds being exceeded
- Need also to consider "linked" and "partner" enterprises in calculating totals

- SME exemptions do not apply where:
  - Taxpayer makes an election
  - The UK person is transacting with an entity which is not in a qualifying territory
- Qualifying Territories are:
  - Countries with DTT with UK with non-discrimination provisions
  - Other countries with DTT with UK and designated as qualifying by HMRC
- Transactions with “tax haven” jurisdictions therefore are excluded from SME exemption and are subject to transfer pricing rules

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HMRC’s power to adjust tax computations

- HMRC may adjust the tax on UK taxpayer’s profits and losses to reflect those which would have arisen had the transaction been on arm’s length terms
- Corresponding adjustment in associated entities for UK residents
- Burden on business:
  - Businesses required to determine their transfer pricing policy and methodologies and to collect information on comparables
  - Can be difficult in unstable or recessionary cycles
  - Required to keep records and “evidence” of pricing methodology for at least six years
- Penalty for failure equivalent to 100% of tax lost

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HMRC Approach

- HMRC established a transfer pricing group in April 2008 as a specialist group to target enquiries
- No focus on particular industries
- Audits are triggered by Local Tax Office Compliance Officers who are trained to identify certain risks and indicators which might trigger an enquiry

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Risk Factors

- Factors include the “value of the tax” risk, “behaviour” risk and “complex transaction” risk
- HMRC look for specific indicators such as commercial relationships with related parties in low tax jurisdictions; costs sharing arrangements without commensurate income flows; expenditure on assets (such as IP) used by other group members
- From April 2009 HMRC has introduced a new, more stringent penalties regime which increases the risk to companies that do not comply with the transfer pricing regulations

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Inter-company debt

- Financial transactions are included in the transfer pricing rules
- Companies must consider:
  - Whether the loan would have been made were it not for the connection
  - The amount of the loan without the connection
  - The rate of interest and other terms
  - Debt-equity ratio
  - Interest cover

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UK new worldwide debt cap

- Introduced as of 1 July 2009
- Part of reform of UK taxation of foreign profits including exemption on foreign dividends
- Applies only where the UK group companies are members of a "large" worldwide group (EU definition) which prepares consolidated account
- Restricts allowable UK finance expenses to a proportionate amount of the external debt acquired by the group as a whole

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Features

- Exemptions if UK company's "net financing deduction" is less than £500,000
- Targeted anti-avoidance rules
- Group Treasury companies can elect to be taken outside the debt cap rules
- Gateway test: where the UK total net debt of the worldwide group does not exceed 75% of the gross debt from the group's consolidated accounts. No restriction if under gateway
- Transfer pricing rules take priority to the debt cap rules

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