

UK adopts OECD Action 13 Master File and Local File and adds a “Summary Audit Trail”

December 22, 2021

In brief

On March 23, 2021, HMRC released a [public consultation document](#) setting out proposed changes to UK transfer pricing documentation requirements. The stated objectives of the proposed changes were to:

- Provide greater certainty for UK businesses around documentation requirements for transfer pricing;
- Provide HMRC with better quality data to enable more efficient and targeted compliance interventions; and
- Align the UK’s practice more closely with the documentation requirements of other jurisdictions and with the [BEPS Action 13 Report](#).

Two main changes put forward were the introduction of:

- Mandatory Master File and Local File requirements (in line with the BEPS Action 13 Report) for UK multinational enterprises (MNEs) within the scope of Country-by-Country reporting (CbCR) requirements, with the possible inclusion of an “evidence log” in the Local File; and
- Additional disclosures about cross-border transactions with associated enterprises to be included in an International Dealings Schedule (IDS).

On November 30, 2021, HMRC published its [consultation outcome](#), summarizing the representations it received, providing government comments, and setting out a path forward for transfer pricing documentation in the UK:

- For larger taxpayers, the maintenance of Master File and Local File format documentation will become a legal requirement in 2023.
- The “evidence log” has been replaced with a “Summary Audit Trail” (SAT) document.
- The introduction of an IDS has been put on hold but will be kept under review.

HMRC plans to move forward with consultation on draft legislation and guidance in 2022, with new rules taking effect from April 2023 (presumably for accounting periods beginning on or after April 1, 2023).

Action item: Businesses should continue to assess their transfer pricing reporting systems and controls and evaluate their approach to transfer pricing documentation for the UK as a priority in seeking to satisfy HMRC's expectations in terms of process, content, and supporting evidence.

In detail

Master File and Local File requirements

HMRC conclusions

In line with HMRC's initial proposals, the Master File requirement will apply based on the CbCR threshold — i.e., a group with consolidated group revenues over €750 million. For the Local File, while reference is made to "the largest customers" needing to maintain such a file, it is not explicit that this also will be based on the CbCR threshold. The Files do not need to be submitted to HMRC as a matter of course, but should be prepared in advance of the annual filing of a return and would need to be provided within 30 days of a request. All taxpayers that must apply transfer pricing would be encouraged by HMRC to take the same approach to their documentation, reflecting HMRC's view that the Master File and Local File approach represents best practice.

HMRC clearly expects that a Master File can be provided, notwithstanding the questions of whether one already is prepared elsewhere in the group and, if so, whether it is in the power or possession of the UK taxpayer. The Master File information is viewed as a necessary element of the application of the arm's-length principle, and that its absence would suggest that "the entity may not have been able to establish that it has made a correct return."

HMRC has said that it will "closely align the requirements and guidance to the OECD standard" for Master File and Local File, with the addition of a SAT requirement.

Observations

While the UK was one of the first countries to introduce a requirement to prepare and file a CbC report intended to help HMRC with risk assessment, to date there has been no formal requirement to follow Action 13 format and content for other components of a taxpayer's transfer pricing documentation. The introduction of formal rules for Action 13 Master and Local Files will remove the degree of flexibility that previously existed and align the UK with many other countries, although the United States and some other countries have not adopted this approach. Even countries that do have rules often have their own version of the Action 13 requirements; it will be interesting to see the extent to which the UK rules do "closely align" with the OECD standard, given that the addition of the SAT already represents a significant departure from that standard.

The limitation — to larger taxpayer groups — of the scope of the legal requirement to adopt the OECD standard might be interpreted as meaning that the impact felt by many MNEs would be relatively limited, with Master and Local Files already being produced. With the increasing emphasis on the underlying process and supporting evidence (including the SAT requirement), together with HMRC's reiteration that it sees the OECD standard as best practice for all taxpayers, this interpretation should be carefully and cautiously considered.

"Summary Audit Trail" requirement

HMRC conclusions

As part of its original proposals, HMRC suggested that it would like "to explore the benefits of requiring the local file to be supported by some form of evidence log setting out key facts, potentially as an appendix to local file documentation." In HMRC's view, this would help with a common problem in transfer pricing inquiries of distinguishing underlying facts and evidence from technical opinions and would result in better-focused inquiries and faster resolution by reducing long periods of fact-finding. An evidence log is a fundamental part of the approach adopted in HMRC's [Profit Diversion Compliance Facility](#) (PDCF).

The SAT is presented as a more limited requirement, compared to the evidence log which it has replaced, and the SAT will be required by law, with supporting guidance. HMRC has stated that in practice, the SAT will be “a short, concise document summarizing the work already undertaken by the customer in arriving at the conclusions in their transfer pricing documentation.” The dual purpose of the SAT is to provide encouragement for “sufficient” work to be undertaken to support transfer pricing arrangements, by increasing the level of transparency around process and evidence, and to provide better HMRC focus during inquiries, through high level quality assurance.

Observations

Like the evidence log before it, the introduction of the SAT is a novel step beyond the scope of the Action 13 requirements. Taxpayers should recognize this as a fundamental change, whereby HMRC is in effect asking MNEs to set out contemporaneously the process they have followed in reaching and documenting their position that the arm’s-length principle has been properly and diligently applied.

The description of the SAT so far is brief and general, but taxpayers reasonably should expect HMRC to be interested in the steps the business has gone through in seeking to make its documentation compliant — e.g., what did the business do to verify the accurate execution of policies and the reliability of the numbers that go into the tax return; which business representatives were interviewed or consulted; what supporting documents and evidence were collated and reviewed; how many times did the business engage with an advisor; what instructions were given; and when did these actions take place.

There then is the question of how HMRC intends to use the SAT as part of its risk assessment and inquiry processes. This is described as “high level quality assurance” to assess whether sufficient work has been carried out, at the right time. Potentially, the SAT also provides HMRC with the opportunity to make targeted requests for supporting evidence — for example, meeting notes from discussions with identified business representatives — and otherwise to test the process laid out in the SAT. Recent inquiry experience in the UK, coupled with the introduction of the PDCF, already has shown a marked increase in the level of evidence that HMRC is asking to see.

At the same time, there is an opportunity for groups to demonstrate that their processes are robust and that they have been applied with due care, which may be helpful in terms of the application of penalties and the ability of HMRC to go back into earlier years using Discovery Assessments.

International Dealings Schedule

HMRC conclusions

The original consultation proposed the introduction of an IDS to report transactional data about intragroup cross-border transactions in a structured format which would be used by HMRC to identify transfer pricing risks more accurately. All UK businesses within the scope of UK transfer pricing legislation (which generally excludes small and medium-sized enterprises) would have been required to file an IDS under the current proposals, but with materiality limits being considered to exclude certain transactions and reduce the potential administrative burden.

HMRC has reiterated the benefits it sees from the collation and provision of data which are of high quality and would support data-led risk assessment and tax compliance. At the same time, there is acknowledgment of the challenges of making any IDS proportionate and meaningful, without excessive cost, systems requirements, and administrative burden. HMRC will not implement or consult further on an IDS at present, but this will be kept under review.

Observations

HMRC’s IDS proposal generated much taxpayer feedback highlighting considerable concerns around the costs, resources, and complexities involved in extracting, compiling, and submitting an IDS, particularly given the extensive list of suggested items for inclusion in the schedule. Therefore, it will come as welcome news and perhaps a bit of a surprise to many MNEs that this is not being implemented, nor will it be the subject of further

consultation for the time being. A number of other countries do require the compilation and submission of information on intercompany transactions in one form or another, and HMRC plans to keep this option under review, but their reaction to the feedback is encouraging and suggests they will give careful consideration to any future proposals in this area.

Legislation and guidance

HMRC conclusions

HMRC intends to consult on draft legislation in 2022, with new rules coming into force in 2023 (presumably for accounting periods beginning on or after April 1, 2023). Also, there are repeated references to the need for updated and more detailed guidance in a number of areas, with HMRC noting that this may be the first time that a number of taxpayers have prepared documentation in Master File and Local File format, that the introduction of the SAT element to the Local File is a new and unfamiliar concept, and that there are issues of materiality and administrative burden still to be addressed.

Observations

The consultation outcome provides taxpayers with an index of the transfer pricing documentation components that will be required by UK law in the future. Converting that index into unambiguous legislation, clear definitions, and guidance which is both effective and practical by no means will be an easy next step.

The takeaway

The confirmation of OECD-format Master File and Local File requirements for larger groups for the most part brings the UK into alignment with many other territories. The SAT will need clear guidance on expectations regarding the 'sufficiency' of processes and the documentation of the audit trail itself so that this can be prepared in a pragmatic and cost-effective manner; and it is encouraging that HMRC is thinking about materiality, cost, and administrative burden to taxpayers.

Legislation will come into effect in 2023, but the rules are expected to enact what HMRC already considers to be best practice. Taxpayers need to manage their risks proactively in what is already an active and challenging dispute environment in the UK.

Generally, HMRC has made a thoughtful and measured response to the consultation, and the commitment to the further involvement of external stakeholders in the process of producing legislation and guidance is welcome. It is key that businesses take the opportunity to engage in the further consultation process and to make representations where appropriate.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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