

HMRC issues Guidelines for Compliance on transfer pricing

September 24, 2024

In brief

What happened?

The development of Guidelines for Compliance (GfC) was announced by HMRC in November 2021 as part of its review of tax administration for large businesses. The GfC aim to provide HMRC's view on complex, widely misunderstood, or novel risks that can occur across tax regimes. They are not intended to be technical papers focusing on interpretation of tax law, but best practice guidance with regards to HMRC's expectations, offering insights into HMRC's practical application of the law and administrative approaches, in order to assist businesses in administering the tax compliance process. One of these GfC covers transfer pricing, a key focus area of HMRC, which was published on September 10, 2024.

Why is it relevant?

The transfer pricing GfC are designed to help businesses understand HMRC's expectations as they plan, implement, manage, and document their transfer pricing, setting out what HMRC considers best practice compliance and higher risk approaches. The guidelines are aimed at all businesses that must apply transfer pricing, both those within the new UK transfer pricing documentation requirements and those who, although exempt from these requirements, must still self-assess that their transfer pricing is arm's length and retain appropriate books and records (including documentation) when filing a tax return.

The guidelines are structured into three sections reflecting the needs of different audiences:

- **Part 1 - Managing compliance risks for UK businesses:** aimed at those within businesses who are responsible for managing UK tax risks, accounting risk, and filing tax returns (referred to as "UK risk leads"), covering scoping, governance, controls, and checks and evidence.
- **Part 2 - Common compliance risks:** aimed at transfer pricing specialists, including both advisors and in-house teams, covering best practice approaches to transfer pricing analysis and support and evidence.
- **Part 3 - Indicators of transfer pricing policy design risk:** aimed also at transfer pricing specialists, covering common risks in transfer pricing design and implementation.

HMRC makes it clear that the extent of underlying work and evidence will vary based on the size and complexity of the business and the risk profile of the business — e.g., the level of business change, and the materiality of transactions.

Actions to consider:

The guidelines are lengthy and, for many businesses, compliance with all aspects could be onerous and in some cases disproportionate. However, HMRC will expect businesses to be familiar with the content and to make an informed decision as to whether any action should be taken. Therefore, businesses should take the time to read the guidelines and to understand HMRC's expectations compared to their current transfer pricing compliance and governance processes. Considering any gaps alongside the business' size, complexity, and risk appetite will enable businesses to make an informed decision about the impact on their transfer pricing compliance and governance strategy as well as the level of any risk mitigation work to undertake. Businesses should consider documenting that they have done so, along with the reason(s) for any decision not to take forward possible mitigating actions.

The guidelines recognize that there are a number of statutory obligations linked to transfer pricing compliance, non-compliance with which can result in penalties. The guidelines reference, in particular, to Senior Accounting Officer (SAO) obligations, declaration that the tax return is correct and complete and Master and Local File documentation requirements. The guidelines therefore need to be considered in the context of these other statutory obligations.

In detail

Part 1 - Managing compliance risk for UK businesses

The guidelines note that transfer pricing compliance is a cyclical process comprising four main phases of activity:

- Compliance planning and scope
- Implementation and monitoring checks
- Transfer pricing analysis and documentation
- Filing an arm's-length return

Compliance planning and scope

Effective transfer pricing compliance planning and scoping is crucial for UK businesses to mitigate the risk of HMRC enquiry and potential tax liabilities and penalties. This section of the guidelines sets out that best practices include:

- Understanding the group's compliance model and how this impacts the UK transfer pricing compliance plan
- Being aware of group policies and intragroup agreements affecting the UK
- Appropriately scoping compliance activities to account for business developments since the prior period
- Appropriately scoping for materiality, proportionality and depth
- Building in implementation and monitoring checks to processes up front

Implementation and monitoring checks

Transfer pricing compliance risk can be created where checks to ensure transfer pricing policies are implemented correctly are not performed or when business changes impacting the transfer pricing position are not identified. The guidelines set out best practice suggestions for:

- When to perform monitoring and checks
- Monitoring and checking that transfer pricing policy implementation is correct
- Identifying, monitoring and evidencing business changes
- Identifying and retaining contemporaneous evidence of business change
- Responding on a timely basis to issues identified

Transfer pricing analysis and documentation

Transfer pricing risk is heightened when transfer pricing analysis is insufficient in scope and depth, does not involve those knowledgeable of the UK business, is performed too late, or is supported by inadequate documentation.

The guidelines highlight that transfer pricing analysis should be conducted, and evidence supporting conclusions identified and retained, prior to filing the tax return. The guidelines indicate that postponing transfer pricing analysis until after filing the tax return undermines a business' ability to rely on the certification that the tax return is correct and complete, impacting penalty considerations.

HMRC sets out that it expects that UK risk leads review transfer pricing documentation outputs to ensure that they accurately reflect the facts regarding the UK business, and that this review is documented. This is particularly important where a group's compliance approach includes the preparation of standard content for more than one territory. The guidelines indicate that this review should focus on the functional analysis and the pricing and benchmarking conclusions to ensure that these verifiably and accurately reflect the UK business.

Filing an arm's-length return

The arm's-length nature of actual profits and losses needs to be reviewed and an assessment made as to whether an adjustment is required to comply with transfer pricing rules. This section of the guidelines sets out best practice suggestions to assist businesses in avoiding common calculation pitfalls and sets out considerations for the retention of supporting documentation. It notes that, in the event of an enquiry, UK businesses that can readily provide relevant supporting information on request can expect a more focused and less protracted enquiry.

Observations:

The guidelines highlight the importance of UK risk leads being dialed into the wider business to ensure, for example, they are aware of business changes and therefore appropriately consider such changes in their transfer pricing compliance lifecycle. They also highlight the importance of ensuring that transfer pricing analysis and documentation accurately reflects the UK business and is not a generic description of the business. Finally, the importance of the timing of transfer pricing analysis and contemporaneous evidence gathering is also key. This is reflective of our experience of transfer pricing disputes and many areas referenced in the GfC echo HMRC's manual on transfer pricing records and risk control, all of which directly ties into the existing obligations under the UK SAO regime, but may require groups to update their approach.

For non-UK parented groups in particular, where the UK risk lead might not be co-located with the headquarter tax and transfer pricing teams, this may require UK risk leads to work more closely with their headquarter tax or transfer pricing teams, who may be responsible for many aspects of the business' transfer pricing compliance

lifecycle, to ensure that UK-specific nuances are captured in the transfer pricing policy design, processes and documentation.

Part 2 - Common compliance risks

HMRC notes that it frequently sees transfer pricing documentation that is too high level and insufficiently evidenced.

This section sets out common issues observed by HMRC and best practice suggestions to reduce compliance risk for the following areas:

- Compliance planning and scoping
- Common issues with functional analysis
- Common issues with comparability analysis
- Common risks in calculations and adjustments
- Documenting the functional analysis

Compliance planning and scoping

HMRC indicates that transfer pricing specialists should work with UK risk leads to identify business and potential policy changes and agree scope and timing of compliance work. Specialists also are encouraged to ensure that UK risk leads clearly understand the risk and benefits of different compliance approaches, budgets, and resourcing options.

Common issues with functional analysis

It is important that the facts within a functional analysis accurately reflect the UK business activities. Emphasis is on the standard of functional analysis and sufficiency of the facts and evidence relied upon in performing that analysis. HMRC again references proportionality. HMRC notes that it often encounters issues in the following areas:

- Timing of functional analysis
- Multi-territory functional analysis prepared centrally
- Re-use or roll forward of functional analysis
- Reflecting business change in functional analysis and delineation conclusions
- Functional analysis - risk analysis
- Functional analysis - intangibles
- Evidencing people functions

Common issues with comparability analysis

The guidelines set out that HMRC frequently encounters issues with the documentation of comparability analysis or stand-alone benchmarking studies being too brief or incomplete. It sets out best practice approaches in a number of areas including:

- General comparability analysis documentation observations, including a well-documented process for identifying external comparables, search for potential internal comparables and conclusions, explanation of profit measure selected and analysis of areas where comparability is less reliable

- Centralized comparability analysis, in particular the need to localize the comparability analysis performed for the UK business
- Reuse or roll forward of comparables
- Common risks in comparability analysis

Common risks in calculations and adjustments

This section of the guidelines indicates that HMRC commonly observes errors in the calculation of the arm's-length result or range resulting in returns being filed on a non-arm's length basis. This section sets out common examples of errors in order to help businesses minimize the likelihood of such errors occurring.

Documenting the functional analysis

The guidelines highlight that HMRC frequently sees transfer pricing documentation that is too high level and insufficiently evidenced such that HMRC is unable to assess from the documentation whether an arm's-length return has been filed, which leads to increased compliance costs. This section sets out both best practice and unhelpful approaches with regards to:

- Timing
- Evidence
- Common quality issues including lack of consistency with other documentation (for example, patent box and R&D claims), one sided analysis and generic analysis
- Documenting functional analysis conclusions
- Documenting the arm's-length result, including a reconciliation of the returns to the statutory P&L results and details of allocation keys

The GfC reference the new UK transfer pricing documentation requirements and the need for businesses to keep records and evidence to demonstrate an arm's-length result.

Observations:

The guidelines highlight the importance of the preparation of contemporaneous documentation and collation of evidence. They also highlight the importance of UK localization and the need for UK specificity, in particular with respect to functional analysis and benchmarking. It is clear that, in order to reduce transfer pricing compliance risk, centrally prepared transfer pricing analysis and documentation cannot be relied upon by UK businesses without review by the UK business and (where relevant) localization. This applies both for those businesses within the new UK transfer pricing documentation requirements and those who, although exempt from these requirements, still must retain appropriate books and records (including documentation) when filing a tax return.

Where external advisors are used to support transfer pricing compliance, businesses will need to work closely with them to ensure transfer pricing documentation projects are appropriately scoped and that they understand the risk if analysis and documentation is of insufficient detail and/or not UK specific.

Part 3 - Indicators of transfer pricing policy design risk

HMRC notes that compliance risk often is created by setting transfer pricing policies that are not sufficiently supported by analysis or do not adequately reflect the facts and circumstances of the UK business.

This section of the guidelines sets out high-risk approaches to transfer pricing policy design and best practice approaches to reduce risk in the following areas:

- General risks in policy-setting approaches
- Intangible assets ownership and exploitation
- Above market intra-group services
- Transfer pricing target margin models
- Cost-based reward for services
- Sales-based reward for services
- Franchise fees and similar single-fee arrangements

HMRC clearly indicates that these guidelines do not represent its underlying policy positions in these areas.

Observations:

This section of the guidelines echoes points made by HMRC throughout the preceding two sections. In particular, it again highlights the importance of functional analysis and evidenced underlying control over risk and substance, and alignment of this with transfer pricing policy and documentation. As noted by HMRC, this is of particular relevance to low risk or de-risk entity characterizations.

In particular, in relation to the risk areas highlighted in the guidelines, we are already seeing notable investigations and challenges from HMRC in the following areas:

- Challenge that a cost-plus or routine target margin approach is insufficient reward for senior UK-based decision-makers where they are viewed to make contributions to control over risk
- Related to the above, investigations where an overseas IP owner earns all the residual profit and the UK business performs significant services to that overseas IP owner (most notably in relation to R&D and marketing services)
- Assertion that service fee calculations should be amended to include the application of a mark-up on costs that a business has treated as pass-through costs
- Challenges in relation to situations where a UK business has entered into a cost contribution arrangement that results in the UK business then making losses; this often can include investigation as to whether the UK has sufficient functionality to be a cost-share participant, as well as valuation issues where a buy-in payment was paid by the UK business

The takeaway

Transfer pricing is a key area of focus for HMRC; the transfer pricing compliance burden on businesses and HMRC expectations are increasing. New transfer pricing documentation requirements, recently issued guidance on risk control, and further expected updates to the transfer pricing legislation are coupled with more frequent, complex, time-consuming and costly transfer pricing disputes, characterized by lengthy, evidence-based audits, increased scrutiny, and rigorous application of penalties. In addition, we expect HMRC, given its new information powers, to more regularly request transfer pricing documentation both during and outside of a tax audit — e.g., as part of its increasing scrutiny of transfer pricing risk during business risk reviews. Consequently, maintaining robust transfer pricing compliance and governance processes, alongside evidence-based, contemporaneous UK transfer pricing documentation, is crucial.

This guidance is helpful in that it sets out HMRC's expectations with regards to best practice, which HMRC could use as a risk assessment tool. However, the guidelines are lengthy and, for many businesses, compliance with all aspects could be onerous and, in some cases, disproportionate.

Businesses that must apply transfer pricing should take the time to read the GfCs in order to understand HMRC's expectations compared to their current transfer pricing compliance and governance processes. The guidelines should be considered alongside other transfer pricing compliance related requirements and guidance, in particular, the UK transfer pricing records regulations, UTT notification obligations, and SAO requirements.

Due consideration should be given to the current processes and governance in place for obtaining and documenting evidence and the timing of these, in particular in relation to performing functional and comparability analysis. Based on this analysis, gaps can be identified, as well as potential risk mitigation actions. Considering this alongside the business' size, complexity and risk appetite will enable businesses to make an informed decision with respect to the level of risk mitigation work to undertake.

Let's talk

For a deeper discussion of how these guidelines might affect your business, please contact:

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