The Transfer Pricing Law Review

Fifth Edition

Editors
Steve Edge and Dominic Robertson

The Law Reviews

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THE TRANSFER PRICING LAW REVIEW

FIFTH EDITION

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This article was first published in July 2021
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Steve Edge and Dominic Robertson

THE LAWREVIEWS

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Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK
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www.TheLawReviews.co.uk

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Enquiries concerning editorial content should be directed
to the Publisher – clare.bolton@lbresearch.com

ISBN 978-1-83862-837-6

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ARENDT & MEDERNACH

ATLAS TAX LAWYERS

BLAKE, CASSELS & GRAYDON LLP

BMR LEGAL ADVOCATES

CMS RUI PENA & ARNAUT

DDTC

FLICK GOCKE SCHAUMBURG

HERZOG FOX & NEEMAN LAW OFFICES

HORTEN LAW FIRM

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PINHEIRO NETO

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UDO UDOMA & BELO-OSAGIE

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PREFACE

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

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

Given their economic importance, transfer pricing rules will be high on the corporate tax agenda (and the broader political agenda) for many years to come, and they are continuing to evolve at a rapid pace. Over the next few years, we expect the following to be among the main areas of focus.

First, the transfer pricing impact of the covid-19 pandemic still needs to be worked out by many countries, though the OECD should be commended for publishing clear guidance on this within a few months of the start of the pandemic. At this time last year, many advisers were arguing (in our view, rather optimistically) that companies that were rewarded on cost-plus or the transactional net margin method bases as routine service providers should, as a result of the pandemic, bear a share of the 'system losses' in groups that had been pushed into heavy loss-making positions by lockdowns or travel restrictions. The OECD guidance has largely rejected that approach, arguing that the existing arm's-length principle and the OECD guidelines remain fit for purpose during the pandemic. In particular, the guidance warns tax authorities to be sceptical of claims that a routine service provider should bear a share of residual losses, and notes (rightly, in our view) that this argument – if accepted – would likely require that entity to share in residual profits in happier times. Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

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Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts have recently held that transfer pricing rules are not limited to pricing adjustments alone; and Ireland has introduced rules that enable the Irish Revenue to impose a 'substance over form' principle. In contrast, the Canadian courts ruled, in the *Cameco* case last year, that TP recharacterisation was permitted only where the underlying transactions were 'commercially irrational'.

Third, many countries are strengthening the requirements for contemporaneous transfer pricing documentation, either aligning with the OECD master file or local file model (as in Israel), or potentially going beyond this (as the UK has proposed).

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards agreeing a solution in 2021, which has become more likely following the arrival of the Biden administration in January 2021. Immediately before this preface was written, the G7 finance ministers confirmed that they have agreed to a global minimum tax rate of at least 15 per cent; and, more significantly for transfer pricing purposes, a pivot away from the arm's-length standard for large and highly profitable multinationals, under which a portion of their profits (above a 10 per cent hurdle rate) would automatically be reallocated to market jurisdictions. This is, of course, a radical shift away from the traditional arm's-length standard, but it is worth emphasising that the arm's-length principle will continue to play a crucial role for large businesses and tax authorities. This is, first, because it will take several years for the reallocation rule to become embedded in national laws and double tax treaties; and, more enduringly, because the arm's-length standard will continue to apply (1) to the vast majority of businesses that fall outside the reallocation rule, either because of size or profit margins; and (2) to the majority of the profits of those businesses that are subject to the reallocation rule. Clearly, there is much more detail to come on these changes, and we look forward to seeing this discussed in depth in the next edition of the *Review*.

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

Steve Edge and Dominic Robertson
Slaughter and May
London
June 2021

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Chapter 18

UNITED KINGDOM

Steve Edge, Dominic Robertson and Tom Gilliver[1]

I OVERVIEW

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

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

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

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

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

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

i Meaning of 'provision'

A 'provision' must be made for the UK rules to apply. While the term 'provision' is not defined in the legislation, Her Majesty's Revenue and Customs (HMRC) guidance suggests that it should be given a wide meaning, and embraces all the terms attaching to a transaction or series of transactions. The guidance also provides that the term is broadly equivalent to the phrase 'conditions made or imposed' in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (the Model Convention) and should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines).[2] The Upper Tribunal has held that a share issue is a provision for transfer pricing purposes,[3] which means that the term is not confined to commercial transactions, and UK transfer pricing legislation can also impact shareholder transactions.

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

2 HMRC International Manual (INTM412050).

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

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

ii Degree of relationship

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

'Direct' control is most commonly satisfied through voting control. Additional rules apply to determine whether a person has 'indirect' control.[5] Indirect control will arise in any of the following scenarios:

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

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

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

iii Scope

The UK rules apply where an actual provision has been made or imposed between two 'persons'. There is no definition of 'person' in UK tax legislation, but HMRC will apply the term to include bodies corporate, partnerships and individuals. A recent tribunal decision held that the rules can apply to a provision between a company and an individual acting in their personal capacity.[6] The effect of the participation condition (see above), however, is that one of the parties to the actual provision must be a body corporate or a partnership.

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

Where an adjustment is required by the transfer pricing rules to increase the profits (or reduce the losses) of one party (the advantaged party), the connected UK party (the disadvantaged party) may, in turn, claim a compensating adjustment to its taxable profits. The rules also allow for a balancing payment to be made by the disadvantaged party to the advantaged party tax-free up to the amount of the compensating adjustment.[7]

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

4 Section 1124 of the Corporation Tax Act 2010.

5 Sections 157 to 163 of TIOPA.

6 *BCM Cayman LP and BlueCrest Capital Management Cayman Limited v HMRC* [2020] UKFTT 298 (TC) (under appeal).

7 Section 196(2) of TIOPA.

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The UK transfer pricing rules do not apply to the calculation of capital gains or losses except to facilitate a claim for a compensating adjustment where there has been a transfer pricing adjustment.[8] However, a market value rule applies to many related-party transactions under the Taxation of Chargeable Gains Act 1992, which should generally produce a similar result.

iv OECD principles

The UK rules contain an express provision that Part 4 of TIOPA should be construed in a manner that best secures consistency with the arm's-length principle in Article 9 of the Model Convention and the 2017 OECD Guidelines.[9] The definition of the OECD Guidelines has been updated to include the Base Erosion and Profit Shifting (BEPS) Actions 8–10 Final Reports. HMRC view updates to the OECD Guidelines as clarificatory, and contend that transactions should always be tested under the current version of the OECD Guidelines.

II FILING REQUIREMENTS

There is currently no specific requirement under the UK rules to prepare a transfer pricing report. However, a taxpayer must keep and retain appropriate records and documentation to support its tax return.

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

a primary accounting records;
b tax adjustment records;
c records of transactions with associated businesses; and
d evidence to demonstrate an arm's-length result.[10]

While HMRC would expect the first three categories to be prepared before a tax return is filed, evidence supporting an arm's-length result may be required only in response to a subsequent information request from HMRC. However, where HMRC make any adjustments to the transfer pricing position in a tax return, HMRC will in practice require some evidence that the company had carefully considered the arm's-length position, to be satisfied that no 'careless error' penalty is due. Traditionally, this can be done by preparing a formal transfer pricing report; the company should of course verify that the comparables identified in the report are genuinely functionally similar to the company itself.

In March 2021, HMRC published a consultation on whether large UK companies should be required to prepare transfer pricing reports or to report material cross-border transactions with associated enterprises, or both.

8 HMRC International Manual (INTM412040).
9 Section 164 of TIOPA.
10 HMRC International Manual (INTM483030).

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III PRESENTING THE CASE

i Pricing methods

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

The OECD Guidelines permit taxpayers to adopt 'other methods' outside the five OECD-recognised methods where the latter are regarded as less appropriate or unworkable based on the facts and circumstances of the case. Under most of the methods, the controlled (i.e., related party) transaction then needs to be compared against an uncontrolled (i.e., independent party) transaction.

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

Comparability

HMRC emphasise the importance of carrying out a robust comparability analysis in determining the acceptable range of arm's-length pricing. Inevitably, this is complicated by limits on the available information on a third party's actual position. A determination as to whether a comparable is reliable must be made case by case, based on the extent to which it satisfies the five comparability factors identified in the OECD Guidelines (i.e., characteristics of the property or services transferred, functions performed (including assets used and risks assumed), contractual terms, the economic circumstances of the parties and the business strategies of each party).

In practice, HMRC acknowledge that a small number of strong comparables are likely to give a more accurate result than a large number of weak comparables.

HMRC will carefully scrutinise any comparability adjustments made (for example, for accounting consistency, and adjustments for differences in functions, assets and risks). In line with the OECD Guidelines, the only adjustments that should be made are those that will have a material effect on the comparison and that are expected to improve comparability. If numerous or substantive adjustments are required, this may indicate that the independent transaction is not, in fact, comparable.

Cost-plus

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

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Profit split

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

Cost sharing

The OECD Guidelines on cost-sharing arrangements apply in the UK. HMRC emphasise that there is no difference in the approach to transfer pricing for cost-sharing arrangements than for any other transactions, and that parties performing activities under similar economic circumstances should receive the same expected return, irrespective of whether those activities are performed under a cost-sharing arrangement or not.

ii Authority scrutiny and evidence gathering

Cross-checks

While one particular method may be selected and applied to determine the arm's-length pricing of the transaction, HMRC also emphasise the importance of cross-checking this result against other methods and applying 'sense checks'.

In particular, HMRC generally want to test the outcome against the 'system' profit share in each jurisdiction in the value chain. This enables HMRC to form a view on whether the UK is getting its 'fair share' of the profits.

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

Country-by-country reporting

The UK has adopted country-by-country reporting (CbCR). The rules require any UK-headed multinational enterprises or, in certain circumstances, UK sub-groups of multinational enterprises, with a consolidated group turnover of €750 million or more to file an annual report with HMRC containing information about global activities, profits and taxes.

Evidence gathering

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

HMRC will normally obtain information in a transfer pricing enquiry through informal information requests that are discussed and agreed with the taxpayer, but HMRC have the formal power to require taxpayers (and, subject to some restrictions, third parties) to provide information and documents, which they will use if the taxpayer is not cooperating fully with the enquiry, or where the use of HMRC formal powers is helpful to deal with any confidentiality or data privacy restrictions on disclosing documents informally. HMRC

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cannot require the production of legally privileged documents, or documents outside the 'power or possession' of the relevant party, which can lead to practical difficulties where documents are held elsewhere within a multinational group.

Interviews

In addition to carrying out a review of documentary evidence (including emails), witness interviews may be required. Interviews with key business personnel can help to address any gaps in HMRC's knowledge following a review of the documentary evidence, to verify HMRC's analysis of the functions and risks, and to assess whether there is any divergence between the written intra-group contracts and the practical operation of the business. In particular, HMRC are keen to meet with those working at the coalface to get a proper understanding of where they perceive the real value-generating activities of the business to be located. It is fairly unusual for expert witnesses, such as economists, to be involved prior to an appeal, but in some cases HMRC may consult its in-house economists.

In some cases, HMRC may request interviews with third parties outside the taxpayer group, including customers. To avoid undue business disruption and to protect taxpayer confidentiality, HMRC should try, where practical, to obtain information and documents from the taxpayer concerned before approaching third parties.

Information exchange powers

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

Exchange of information articles typically restrict HMRC's use of the exchanged information and the onward disclosure of that information. Normally, the information can be used only for the purposes of the assessment and enforcement of the taxes covered by the relevant treaty.[11] While transfer pricing will fall within the scope of most double tax treaties, this may not be the case for DPT, since HMRC view DPT as a tax 'in its own right' and not as corporation tax.[12]

IV INTANGIBLE ASSETS

HMRC recognise that intangible assets represent a material risk area for transfer pricing.

The BEPS Actions 8–10 Final Reports provide revised guidance tailored to determining arm's-length conditions for intangible asset transactions. This guidance provides a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles, based on the value they create through functions

11 HMRC International Manual (IEIM200200).

12 HMRC DPT Guidance (INTM489570).

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performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (DEMPE). In 2018, the OECD issued guidance for tax administrations on hard-to-value intangible assets.

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

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

V SETTLEMENTS

The settlement of a transfer pricing enquiry must be approved by HMRC governance boards that specifically review transfer pricing or diverted profits tax cases (or both), which will make a recommendation to the Tax Disputes Resolution Board (TDRB) and to the Tax Assurance Commissioners (TAC) if the case falls within 'those bodies' remit.

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

The relevant board will examine the recommendations made in the case team's resolution report. If the settlement is authorised, HMRC will confirm the agreement and its terms in writing to the taxpayer and its advisers. The taxpayer is then afforded a 30-day cooling-off period in which it may withdraw from the agreement before a closure notice or assessment is issued.[13]

If the resolution report is not approved, the relevant board will set out the reasons why and the basis upon which the case team should revisit the negotiation or proceed to litigation.[14]

Where a settlement has resulted in an adjustment to a taxpayer's returned profits, this may, in practice, potentially be relied upon to inform the future returning position, provided there has been no material change in the circumstances of the business or in market conditions. However, HMRC emphasise in their guidance that they cannot provide any assurances that a future return will not be subject to a transfer pricing enquiry. Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process.[15] Certainty will only be achieved, of course, if the critical assumptions arrived at in the APA process remain true. Negotiating these assumptions will often require significant work.

13 Sections 208 and 209 of TIOPA.

14 HMRC International Manual (INTM483070).

15 HMRC International Manual (INTM483130).

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In some cases, HMRC will recommend an APA either following a transfer pricing enquiry or during the process. This has the obvious advantage of enabling a taxpayer to realise longer term benefits from the cost and effort involved in resolving the enquiry itself – though the critical assumptions on which the APA is based can, of course, mean that the APA falls away whenever the critical assumptions are breached.

VI INVESTIGATIONS

i Process

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

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

ii Time limits

In most cases, HMRC may open an enquiry into a taxpayer's return within 12 months of the date on which the tax return is filed. Once opened, there is no specified time limit for completing the enquiry. Although HMRC aim to resolve transfer pricing enquiries within 18 months for most cases, and 36 months for complex and high risk cases, in practice many enquiries can run beyond this. The taxpayer may request HMRC (or the tax tribunal) to close an enquiry if there appears to be an unnecessary delay by HMRC in progressing the case.[16]

Where the 12-month period within which an enquiry must be opened has passed, HMRC have the power to raise a discovery assessment where there has been incomplete disclosure or careless or deliberate conduct by the taxpayer. The time limit for raising a discovery assessment is generally four years from the end of the relevant accounting period. This may be extended to six years where the underpayment of tax was due to carelessness by the taxpayer (or 20 years where the error in the taxpayer's transfer pricing position was deliberate).[17]

To conclude a formal enquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend its return.[18] If a taxpayer fails to comply with the closure notice, HMRC may make a determination as to the amount of tax that it considers is payable by the company.[19] Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.[20]

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days of the notice or assessment being issued.[21]

16 Paragraph 33 of Schedule 18 to the Finance Act 1998.
17 Paragraph 46, ibid.
18 Paragraph 32, ibid.
19 Paragraph 36, ibid.
20 Paragraph 39, ibid.
21 Paragraph 48, ibid.

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iii Profit Diversion Compliance Facility

In January 2019, HMRC launched a Profit Diversion Compliance Facility (PDCF) intended to enable multinational enterprises to correct transfer pricing irregularities. The PDCF is targeted at situations in which a multinational enterprise has adopted cross-border pricing arrangements that might trigger a DPT investigation because the arrangements either do not reflect what is happening on the ground or are inconsistent with the OECD Guidelines. An enterprise wishing to use the PDCF must submit a detailed disclosure report of its transfer pricing affairs, including a proposal for the tax, interest and penalties payable to remedy the identified irregularities. By using the PDCF, an enterprise may obtain more control over its interactions with HMRC regarding transfer pricing, avert a future DPT investigation or benefit from lower penalties. HMRC will aim to respond to proposals submitted through the PDCF on an accelerated three-month timescale, though this may be optimistic given the time taken to investigate and resolve recent transfer pricing cases in the UK.[22]

VII LITIGATION

i Procedure

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

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

As HMRC are a public body, a taxpayer may apply to the High Court for judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if believing, for example, that an HMRC officer has failed to carry out his or her duties properly or has misdirected the taxpayer, and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims. In *R (Glencore Energy UK Ltd) v. HMRC*,[23] the taxpayer received a DPT charging notice and sought judicial review of the notice, arguing that the statutory appeal process was 'slow, inappropriate and ineffective'. Unsurprisingly, given the very high threshold required for a judicial review case to succeed, and the availability of an alternative remedy through the normal appeals process, the Court of Appeal refused this application.

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

A court decision may be appealed where permission has been granted. Appeals against the decisions of the FTT can generally be made only on a point of law. However, if a party believes that the findings of fact made by the FTT are such that no judge properly could have come to that determination, an appeal may be permitted on those wider grounds.

22 HMRC Profit Diversion Compliance Facility Guidance dated 10 January 2019.

23 [2017] EWCA Civ 1716.

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ii Recent cases

Until recently, very few transfer pricing cases had been litigated in the UK.

DSG Retail Ltd v. HMRC [24] concerned a UK company that sold electrical goods. It encouraged customers to purchase extended warranty agreements. The liability to customers under those warranty agreements was insured or reinsured by an associated Isle of Man company via a third-party insurer. The tribunal considered whether transfer pricing rules apply to the indirect provision of a business facility between connected companies where there is no contractual relationship between those companies, and the appropriate transfer pricing methodology for an adjustment.

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

In the *BlueCrest* case,[25] HMRC argued that a UK permanent establishment that borrowed US$165 million from related parties would have been unable to do so at arm's length, and, more surprisingly, that a further US$200 million that it borrowed from a third party bank could not have been borrowed from a third party acting wholly independently either (on the basis that it was supported by covenants from other members of the group). The FTT found in favour of the taxpayer on this issue, based on a careful weighing of the expert evidence, with HMRC's case not being helped by the fact that their expert sought to recharacterise the entire transaction into an alternative transaction, which would have failed to achieve the transaction's commercial aims.

In *BlackRock Holdco5 LLC v HMRC*,[26] which was heard by the same FTT judge as *BlueCrest*, one of the arguments HMRC put forward to challenge an acquisition structure that (in the taxpayer's view) produced large interest deductions in the UK was that the intra-group interest costs would not have been incurred at arm's length. The expert witnesses for both parties agreed that an independent lender would have been prepared to lend the amount at similar interest rates, albeit subject to additional covenants. However, HMRC argued that the group simply would not have implemented a structure under which the company borrowed from an independent lender. The FTT rejected that argument, on the basis that HMRC were speculating about what the group as a whole might or might not have chosen to do, which is irrelevant to the question of what the terms of the lending transaction would have been at arm's length.

It is notable that, in both cases, HMRC used an economist as their expert witness, with the taxpayer preferring to use a businessperson; and that, in each case, the FTT preferred the taxpayer expert over the rather more speculative approach from the HMRC experts. Both *BlueCrest* and *BlackRock* have been appealed to the Upper Tribunal.

As noted in Section I.i, above, it was held in the *Union Castle* case that shareholder transactions such as bonus issues can be subject to adjustment on transfer pricing grounds.

24 SpC [2009] SSCD 397.

25 *BCM Cayman LP and BlueCrest Capital Management Cayman Limited v HMRC* [2020] UKFTT 298 (TC).

26 [2020] UKFTT 443 (TC).

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VIII SECONDARY ADJUSTMENT AND PENALTIES

i Secondary adjustments

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

ii Penalties

HMRC may impose penalties if an incorrect return is made and a taxpayer has been careless in establishing an arm's-length basis for the return; or a taxpayer does not maintain adequate records.[27] Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an enquiry.[28]

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

Given that transfer pricing is more of an art than a science and identifying an arm's-length price is a matter of judgement, it can be difficult to determine what is meant by 'careless' in a transfer pricing context. While each case must be judged on its own merits and facts, HMRC provide some examples in its guidance on how it interprets these concepts. For example, where HMRC are satisfied that the taxpayer has made an honest and reasonable attempt to comply with the arm's-length principle, no penalty should apply.[29]

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

DPT was introduced from 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements.[30] It is intended to provide the transfer pricing legislation with a little more steel to support HMRC enquiries in high-risk transfer pricing areas (such as the digital economy). The expectation is that this, in turn, encourages better transfer pricing compliance, and greater transparency with HMRC in dealing with transfer pricing enquiries.

Broadly speaking, a DPT charge can arise in two scenarios:

a where a UK subsidiary or permanent establishment enters into arrangements with a related person where that person or the arrangements lack economic substance, resulting in a reduction in taxable profits; or

b where a person carries on an activity in the UK connected to the supply of goods, services or other property made by a non-UK resident company in the course of its trade in a way that avoids creating a UK permanent establishment.

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27 HMRC International Manual (INTM483110).

28 Part 7 of Schedule 36 to the Finance Act 2008.

29 HMRC International Manual (INTM483120).

30 HMRC DPT Guidance (INTM489500).

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The amount of DPT payable is 25 per cent of the amount of 'taxable diverted profits'.[31] As the headline UK corporation tax rate will increase to 25 per cent from 1 April 2023, the DPT rate will similarly increase to 31 per cent to maintain the differential. (An error in the DPT legislation meaning that both DPT and corporation tax were technically payable on the amount of taxable diverted profits was corrected in 2019, such that profits charged to DPT are excluded from corporation tax to avoid double taxation.)

In most cases, any DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can accelerate resolution of a transfer pricing enquiry for the following reasons:

a the DPT rate is considerably higher than the corporation tax rate;

b it is not possible to postpone any DPT payment once a charging notice has been issued; and

c DPT gives credit for transfer pricing adjustments only if they are made before or within 12 months after issuance of the DPT charging notice.

In 2019–2020, HMRC issued 55 DPT preliminary notices to 24 businesses and 53 DPT charging notices to 23 businesses. The amount raised from DPT charging notices themselves during the 2019–2020 financial year was only £17 million, though most of the DPT revenue impact comes through transfer pricing adjustments and changes in taxpayer behaviour.[32]

ii Double taxation

Most of the UK's tax treaties have effective mutual agreement procedures (MAPs), some of which now include provisions for mandatory binding arbitration (MBA) in accordance with Part VI of the OECD multilateral instrument. These provisions typically permit HMRC to engage in MAP, but those that do not include MBA provisions do not require the case in question to be resolved. Consequently, there is no guarantee of relief from double taxation under MAP. That said, the UK is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments. HMRC resolved 72 MAP cases in the 2019–2020 financial year.[33]

MAP is not an alternative to the normal transfer pricing enquiry process. An enquiry will not be conducted as part of MAP and, equally, MAP will not suspend or replace an enquiry. A taxpayer cannot pursue domestic legal remedies and MAP concurrently. If a case is accepted for MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay MAP until these remedies are exhausted.[34]

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

31 Section 79 of the Finance Act 2015.

32 Transfer Pricing and Diverted Profits Tax Statistics, to 2019–2020.

33 ibid.

34 HMRC Statement of Practice 1/2018.

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iii Consequential impact for other taxes

VAT

Where a business records its transactions with related parties on arm's-length terms, no transfer pricing issues should typically arise in respect of those transactions for VAT purposes. Further, HMRC's view is that balancing payments do not in themselves create taxable supplies for VAT purposes. However, the existence of a transfer pricing adjustment or the payment or receipt of a balancing payment may indicate that the value of a previous VATable supply has been understated so that a VAT correction may be required.[35]

Where the advantaged party and the disadvantaged party are within the same VAT group at the time of the original supply and subsequent adjustment, no VAT liability would normally arise.[36]

Import and customs duties

Similar issues arise in relation to the interaction of the transfer pricing rules with import and customs duties. Balancing payments may have to be considered in ascertaining whether there has been an under- or overvaluation of the import price of a particular transaction and, therefore, in determining whether an adjustment is required.[37]

iv Income tax in respect of intangible property

Since April 2019, income tax is charged on income from intangible property received by non-UK residents in low-tax jurisdictions that do not have tax treaties with the UK, to the extent that such income is referable to the sale of goods or services in the UK.[38] Tax is charged on the gross amount of income, rather than on profits.

If the non-UK resident subject to the income tax charge fails to pay, the tax will be recoverable from other entities in the same corporate group (whether or not the other entity is resident or taxable in the UK).[39]

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

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

v Digital services tax

Since April 2020, the UK has levied a digital services tax on large search engines, social media platforms and online marketplaces. The tax is levied at 2 per cent of the gross revenues attributable to UK users. The Government has said that this will be a temporary measure,

35 HMRC VAT Valuation Manual (VATVAL 15700).

36 ibid.

37 HMRC VAT Valuation Manual (VATVAL 15900).

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

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

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which will be removed if and when international agreement is reached on reforming transfer pricing principles to reflect the growing digitalisation of the economy. In March 2021, the Biden administration threatened to impose tariffs on various UK exports in response to the digital services tax.

X OUTLOOK AND CONCLUSIONS

DPT continues to lurk in the background of many UK transfer pricing disputes, and it has emboldened HMRC to adopt an increasingly assertive and inquisitive approach to policing multinationals' transfer pricing. In some cases, this is making it harder for taxpayers and HMRC to reach a mutually acceptable resolution, thus forcing taxpayers to resort to MAP or litigation.

Taking a wider view, the UK transfer pricing landscape continues to be reshaped by international tax reform efforts led by the OECD. The original BEPS project increased focus on functional analysis in applying the transfer pricing rules in the UK, to ensure that transfer pricing outcomes are aligned with the individuals involved in value creation. More profound change is potentially around the corner, in the form of the OECD's Pillar One and Pillar Two proposals. It is already clear that the challenge of integrating the conceptual and practical framework of Pillar One (and, to a lesser extent, Pillar Two) with conventional approaches to transfer pricing, and navigating the areas of overlap, will open up new perspectives on fundamental tenets of transfer pricing, in the UK no less than elsewhere.

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Appendix 1

ABOUT THE AUTHORS

STEVE EDGE

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

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

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

DOMINIC ROBERTSON

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

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

TOM GILLIVER

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

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ISBN 978-1-83862-837-6

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