74.

United Kingdom

Introduction

In recent years, the most significant change has been the introduction by Her Majesty's Revenue and Customs (HMRC) (the successor to the Inland Revenue) of a new framework for handling all transfer pricing enquiries. The Transfer Pricing Group (TPG) was introduced in April 2008, and all enquiries are now subject to its governance and procedures (*see Tax audits, below*).

Transfer pricing disputes in the United Kingdom (UK) are usually resolved by negotiation between HMRC and the taxpayer. Until recently, there was little case law, but in 2009 the tax tribunal found in favour of HMRC in *DSG Retail and others v HMRC*, the UK's first substantive transfer pricing case (*see Legal cases, below*).

A large amount of guidance material is published by HMRC on its interpretation of the law and how it assesses transfer pricing risks. This is in HMRC's International Manual, which is available to the public via the HMRC website (www.hmrc.gov.uk) (*see Other regulations and guidance, below*).

Tax and Reputation

During late 2012 the House of Commons Public Accounts Committee (PAC) launched investigations into tax avoidance by multinational companies. In particular this focused on examples of three high profile inbound multinationals which were seen to have implemented structures which resulted in those companies not paying their fair share of corporation tax due to the transfer pricing arrangements that these companies had in place. This has raised the profile of transfer pricing as an issue in the media and has led to a national debate on the morality of taxation. The resulting potential for reputational damage as a result of this increased media and public scrutiny on transfer pricing means that multinationals should give greater consideration to how their tax strategy is communicated externally to interested stakeholders. Whereas in the past, such stakeholders would have been limited to shareholders and HMRC, this list may now have expanded to customers, employees, regulators and other government departments.

Statutory rules

The UK's current transfer pricing rules – TIOPA 2010, Part 4 – were enacted in February 2010 and took effect for all accounting periods ending on or after 1 April 2010. TIOPA 2010 represents a restatement of the previous rules which were contained in ICTA 1988, Schedule 28AA, including later amendments, and which took effect for all accounting periods ended on or after 1 July 1999. TIOPA 2010 was part of the UK government's tax law rewrite project to update and consolidate a wider body of personal and corporate tax legislation.

The UK rules are widely drafted and are intended to cover almost every kind of transaction. Since 1 April 2004, the rules have applied to UK-to-UK transactions, and thin capitalisation rules have been brought wholly within the transfer pricing regime (*see Thin capitalisation, below*).

Self-assessment

UK enterprises are required to self-assess their compliance with the arm's-length principle in filing tax returns. Where an enterprise would have lower taxable profits or greater allowable losses calculated on the basis of the actual provision for the transaction as shown in their accounting records than if calculated on the basis of the arm's-length provision, it is regarded as an 'advantaged person'. Such companies and partnerships must identify and make transfer pricing adjustments when submitting their tax returns under self-assessment. An important implication of this approach is the potential for interest and penalties for 'carelessness'. Penalties are discussed at *Additional tax and penalties section*, below.

The rules apply a 'one-way street' approach. Taxpayers are required to make transfer pricing adjustments where these result in increased taxable profits or reduced allowable losses in the UK, but are not permitted to make adjustments that result in decreased taxable profits or greater allowable losses. A decrease in the taxable profits or increase in allowable losses of the UK enterprise may be effected only through the operation of the competent authority procedures of the relevant double tax agreement (DTA) or, in the case of a UK-to-UK adjustment (*see below*), through a 'compensating adjustment'. This allows a 'disadvantaged person' involved in the transaction to calculate their tax on the same basis by making a 'compensating adjustment' to their taxable profits or losses. Such an adjustment can be made only by a disadvantaged person, and can be made only in respect of a transaction where a transfer pricing adjustment has been made by an advantaged person.

The participation condition

The legislation applies to transactions where the 'participation condition' is met. This is widely defined in the legislation but generally means a transaction or series of transactions involving entities where one party controls the other, or both parties are under common control. The parties exerting control may include companies, partnerships and, in certain circumstances, individuals.

'Control' for the purposes of this legislation is defined in CTA 2010, Section 1124 (formerly ICTA 1988, Section 840). It is important to note that control is not confined to situations where one party is the majority shareholder in the other. Effectively, control exists where one party has the power to ensure that the affairs of another party are conducted in accordance with the first party's wishes.

The concept of control set out in CTA 2010, Section 1124 is subject to important extensions for transfer pricing purposes under TIOPA 2010, Part 4 (and formerly ICTA 1988, Schedule 28AA):

- The rules apply to many joint venture companies where two parties each have an interest of at least 40%.
- Attribution rules are used to trace control relationships through a number of levels in determining whether parties are controlled for the purposes of the transfer pricing rules.

Further changes known as the ‘acting together’ rules affecting financing deductions were made with effect from 4 March 2005. These changes were triggered by structures adopted by private equity houses but have wide-ranging effect beyond private equity (*see Thin capitalisation, below*).

Concept of ‘provision’

The legislation uses the concept of ‘provision made by means of a transaction or a series of transactions’ to describe the situations to which the legislation applies. Provision is undefined within the legislation, although it is understood that the use of the term is intended to allow the wider consideration of all the terms and conditions surrounding a transaction or series of transactions in deciding whether it has been conducted at arm’s length. According to HMRC, ‘provision’ is broadly analogous to the phrase ‘conditions made or imposed’ in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention and embraces all the terms and conditions attaching to a transaction or series of transactions. While it might be argued that the term ‘provision’ is arguably wider than the phrase ‘conditions made or imposed’, HMRC takes the view that the scope of the UK legislation can be no wider than the scope of Article 9, as informed by the OECD Transfer Pricing Guidelines.

In a recent tax case, *DSG Retail and others v HMRC (TC00001)*, the tribunal accepted a broad interpretation of the term ‘provision’, in line with Article 9 of the OECD Model Tax Convention, which refers to ‘conditions made or imposed between two enterprises’. The court also accepted that a provision may exist where there is no formal or enforceable conditions (e.g. a contract), accepting that Schedule 28AA (the applicable legislation in the case), which refers to ‘informal arrangements and understandings’, applied (*see Legal cases, below*).

OECD Guidelines

The legislation is drafted to explicitly require that the rules be ‘construed in such manner as best secures consistency’ between the domestic legislation and Article 9 of the OECD’s Model Tax Convention and the OECD Guidelines. Legislation was passed in Finance Act 2011 to update the definition of ‘the transfer pricing guidelines’ to refer to the revised OECD Guidelines published in July 2010. As a result, from 1 April 2011, HMRC will use the 2010 OECD Guidelines in analysing a company’s transfer prices (although the changes will influence HMRC thinking for prior years as well, for example in the area of comparability).

Branches and permanent establishments

TIOPA 2010, Part 4 (and formerly ICTA 1988, Schedule 28AA) cannot be applied to dealings between a branch or permanent establishment and the company of which it is a part, since the two are not separate legal entities. Instead, other sections of the legislation as well as the ‘Business Profits’ article of the relevant DTA operate to tax the appropriate amount of profit in the UK. In the case of an overseas branch or permanent establishment of a UK company, the profits of the branch were taxed as part of the profits of the UK company, until the introduction of the exemption of foreign branches as part of the latest corporate tax reform programme. In the case of a UK branch or permanent establishment of an overseas company, income arising directly or indirectly through or from the branch remains taxable in the UK under CTA 2009. The transfer pricing rules in TIOPA 2010, Part 4 can of course be applied to transactions involving related parties of the legal entity to which the branch or permanent establishment belongs. Hence, an overseas associated company of a UK company is also a related party in relation to an overseas branch or permanent establishment of that UK company, and TIOPA 2010, Part 4 could be applied to transactions between the two overseas enterprises.

Secondary adjustments
HMRC does not make secondary adjustments, such as deemed distributions or deemed capital contributions, when it makes a transfer pricing adjustment, as there is no basis in UK law for such adjustments.

Where the primary adjustment is made by a treaty partner, HMRC considers the merits of claims to deduct interest relating to the deeming of a constructive loan by a treaty partner following a transfer pricing adjustment. The claim would, however, be subject to the arm's-length principle and would be considered in the light of relevant provisions relating to payments of interest.

Where a treaty partner applies a secondary adjustment by deeming a distribution to have been made, this is now normally exempt from tax in the UK under the recently introduced dividend exemption rules. Any withholding tax on the deemed dividend would likewise not be eligible for relief in the UK.

UK-to-UK transfer pricing
When it was originally enacted, ICTA 1988, Schedule 28AA included an exemption for UK-to-UK transactions, subject to certain restrictions. With effect from 1 April 2004, the government removed the exemption for UK-to-UK transactions from the transfer pricing legislation, primarily due to its concern that the existing rules might be held to be in breach of the Treaty of Rome, now the Treaty on the Functioning of the European Union (TFEU).

As there is no consolidated tax return in the UK, the UK-to-UK transfer pricing potentially has an impact where there is tax at stake, either because of particular tax planning arrangements or where some more routine aspect of the tax system (such as losses in one company in the group which cannot be offset) means that there is tax to be collected. One particular area where the amended rules have an effect is where no charge is currently made, for example, for services or for the use of assets (including intellectual property).

However HMRC has no great desire to tie up resources investigating UK-to-UK transactions where the tax risk is low and experience of the level of such enquiries by HMRC since UK-to-UK rules were introduced generally supports this. Additionally, there is a corresponding adjustment mechanism to effect relief on the counter side of a UK-to-UK transaction for which an adjustment has been assessed.

Concessions and exemptions
There are limited exemptions from the UK transfer pricing rules for small- and medium-sized enterprises (SMEs), where the definition of SMEs is assessed at a group level. Groups with more than 250 employees, turnover of more than 50 million euros (EUR) or a balance-sheet worth of more than EUR 43 million do not qualify for the exemption, nor do SMEs entering into transactions with a tax-haven entity. Because denomination of these thresholds are in euros (as the definition of SMEs is an EU one), exchange rate movements may have an impact on a given SME group's qualification for exemption from the transfer pricing rules from one year to the next. The exemption does not apply where the enterprise has transactions with or provisions which include a related enterprise in a territory with which the UK does not have a double tax treaty

with an appropriate nondiscrimination article. Such transactions remain subject to the UK's transfer pricing rules.

HMRC has also reserved the right to direct that the rules apply to medium-sized companies where it considers that transfer pricing has been manipulated egregiously.

Other regulations and guidance

HMRC manuals are prepared for internal use by the tax authority and are updated periodically. They are also publicly available, including online versions accessible on the HMRC website. In general, these manuals provide a detailed description of how the tax authority interprets the existing legislation and a rationale and explanation of its development. The International Manual contains guidance on the principles of double taxation relief, an introduction to DTAs and guidance on controlled foreign companies (CFCs) legislation, guidance on transfer pricing, cross-border financing and thin capitalisation legislation, and practical advice to HMRC officials on conducting enquiries in these areas.

The transfer pricing sections of the International Manual were substantially rewritten in 2012 in order to make this guidance more clear, and to ensure that the manual was consistent in the messages that it gave. In terms of transfer pricing, the International Manual provides guidance on the factors HMRC should consider when applying the legislation, such as the circumstances indicating the presence of potential transfer pricing issues to address and matters to consider when deciding whether to pursue an enquiry and how enquiries are to be progressed through the TPG governance framework. The manual contains training and instructional material aimed at specialists in the TPG and at HMRC staff in local offices who are part of the team dealing with transfer pricing enquiries. The practical guidance on transfer pricing covers the following main areas:

- Governance.
- Risk assessment.
- Working an enquiry.
- Examining TP reports.
- Gathering evidence.
- The interaction with direct taxes.

In addition, HMRC has issued statements of practice relating to advance pricing agreements (APAs), advance thin capitalisation agreements (ATCAs) and mutual agreement procedures. These statements also explain how HMRC interprets the relevant UK legislation and views its obligations under income tax treaties and how it applies these in practice.

Legal cases

Until recently, the few cases brought before the courts on transfer pricing issues in the UK had largely concerned procedural and interpretative issues rather than the substantive application of the rules. The early case law, such as *Watson v Hornby* (1942), *Sharkey v Wernher* (1955) and *Petrotim Securities Ltd v Ayres* (1963), established the principle of arm's-length prices for transactions between related parties as now embodied in the legislation. Two more recent cases are of importance in the interpretation and application of the legislation which preceded ICTA 1988, Schedule 28AA.

Ametalco UK v IR Commrs (1996)

The facts of Ametalco concerned the nature of the transactions to which the transfer pricing legislation could be applied. The UK company had, at the request of its parent, advanced an interest-free loan to a related company. Under the provisions of ICTA 1988, Sections 770 to 773, the tax authority claimed the right to impute notional interest on the loan and tax the consequent notional income in the hands of the UK lending company.

The Revenue maintained that the legislation applied to all types of transaction, including loans or advances of money, and, in its view, this type of transaction was covered by ICTA 1988, Section 773 as a business facility of whatever kind. Various arguments to refute this position were advanced by the taxpayer, but these were rejected by the Special Commissioners who decided in favour of the Revenue.

This case was important in relation to the old legislation, since it clarified the position with regard to the applicability of the legislation to loans and interest in general, and interest-free loans in particular.

Glaxo Group Ltd v IR Commrs (1995)

In *Glaxo Group Ltd*, several companies in the Glaxo group had many years of open (unagreed) assessments as a result of unresolved appeals. The Revenue suspected that the companies had been engaged in transactions with related parties on a non-arm's-length basis and sought to increase the open assessments to reflect transfer pricing adjustments.

Glaxo contended that transfer pricing adjustments had to be effected by raising new assessments and not by amending existing open assessments. There was then a six-year time limit on new assessments (except in cases involving fraud or negligence) and this would have limited the adjustments the Revenue could make. It was held by the Special Commissioners that transfer pricing adjustments could be made to the open assessments.

Special Commissioners decision – Waterloo plc and other v IR Commrs (2001)

In this case, the Special Commissioners considered the transfer pricing rules in connection with the costs associated with the operation of international share plans by Waterloo plc (the name of the company was made anonymous in the published judgment). The Special Commissioners held that Waterloo plc should be taxed as if it had charged a fee to its overseas subsidiaries for providing share benefits to their employees, and that an upward adjustment to Waterloo's taxable profits should be made under the transfer pricing rules.

The Special Commissioners decided that providing the ability for the employees of the subsidiaries to participate in the option arrangements was a 'business facility'. The Special Commissioners accepted that the options were remuneration for the employees. The parent company therefore provided some of the remuneration of employees of the subsidiaries, by means of the totality of the arrangements. Provision of remuneration to the subsidiaries was the valuable business facility in question.

The business facility was made directly to the subsidiaries employing the individuals who participated in the option arrangements. ICTA 1988, Section 770 as amended by Section 773(4) required a 'giving' of facilities to a recipient – not a clear transaction with a sale and a purchaser – therefore, there was no need to identify a transaction directly between the parent and the subsidiary. The Special Commissioners decided that there was a clear, valuable benefit from the share scheme to the subsidiary employing the relevant employees, and the value of that benefit was capable of being calculated. On a wider level, the case provides a presumption that ICTA 1988, Section 773(4) allowed the Revenue to tax the total facility provided intra-group and did not require a transaction-by-transaction analysis: "the phrase 'business facility' is a commercial not a legal term, and … that where a commercial term is used in legislation, the test of ordinary business might require an aggregation of transactions which transcended their juristic individuality" (paragraph 57 of the published decision).

Following this reasoning, Waterloo plc failed in its argument that ICTA 1988, Section 770 did not apply because the transactions took place between persons not under common control (i.e. the share scheme trustee and Waterloo plc).

The Revenue issued guidance on its view of this case and, subsequently on the application of the arm's-length principle to share plans in light of the accounting rules for share-based payments under IFRS, which apply to accounting periods beginning on or after 1 January 2005.

In addition to these court cases, appeals on transfer pricing – which are now heard in the first instance by the tax tribunals rather than the Special Commissioners – create a rebuttable presumption on the interpretation of the legislation and can establish the facts of a case and the transfer pricing methodologies that should be applied.

Tax tribunal decision – DSG Retail and others v HMRC (TC 00001) (2009)
This case was the first UK litigation in which issues of transfer pricing methodologies and the application of the OECD Transfer Pricing Guidelines was heard in detail.

This is widely known as the Dixons case because it concerns the sale of extended warranties to third-party customers of Dixons, a large retail chain in the UK selling white goods and home electrical products. The DSG group captive (re)insurer in the Isle of Man (DISL) insured these extended warranties for DSG's UK customers. Until 1997 this was structured via a third-party insurer (Cornhill) that reinsured 95% on to DISL. From 1997 onwards the warranties were offered as service contracts that were 100% insured by DISL. The dispute concerned the level of sales commissions and profit commissions received by DSG.

The First Tier Tax Tribunal rejected the taxpayer's contentions that the transfer pricing legislation did not apply to the particular series of transactions (under ICTA 88 Section 770 and Schedule 28AA) – essentially the phrases 'facility' (Section 770) and 'provision' (Schedule 28AA) were interpreted broadly so that there was something to price between DSG and DISL, despite the insertion of a third party and the absence of a recognised transaction between DSG and the other parties involved.

The tribunal also rejected potentially comparable contracts that the taxpayer had used to benchmark sales commissions on similar contracts on the basis that the commission rate depended on profitability, which itself depended on the different level of loss ratios expected in relation to the products covered. A much more robust looking comparable provider of extended warranty cover offered as a benchmark for the market return on capital of DISL was also rejected owing to its differing relative bargaining power compared to DISL. This third-party re-insurer was considered to be a powerful brand providing extended 'off-the-shelf' warranty cover through disparate distributors – the tribunal noted that DSG had a strong brand, powerful point of sales advantage through access to customers in their shops and could easily have sourced the basic insurance provided by DISL elsewhere.

The overall finding of the tribunal was that, to the extent that 'super profits' were available, these should be distributed between the parties according to the ability of each party to protect itself from normal competitive forces and each party's bargaining power. The tribunal noted in this context that DISL was entirely reliant on DSG for its business. According to the facts of this case, the super profits were deemed to arise because of DSG's point-of-sale advantage as the largest retailer of domestic electrical goods in the UK and also DSG's past claims data. DISL was considered to possess only routine actuarial know-how and adequate capital, both of which DSG could find for itself.

As a result, the tribunal thought that a profit-split approach was the most appropriate, whereby DISL was entitled to a market return on capital, with residual profit over and above this amount being returned to DSG via a profit commission.

This decision is important in an understanding of HMRC's approach to transfer pricing and to future litigation in this area. It offers valuable insights into consideration of:

- The level of comparability demanded to support the use of comparable uncontrolled prices.
- Selection of the appropriate 'tested party' in seeking to benchmark a transaction.
- The importance of bargaining power.
- The tribunal's acceptance and approval of profit split as the most appropriate methodology.
- HMRC's expectation that a captive insurer that is underwriting 'simple' risks, particularly where the loss ratios are relatively stable and predictable, and that does not possess significant intangibles or other negotiating power, should not expect to earn more than a market return to its economic capital.

It is debatable whether this success in the tribunal will encourage HMRC to take more transfer pricing cases to litigation. Litigation is a costly process for both sides, and subsequent cases may not go as well as this case did for HMRC. At present there does not appear to be a pipeline of transfer pricing cases in the UK awaiting litigation, indeed, all the indications are HMRC will be keener to resolve disputes with taxpayers on a more collaborative basis and will be more inclined to take cases to facilitative mediation rather than litigation (*see Anticipated developments in law and practice, below*).

Burden of proof

Under the UK's current legislation, the burden of proving that transfer prices are at arm's length falls on the taxpayer. The act of submitting the return under self-assessment implicitly assumes that the taxpayer has made all necessary adjustments to taxable profits to take account of non-arm's-length pricing.

Where HMRC considers there has been tax revenue lost as a result of negligence or carelessness (for accounting periods ending on or after 1 April 2009), the burden of proving that this was a result of the taxpayer's negligence or carelessness, rather than for the reasons given by the taxpayer, falls on HMRC.

Tax audits

Under self-assessment, a company submits a corporation tax return and its statutory accounts, with a due date for submission normally within 12 months after the end of the accounting period to which the return relates. HMRC may commence an enquiry into the return by issuing a formal notice by the local tax inspector with responsibility for the company, within specified time limits. Once an enquiry has been initiated, the scope may extend to anything covered in the tax return, including transfer pricing. HMRC is not obliged to state reasons for initiating an enquiry.

Transfer pricing enquiry governance and management

In 2008, HMRC revised its practices and procedures through the introduction of the Transfer Pricing Group, largely to achieve the objectives set out in the Varney Report on Links with Large Business. Specifically, HMRC aims to provide greater certainty, an efficient risk-based approach to dealing with tax matters, a speedy resolution of issues and greater clarity through effective consultation and dialogue.

In specific relation to transfer pricing, HMRC stated that it aims to conclude most enquiries within 18 months, with only the most high-risk and complex cases taking 36 months. The introduction of the TPG and its governance framework together with resources available to the transfer pricing teams dealing with enquiries is intended to enable HMRC to deliver this objective.

Transfer pricing team

Working enquiries on a team basis marks a significant change from HMRC's previous approach to transfer pricing. The size and make-up of a transfer pricing team is dependent on the scale and complexity of the enquiry. The team is usually led by the HMRC customer relationship manager (CRM) of the business and consists of other members of the case team working for the CRM as well as members from various disciplines, including at least one transfer pricing specialist from the TPG.

The TPG consists of dedicated transfer pricing specialists based in the Large Business Services or in Large and Complex (part of Local Compliance) and other specialists, such as economists, systems analysts and specialist investigators. The role of the transfer pricing specialist is to support the team as appropriate, from providing specialist advice to hands-on involvement.

Practices and procedures

When the TPG was set up, each enquiry or potential enquiry to which the transfer pricing governance applied was subject to a process involving five stage gates consisting of the business case, enquiry decision, action plan, six monthly review and resolution review. HMRC has since streamlined this approach into three stages. These stages aim to provide a structured and consistent approach in relation to the management and governance of enquiries.

The three stages of TP Governance are:

- Making sure the selection of a case is appropriate.
- Ensuring there is effective progress in a case.

- Reaching the appropriate conclusion in a case

HMRC has stated that all three aspects are essential to the process and all are mandatory for HMRC case officers. Therefore, the selection stage will require that a business case is made, and approved, before an enquiry is commenced. The second, progress, stage brings together the former action plan requirement and the progress review requirement into one ongoing review process which is linked, where appropriate, through a new template to existing casework control mechanisms in place within HMRC. The resolution phase is unchanged from the old stage gate five in requiring approval for any settlement proposals.

Triggers for a transfer pricing enquiry

HMRC identified the following risk areas that are most likely to trigger a full transfer pricing enquiry:

- The existence of tax haven entities – HMRC identifies groups with entities located in tax havens and seeks to establish whether their profitability is commensurate with the level of functions, assets and risks relating to these entities. For example, limited functions undertaken by entities located in tax havens that enjoy healthy profits may give rise to a transfer pricing enquiry.
- Lower returns in the UK than in the group generally – HMRC identifies businesses with profit margins that are lower in the UK than in the group generally and seeks to establish why this is the case.
- The UK business produces only a routine, low-margin profit – HMRC identifies companies that possess the resources to generate high-margin profits, yet produce only a routine, low-margin profit. To understand the potential profitability of a particular entity, HMRC is interested in whether there is, for example, heavy investment in the entity, a highly skilled and remunerated technical or R&D workforce or intangibles (e.g. trade names, know-how, patents).
- Royalty or management fee payments from the UK business that do not appear to make commercial sense and which substantially impact on the UK profits. Examples of such payments include:
  - A brand name unknown in the UK.
  - Technology to which significant value has been added by processes carried out in the UK.
  - Nebulous bundles of intangibles.
  - Poor performance over a number of years. Persistent losses attract the attention of HMRC, and HMRC looks for evidence that there is a clear prospect of a return to profits in later years to justify the risk of continuing losses.
- Changes in the risk profile and hence the reward of the UK business. Examples of this include:
  - Distributor becomes commissionaire (and net profits decrease).
  - Full manufacturer becomes contract manufacturer.
  - R&D activities that once generated royalties move to contract basis.
  - Cost-sharing arrangements are introduced.

HMRC concedes that consideration should be given to both the potential tax at risk and the level of difficulty in establishing the arm's-length price, although there is no *de minimis* limit in the UK's transfer pricing legislation.

The International Manual provides further detailed practical guidance and examples of HMRC's approach and interpretation of transfer pricing principles.

Information powers

Changes to HMRC's general information powers were introduced with effect from 1 April 2009. HMRC can require any person to provide them with information or to produce documents by way of a written notice. It must allow the person a reasonable period of time to produce the information or documents. The person receiving the information notice may appeal against it, unless the notice is to produce the statutory records that the person is obliged to keep or if the tax tribunal approved the issue of the notice.

Penalties may arise for failing to comply with an information notice, or concealing, destroying or otherwise disposing of documents, or providing inaccurate information, or a document containing an inaccuracy, in response to an information notice.

If the taxpayer does not provide information in response to HMRC's requests, where considered necessary, HMRC may enter a company's premises and inspect the premises, assets and documents on those premises that relate to transfer pricing issues under enquiry. HMRC cannot search premises, nor search for assets or documents. Normally, HMRC must give the occupier of the premises at least seven days' notice of an inspection. An unannounced or short-notice inspection is possible, but this must be agreed by an authorised HMRC officer or approved by the tax tribunal.

HMRC also has powers enabling it to obtain information from third parties where it considers such information would be helpful in progressing enquiries. However, such powers are used rarely and only in extreme circumstances, since these powers are viewed by the HMRC itself as controversial and requiring sensitive handling. Failure to provide information as requested is more likely to result in an estimated assessment being raised, for which the company must then provide the evidence to refute it.

HMRC does not have the power to directly obtain information on non-UK-resident parents of UK companies, nor on fellow subsidiaries (in non-UK-controlled groups) that are not UK resident. Note, however, that the UK has an extensive double tax treaty network, and, as a result, is able to request such information under the Exchange of Information article. HMRC also increasingly uses the provisions of the EU Mutual Assistance Directive that provides for Member States to exchange information on taxpayers and embark on 'simultaneous controls' where the tax position of a taxpayer and related entities are of interest to more than one member state (*see Joint investigations, below*).

Revised assessments and the appeals procedure

Where there is an open enquiry or HMRC has issued a closure notice, amended the taxpayer's return or made a 'discovery' assessment, the taxpayer may ask for the case to be listed for hearing by the tax tribunal. Alternatively, the taxpayer may require HMRC to review the point at issue, or HMRC may offer the taxpayer a review (Tax Management Act 1970 section 49A). If a review takes place, HMRC may uphold, vary or cancel its original view of the matter, and must notify the taxpayer of its conclusion within the following 45 days, or other agreed period (TMA 1970 section 49E). If HMRC's review is unfavourable and the taxpayer does not wish to accept it, the taxpayer must file an appeal to the tax tribunal within 30 days; otherwise HMRC's review conclusions are treated as having been agreed.

The tax tribunal has also made it clear that it will expect parties to disputes involving complex facts such as transfer pricing to have sought an internal review or considered other forms of dispute resolution, such as facilitative mediation using an independent mediator, before such cases are brought before the tribunal.

The taxpayer or HMRC may appeal against a decision of the First Tier tax tribunal on a point of law (but not a question of fact). This appeal is normally then heard by the Upper Tier Tax Tribunal and from there to the Court of Appeal and, possibly, the UK Supreme Court, although few tax cases are heard by this court. If a question of European law is involved, any of these courts can refer the case to the European Court in Luxembourg.

Additional tax and penalties

Specific penalty provisions for transfer pricing have not been formulated and the general rules are to be applied. These general rules were considerably revised with effect for return periods beginning on or after 1 April 2009. For earlier periods, the previous legislation in Finance Act 1988 needs to be consulted.

For return periods ending on or after 1 April 2009, penalties may be levied for certain acts or omissions, depending on the offence. The penalties of most relevance to transfer pricing are for:

- Failure to notify chargeability to tax.
- Failure to provide information or documents under a formal notice to do so (*see Information powers, above*).
- Filing an incorrect tax return.

Interest is normally charged on tax underpaid and is calculated from the day on which the tax was originally due.

There are two requirements for a penalty to be chargeable: (1) a loss of tax or an increased claim to a loss or repayment; (2) the inaccuracy is careless, deliberate or deliberate and concealed. There is no penalty if the inaccuracy occurs due to a mistake or despite taking reasonable care. In determining the level of the penalty in cases where losses are claimed, tax penalties apply in the same way as if there were additional tax. For returns relating to earlier periods, a penalty may be due if an incorrect return is fraudulently or negligently submitted.

Interest or penalties paid are not tax-deductible. In some cases the professional fees incurred in the course of the HMRC enquiry are also not tax-deductible.

One of the main concerns of business in relation to transfer pricing and penalties is what is meant by 'carelessness' (or 'negligence' under the previous rules), given that what is an arm's-length price is a matter of judgment and there is not usually one 'right' answer. HMRC's view is that where a taxpayer can show that it has made an honest and reasonable attempt to comply with the legislation, no penalty is imposed, even if there is an adjustment. Indeed, the onus is usually on HMRC to show that there has been a careless or deliberately careless inaccuracy by the taxpayer before a penalty can be charged.

While there is no legal definition of 'carelessness', taxpayers are obliged to do what a reasonable person would do to ensure that their returns are made in accordance with the arm's-length principle. HMRC suggests that this would involve but would not necessarily be limited to:

- Using their commercial knowledge and judgment to make arrangements and set prices that conform to the arm's-length standard.
- Being able to show (e.g. by means of good quality documentation) that they made an honest and reasonable attempt to comply with the arm's-length standard.
- Seeking professional help when they know they need it.

The emphasis is very clear that to avoid any suggestion of carelessness, the taxpayer must have set and documented a reasonable transfer pricing policy and must in practice implement and apply that policy correctly and consistently. HMRC has also made it clear that documentation does not in itself relieve a taxpayer from the possibility of a penalty if that documentation does not show that the business had good grounds for believing its arrangements and prices to be in accordance with the arm's-length principle.

Range of penalties

The amount of penalty that may be charged reflects the degree of culpability. Whereas there is no penalty for a mistake, failure to take reasonable care may incur a penalty of up to 30% of the potential lost tax revenue. If the inaccuracy is deliberate but not concealed, a maximum penalty of 70% may be charged, rising to a 100% penalty if the inaccuracy is deliberate and concealed. All penalties can be mitigated depending on the quality of the disclosure.

Where an inaccuracy has resulted in an amount of tax being declared later than it should have been, the potential lost revenue is 5% of the delayed tax per year or part of a year.

These changes in the UK's penalty regime are expected to result in a significant increase in the number of penalties generally applied to companies. It remains to be seen what specific impact they will have on transfer pricing enquiries, where the incidence of penalties have previously been very low.

Documentation requirements

Notwithstanding the change in the burden of proof on transfer pricing with the introduction of self-assessment, unlike many other transfer pricing regimes, the UK has not issued specific regulations governing the documents that a taxpayer is required to prepare to support its transfer pricing. Instead, the UK has preferred to rely on the general rule for self-assessment that 'requires taxpayers to keep and preserve the records needed to make and deliver the correct and complete return'.

There has been some relaxation of HMRC's expectations on documentation in conjunction with the removal of the UK-to-UK exemption in 2004. In particular, whilst HMRC requires that there be evidence available to support arm's-length pricing at the time a tax return is submitted, the material recording of that evidence may be prepared and provided to HMRC in response to a specific request rather than as a matter of course. Failure to respond to such a request within a reasonable time exposes a company to the risk of penalties.

HMRC provides guidance in its International Manual on record-keeping requirements. HMRC specifies the following four classes of records or evidence that need to be considered:

- Primary accounting records – The records of transactions occurring in the course of the activities of a business that the business enters in its accounting system. These records are needed to produce accounts and the results (in terms of value) of the relevant transactions. In the context of transfer pricing rules, these are the actual results. They may or may not be arm's-length results and are generally created at the time the information entered the business accounting system.
- The tax adjustment records – The records that identify adjustments made by a business on account of tax rules in order to move from profits in accounts to taxable profits, including the value of those adjustments. These adjustments might include the adjustment of actual results to arm's-length results due to transfer pricing rules. These records do not need to be created at the same time as primary accounting records, but do need to be created before a tax return is submitted for the period in question.
- The records of transactions with associated businesses – The records in which a business identifies transactions to which transfer pricing rules apply.
- The evidence to demonstrate an arm's-length result – The evidence with which a business demonstrates that a result is an arm's-length result for the purpose of transfer pricing rules. This evidence needs to be made available to HMRC in response to a legitimate and reasonable request in relation to a tax return that has been submitted. Although the business would need to base relevant figures in its tax return on appropriate evidence, it is possible that, when the return is prepared, the material recording of that evidence may not exist in a form that could be made available to HMRC.

HMRC also quotes the discussion of documentation requirements in Chapter V of the OECD Transfer Pricing Guidelines that the demonstration of an arm's-length result should be "in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance".

To be able to support the view that the pricing method chosen results in arm's-length terms, it is often necessary to include in that documentation a study of third-party comparables, usually requiring a comparison with comparable third-party transactions or with profitability earned by third parties. Without this, HMRC may regard any documentation as incomplete. To be satisfied that these comparables are truly comparable, or to evaluate the results obtained, it may well be necessary to carry out a detailed analysis of the risks and functions undertaken by a particular business.

Acceptable transfer pricing methods

HMRC has stated that the comparable uncontrolled price (CUP) method is the simplest and most accurate of the OECD methods and is the preferred method where there are comparable uncontrolled transactions. However, where it is difficult to identify comparable uncontrolled transactions in practice, HMRC looks to use another OECD-approved method, including TNMM and profit splits and looks for the most appropriate method in the circumstances of the case. This reflects HMRC's long standing acceptance of profit-based methods as well as the 2010 OECD Guidelines, which abolished the hierarchy of methods.

Resources available to the tax authorities

The key resource for transfer pricing enquiries is the TPG (as discussed in *Tax audits section* above). Within the TPG, a centralised specialist transfer pricing unit, which is part of HMRC's Corporate Tax, International and Anti-Avoidance (CTIAA) directorate, has responsibility for the policy on transfer pricing and technical aspects of the legislation. It has traditionally been involved in the transfer pricing enquiries into large multinational groups, as well as housing the mutual agreement procedure (MAP) and the advance pricing agreement (APA) programme management.

Use and availability of information on comparables

HMRC has widely adopted the principles in the OECD Guidelines, including the revisions made in 2010 and, therefore closely follows the OECD guidance on comparability. Information on comparables plays a crucial element in defending transfer pricing policies in the UK.

Availability of company information

All UK companies, public and private, are required to prepare statutory accounts and file these with the Registrar of Companies at Companies House. Certain companies, such as small- or medium-sized companies, need to provide only abbreviated accounts with a limited amount of detail. Copies of these accounts are publicly available, but their usefulness may be limited by the amount of detail given.

HMRC has access to its own sources of comparable data and also uses commercially available databases of company results. These contain a summary of each company's financial results for several years, hence facilitating access to potentially comparable information. In practice, HMRC also generally accepts pan-European searches based on European company data.

HMRC and company advisers are bound by confidentiality considerations in respect of information obtained through work on other companies for the purposes of disclosure to third parties. In reality, both parties accrue considerable expertise and knowledge through the consideration of relevant issues, which can be used in future enquiries. However, HMRC does not overtly use 'secret comparables' to challenge taxpayer prices, although it might use them in selecting cases for enquiry.

Risk transactions or industries

No transactions or industries are excluded from the scope of the transfer pricing legislation. If a particular industry or issue has come to the attention of the TPG, HMRC is likely to use the information and experience gained in dealing with one taxpayer in enquiries into other similar taxpayers. Within the TPG, there is increasing specialisation in certain industry sectors, such as financial services, automotive, consumer goods and pharmaceuticals. Oil and gas cases are also dealt with by specialists within the Oil Office of HMRC's Large Business Service (LBS). The LBS has also established industry specialists within a number of offices to focus on particular sectors.

In short, all transactions and industries are at risk of a transfer pricing enquiry in the UK. There has been a tendency in the past for queries to be raised not in connection with specific industries but in respect of certain inter-company transactions. In particular, focus was given to transfer pricing related to interest, royalties and management fees, rather than the transfer pricing of goods and services. However this is changing with more experience and the specialist approach introduced by the TPG. The risk-based approach to enquiries explained at *Tax audits section* should now inform the focus of most HMRC enquiries.

More recently HMRC is showing particular interest in the transfer pricing of debt as its experience on this topic has increased significantly with ATCA programme.

Limitation of double taxation and competent authority proceedings

In connection with the operation of the mutual agreement procedure (MAP), the following points should be noted:

- The designated competent authority in the CTIAA directorate deals with cases presented under the MAP in respect of transfer pricing; HMRC may provide a unilateral solution to instances of economic double taxation, or consult under the MAP to try to reach agreement with the other tax authority in a way that eliminates the double taxation.
- There is no guarantee that a corresponding adjustment will be made, since the two tax authorities are not required to reach a resolution under the MAP although an increasing number of the UK's double tax treaties now include an arbitration clause and for EU related adjustments, and arbitration is available under the European Arbitration Convention (*see below*).
- If a UK company is considering seeking a corresponding adjustment as a result of an adjustment by an overseas tax authority, a protective claim should be made as soon as possible to avoid a situation where the time limit for a corresponding adjustment has expired.
- The provisions of TIOPA 2010, Sections 124 and 125 (formerly ICTA 1988, Section 815AA) clarify the time limits applicable to the MAP. In the absence of a specific time limit in a treaty, a time limit of six years from the end of the accounting period to which the adjustment relates applies for making claims in respect of cases presented to the UK competent authority.
- TIOPA 2010, Sections 124 and 125 explain how an agreement reached under the MAP is put into effect in the UK. The UK legislation also enables consequential claims to be made within 12 months of the notification of a solution or mutual agreement. This allows, for instance, additional loss-relief claims to be made even though the normal time limits for a loss claim may have expired.
- There is no formal method of making a case under the MAP in the UK. The taxpayer should simply apply in writing stating the details of its case, including the years concerned, the nature of the case and details of the parties involved.

It is worth noting that some competent authority procedures may take several years to complete, with no guarantee of a satisfactory outcome. However, regular meetings between HMRC and certain other tax authorities where the competent authority cases are likely to be most numerous, such as the Internal Revenue Service (US), the NTA (Japan) and the SLF/DGI (France), help considerably to resolve MAP cases.

HMRC has traditionally taken a robust line in relation to engaging in MAP discussions before a transfer pricing adjustment has been made in the UK. This is in contrast to many other tax authorities that allow MAP proceedings to commence before an adjustment is finalised. However, HMRC has recently issued a Statement of Practice on MAPs which has marked a softening of this line by suggesting that HMRC may now be willing to take part in MAP discussions before a transfer pricing enquiry is concluded in particular circumstances. Nonetheless, MAP is not seen by HMRC as an alternative to the normal enquiry process.

Arbitration

As a member state of the EU, the UK has signed up to the arbitration procedures of the EU Arbitration Convention. The convention provides that where the tax authorities concerned cannot resolve differences through a mutual agreement procedure within two years, they will be subject to mandatory arbitration procedures, if the taxpayers concerned wish to proceed to arbitration. The arbitration procedure consists of an advisory commission including independent experts who give an opinion within a specified timescale. Both tax authorities must act on this opinion or agree within six months on another course of action that resolves in full the double taxation.

The benefit of the convention is that it should ensure that the competent authorities resolve cases fully within a specified timescale of two years. While an increasing number of claims are being made under the convention, very few cases have gone forward to arbitration, although a large number of claims are now, in theory, approaching the time limit.

The UK has also included arbitration provisions in its most recent double tax treaties, such as those signed with France, Germany and the Netherlands. The method of arbitration to be used is not specified and will presumably be determined on a case-by-case basis.

Advance pricing agreements (APA)

The UK has had formal APA procedures since 1999. Before 1999, APAs were possible only by means of an agreement under a double tax treaty. A recently updated Statement of Practice 2/10 (the Statement) provides guidance on HMRC's interpretation of TIOPA 2010, Part 5 (formerly Sections 85 to 87 of Finance Act 1999). This legislation allows for APAs and establishes the APA procedures. In the new Statement, which supersedes SP 3/99, HMRC explains how it applies the legislation in practice. The revised Statement has resulted in two significant changes in HMRC's approach, by relaxing the 'complexity' threshold for accepting APA applications and encouraging more unilateral APAs.

Applicants and scope

A UK business may request an APA in respect of transactions that are subject to TIOPA 2010, Part 4 (formerly ICTA1988, Schedule 28AA). APAs may also be requested by non-residents trading in the UK through a permanent establishment or branch, and by UK residents trading through branches or permanent establishments outside the UK. No fee is payable in the UK for an APA.

APAs may involve transfer pricing methods covering different types of related party transactions or only for particular types of transactions, as well as other intra-group arrangements, including transfers of tangible or intangible property and the provision of services. APAs may relate to all the transfer pricing issues of the business or be limited to one or more specific issues.

Historically HMRC expressed its preference for including the tax authority of the related party in the discussions and concluding a bilateral APA. However in the new

Statement it recognises that unilateral APAs may be agreed in certain circumstances such as where the other side of the transaction does not have a formal APA programme, or where the conclusion of a bilateral agreement would provide little additional benefit to either party.

Process

TIOPA 2010, Section 218(1) (formerly Section 85(1)(c) of Finance Act 1999) provides that the APA process is initiated by a business making an application for clarification by agreement regarding the application of the statutory provisions. The APA process typically comprises four stages: an expression of interest, the formal submission of application, evaluation of the proposed methodology and critical assumptions and, finally, drawing up the agreement.

At the expression of interest stage, or at the stage when a formal proposal is submitted, HMRC may exercise its discretion by declining the request for an APA. In that event, HMRC advises the business of the reasons for doing so, and allows the business the opportunity to make further representations. A business may withdraw an APA request at any time before final agreement is reached.

HMRC has stated that it anticipates that all proposals will need to be supported by most of the following information:

- The identification of the parties and their historic financial data (generally for the previous three years).
- A description of the transfer pricing issues proposed to be covered by the APA and analysis of the functions and risks of the parties, and projected financial data of the parties in relation to the issues.
- A description of the worldwide organisational structure, ownership and business operations of the group to which the taxpayer belongs.
- A description of the records that will be maintained to support the transfer pricing method proposed for adoption in the APA.
- A description of current tax enquiries or competent authority claims that are relevant to the issues covered by the proposed APA.
- The chargeable periods to be covered by the APA.
- The identification of assumptions made in developing the proposed transfer pricing method that are critical to the reliability of its application.
- A request for a bilateral APA.
- If applicable, representations from the business that HMRC should exercise its discretion in exchanging information, where the business considers such information to be trade secrets.

Information supplied by a business in relation to an APA contributes to the pool of information held by HMRC about that business. HMRC explicitly states that the information may be used for purposes other than evaluating the APA request. In addition, HMRC has suggested they may now be more likely to share information on unilateral APAs with the appropriate treaty partners that may be impacted.

Nature and term

An executed agreement between the business and HMRC determines the treatment of the transfer pricing issues for a specified period of time. The terms of a bilateral APA also reflect the agreement reached between the two tax authorities. If HMRC does not reach an agreement with the business, HMRC issues a formal statement stating the reasons.

APAs usually operate prospectively, relating to the accounting periods beginning after the application is made, although HMRC does allow 'roll-back' of APAs in certain circumstances, which can sometimes be very helpful in resolving existing transfer pricing disputes. HMRC expects most APAs to be for a maximum term of five years.

HMRC considers that APA information is subject to the same rules of confidentiality as any other information about taxpayers and that the unauthorised disclosure, even of the existence of an APA, is a breach of that confidentiality.

APA monitoring and renewal

The APA identifies the nature of the reports that the business is required to provide under the APA legislation. The agreement also provides for the timing of the submission of these reports, which is typically required annually, coinciding with the filing date for the tax return.

The annual report addresses whether the agreed-upon method was applied during the year, the financial results produced by the method, and whether there was a mismatch between prices actually charged and those obtained by applying the arm's-length standard under the agreed methodology. The business also must provide details of compensating adjustments made, and an assessment of the continued applicability or otherwise of the critical assumptions used in the APA.

HMRC has the power to nullify an APA when the business has fraudulently or negligently provided false or misleading information regarding the APA application. When considering using this power, HMRC takes into account the extent to which the terms of the APA would have been different in the absence of the misrepresentation.

An APA may provide for modification of its terms in specific circumstances. For example, an agreement may provide that when there has been a change that makes the agreed methodology difficult to apply but that does not invalidate a critical assumption, the agreement may be modified with the consent of the parties.

A business may request the renewal of an APA. The request should preferably be made no later than six months before the expiration of the APA's current term. However, HMRC usually accepts requests made before the end of the first chargeable period affected by the renewal. If the transfer pricing issues have changed, or a different method is being proposed, the business must make a new APA application.

Penalties and appeals

A tax-geared penalty is imposed when a business has acted carelessly in making an incorrect return and tax has been lost as a result. When a return is made in accordance with an APA, and false or misleading information was submitted carelessly in the course of obtaining the APA, the agreement is treated as if it had never been made. The business has the right to appeal against the amount of additions to profits arising as a result of the revocation or cancellation of an APA.

Advance thin capitalisation agreements

In 2007, HMRC introduced the advance thin capitalisation agreement (ATCA) to provide certainty to financing transactions. These are unilateral APAs and are based on the same statutory provisions as the normal APA. The process is designed to offer assistance in resolving transfer pricing issues in relation to financing transactions that, for any particular period, have a significant commercial impact on an enterprise's profit or losses.

ATCAs may cover the treatment of a single applicant's financial instrument or the treatment of the overall debt position of a group, depending on circumstances. HMRC issued guidance in relation to which situations are suitable for ATCAs in a Statement of Practice 04/07. This guidance states that situations suitable for ATCAs include, but are not limited, to the following:

- Intragroup funding outside the scope of treaty applications (e.g. involving a quoted Eurobond or discounted bond).
- Financing arrangements brought into TIOPA Part 4, (formerly ICTA 1988 Schedule 28AA by the 'acting together' rules [*see Statutory rules, above*]).
- Financing arrangements previously dealt with under the 'treaty route' (i.e. as part of a claim made by the recipient of the interest to benefit from reduced rates of withholding tax under the provisions of a double tax treaty).

While the ATCA normally applies prospectively in relation to accounting periods beginning after the application is made, it is possible that an ATCA may be applied retrospectively or rolled back as an appropriate means for amending a self-assessment return or resolving outstanding transfer pricing issues in earlier years.

Anticipated developments in law and practice

One development is HMRC seeking to make more use of collaborative dispute resolution tools to resolve long-running and difficult transfer pricing enquiries as an alternative to litigation. Facilitative mediation is being explored, but it is likely to be used only in a small number of cases.

There are also indications that HMRC is becoming more involved in joint audits with other tax authorities as part of greater collaboration and cooperation between tax authorities, which has been endorsed by the OECD's Forum on Tax Administration (*see Joint investigations, below*).

Liaison with customs authorities

In April 2005, the UK government integrated the Inland Revenue and HM Customs & Excise into a single department (Her Majesty's Revenue & Customs, HMRC). The Inland Revenue's Large Business Office (LBO) and Oil Taxation Office and Custom's Large Business Group were also integrated to form a single HMRC Large Business Service (LBS). The Revenue and Customs tax functions within HMRC are able to exchange information freely and work together to compare information on particular groups and industries.

OECD issues

The UK is a member of the OECD and has approved the OECD Guidelines. The UK legislation in TIOPA Part 4 (and formerly ICTA 88, Schedule 28AA) is required to be construed in a manner that best ensures consistency with the Guidelines (*see Statutory rules, above*). As noted, TIOPA 2010 formally recognises the OECD Guidelines as a result of an amendment to the legislation made in Finance Act 2011 HMRC applies the updated 2010 Guidelines from 1 April 2011.

Joint investigations

HMRC is able to participate in simultaneous tax examinations with another tax authority using the exchange of information provisions in their respective double tax treaty or, in the case of an EU member state or other signatory, under the provisions of the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters. Such bilateral or multilateral examinations were comparatively rare, although there is now increasing participation by HMRC in 'simultaneous controls' under the Council of Europe/EU Convention, which include transfer pricing enquiries.

HMRC was proactively involved with the OECD's Forum on Tax Administration in developing proposals for joint audits on transfer pricing cases, whereby HMRC officials may be part of a team including officials from one or more other tax authorities. Together the team would make a joint assessment of transfer pricing risks across an MNE, or might jointly audit those risks that affected both tax authorities or divide up the risks between them. This would have the advantage of reducing the cost to a multinational group of dealing with a number of different audits covering the same transactions, as well as potentially resolving risks of double taxation.

Thin capitalisation

Statutory rules

TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA) includes provisions that incorporate financial transactions. (Until 1 April 2004, thin capitalisation was generally dealt with separately from transfer pricing legislation). Furthermore, general legislation enables HMRC to challenge the deductibility of interest paid by a UK company on a loan from a related party for which the interest rate is excessive or the amount of the loan itself is excessive. This domestic legislation compensates for the position existing under many older double tax treaties where there is an argument that the tax treaty does not provide the authority for the amount of the loan to be questioned. The measure for determining whether the amount of the loan or the interest rate is excessive is the arm's-length principle – that is, whether a third party would have loaned the company that amount of money or at that interest rate. The legislation seeks to align the UK position with Article 9 of the OECD Model Tax Convention.

The consequence of a successful challenge by HMRC is that any interest found to be excessive, by reference to the interest on the part of the loan found to be excessive or by reference to the rate of interest, is not allowed as a tax deduction.

There is no formal UK safe harbour debt-to-equity ratio or acceptable interest cover. However, historically, it has often been suggested that a debt-to-equity ratio of 1:1 and interest cover of 3:1 could be considered to be 'safe' HMRC had explained its tendency to accept these ratios on the basis that they reflect historical averages and that its resources are better used to examine cases with more extreme ratios.

However, more recently, HMRC has stressed that each case is examined individually and the acceptability of a ratio could well be influenced by the averages for the particular industry sector, and those may be different from those noted above. Other ratios are increasingly considered, including the ratio of debt to earnings and other forms of interest cover. Other factors that HMRC would consider are factors that a third-party lender would consider, such as the consolidated debt-to-equity ratio of the borrower's group and the ability of the group to pay interest and repay capital. An acceptable ratio is, therefore, often a matter of negotiation.

HMRC provides clearance in many cases for loan arrangements, under the ATCA procedure, as described above in *Advance pricing agreements section*. This involves the provision of detailed documentation of the loan arrangements and valid projections of the taxpayer's interest cover or debt-to-equity ratio. Guidance is given in the International Manual. This guidance, which was significantly updated in a new version released in March 2010, shows how the basic pricing rule under self-assessment is more broadly formulated than the previous legislation.

The guidance goes on to cover:

- Factors HMRC takes into account in determining whether interest is excessive.
- Cases where interest is not recharacterised.
- Circumstances where transactions should be considered together in order to evaluate compliance with the arm's-length principle.
- Outward investment and where such loans are interest free or at a low rate of interest, and what factors may be taken into account in recharacterising such loans as equity.
- Interaction of the transfer pricing rules with the UK's legislation on foreign exchange and financial instruments.
- Treatment of funding transactions between UK charities and their affiliates.
- The use of third-party loan agreements as potentially comparable evidence of arm's-length borrowing.
- The acceptability of independent credit ratings and the use of company-produced credit ratings in pricing debt.

Acting together

Further provisions were introduced by Finance (No. 2) Act 2005, which are incorporated in TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA), related to the manner through which financing is effected. These provisions are particularly aimed at, but not limited to, private equity financing.

The changes restrict interest deductions to an arm's-length basis, where parties are acting together in relation to the financing of a company. The relevant provisions apply transfer pricing rules where persons who collectively control a company or a partnership have acted together in relation to the financing arrangements of that company or partnership. Given the widely drawn provisions, a third-party bank could be drawn into the rules because it has agreed to provide finance for a deal, although such loans are accepted by HMRC as arm's length. There are clearance procedures for companies to obtain certainty with respect to their particular circumstances.

HMRC issued guidance on what constitutes acting together under TIOPA 2010, Part 4 (and formerly ICTA 88, Schedule 28AA), which indicates that 'acting together' can be construed very widely.

Guarantee fees

TIOPA 2010, Part 4 (and formerly ICTA1988, Schedule 28AA) applies to a provision effected by one or more transactions. So, when a UK company borrows from a bank and the loan is guaranteed by its parent, there may be a provision between the parent and subsidiary. Between independent parties this would usually result in a fee from the borrower to the guarantor.

The rules provide that the borrowing capacity of a UK company must be considered without regard to the guarantee. In such a case (e.g. where the subsidiary is able to borrow more from a third-party bank because of a parental guarantee) there would be no deduction for the guarantee fee related to the excess borrowing, and there would be a potential disallowance of interest in excess of what would have been paid in the absence of the special relationship. This would apply even though the interest is paid to a third-party bank.

Where interest is disallowed for a UK borrower, an affiliated UK guarantor may be able to claim the deduction instead.

The value of a guarantee under the arm's-length principle depends on its terms. The arm's-length fee should be determined based on what would be charged between independent parties under the same or similar circumstances. Where a UK parent provides a guarantee to overseas subsidiaries, in some cases HMRC accepts that a guarantee may be equity in nature, especially where the borrower is thinly capitalised.

Thin Cap GLO

A recent case called into question the compatibility of the pre-2004 UK thin capitalisation legislation with the TFEU. The case, known as the Thin Cap GLO, was heard by the European Court of Justice (ECJ), which decided that the UK thin capitalisation legislation pre-2004 was a restriction on the freedom of establishment provisions of the TFEU. However, the ECJ referred the case back to the UK courts to decide the extent to which the thin capitalisation rules applied and therefore whether these represented a justifiable breach.

In late 2009, the UK court found that the pre-2004 legislation did represent a restriction on the freedom of establishment because the legislation did not include a 'commerciality' test (a separate test to the arm's-length test). It ruled that the pre-2004 legislation should not have applied to thin capitalisation cases where there was a commercial rationale for the transaction and that taxpayers were entitled to restitution for taxes paid as a result of the pre-2004 thin capitalisation legislation.

In February 2011, the UK Court of Appeal has decided that the UK thin capitalisation legislation pre-2004 is European Commission (EC) Treaty compliant. The decision has taken into account two later ECJ judgements OyAA, C-231/05) in July 2007 and Société de Gestion Industrielle (C-311/08) which the UK Court of Appeal took to mean the UK thin capitalisation legislation did not require an additional 'commercial purpose' test in order to be compliant with the EC Treaty. The decision was appealed to the UK Supreme Court, but this has declined to hear the case, and it must now be considered closed.

Management services

The UK has enacted no specific legislation on management services, and, consequently, where a business in the UK is paying for management services from a related party, the general rules on the deductibility of expenses applies. In general, the payment is tax-deductible where the business receives a benefit for the services provided and where the payment is connected with the business and is at an arm's-length price.

Where a UK business is providing services to related parties, it should be remunerated for those services on an arm's-length basis. This usually means that a profit element should be added to the cost of providing the service and invoiced to those businesses receiving the benefit of the services (i.e. a cost plus basis) to represent a market value for the provision of the services. The arm's-length value of services can also sometimes be less than the cost of providing them. In such a situation the service should still be recharged at the market price (i.e. less than cost), and this principle is recognised in the OECD Guidelines.

Where services are recharged on a cost plus basis, the amount of the mark up is often the subject of negotiation with HMRC. There are no safe harbours in the UK, and no guidelines have been published as to standard acceptable rates of marking up costs in specified situations. HMRC has typically sought cost plus between 5% and 10% for low-value UK-provided services. It may well however look for a higher mark up if it considers the services provided to be particularly valuable.