Transfer Pricing

BUSINESS TAX GUIDE

October 2015

OVERVIEW

Transfer Pricing may be described as the price charged in a transaction between connected parties. This price may not be identical to the price that would apply between unconnected parties. To compensate for this potential lost revenue, HMRC have powers to force adjustments to an entity's tax computation which reflect, for tax purposes, the arm's length price that would have been paid for services, goods and loan interest supplied between such connected parties. The intention of the Transfer Pricing rules is to prevent a 'potential advantage' that would otherwise accrue.

Under UK legislation, companies are required to have in place contemperaneous documentation demonstrating their compliance with UK Transfer Pricing legislation. However, exemption from the Transfer Pricing regime is given to small and medium sized entities, subject to their continuing to meet certain conditions.

The protection of the UK tax base is a current 'hot issue' in the present economic and political environment. HMRC are actively seeking to increase the tax yield from Transfer Pricing related enquiries, with a marked increase in the number and scope of investigations. Penalties apply for non compliance.

Scope

The Transfer Pricing provisions apply to goods, services and financial transactions (including loans) between connected parties, in circumstances where the consideration paid for the transaction is not at arm's length and a potential tax advantage arises as a result.

Meaning of Connection

The connection condition (also known as the participation condition) is met where one party to a transaction, directly or indirectly, participates in the management, control or capital of the other, or a third party participates in both. The level of management, control or capital required before the Transfer Pricing legislation becomes effective is not a precise one. However, control of 40% or more of ordinary share capital, shared management or financial interdependence may be indicative of the connection (participation) condition being satisfied.

Meaning of Arm's Length

The arm's length principle attempts to replicate the price at which a transaction would take place, were it transacted between unconnected third parties. The calculation of arm's length profits is a complex process, often made more difficult as a result of interaction between different countries' tax systems, competing financial interests and the inherent complexities in cross border business transactions. Whilst there are internationally agreed guidelines, it is often the case that agreement is reached only after a lengthy period of negotiation. Expert professional advice is a must in these circumstances.

Meaning of Potential Tax Advantage

A potential tax advantage arises when, as a result of the transaction not being on an arm's length basis, one or both party's taxable profits are reduced, or tax losses are created or increased.

Required Documentation

Companies within the Transfer Pricing regime are required to maintain detailed contemperaneous records, documentating their Transfer Pricing policies and demonstrating compliance therewith. A review of Transfer Pricing documentation will normally form a key component of any HMRC compliance enquiry. The precise content of the policies will depend upon the specific nature of the transactions and relationships between the connected parties. However as a general rule, all Transfer Pricing documentation will provide details of the following;

- An analysis of the market and economic background in which transaction(s) take place
- The methods by which the terms of the relevant transaction were arrived at
- A summary of the analysis and comparables used in arriving at the Transfer Price
- An explanation of the Transfer Pricing adjustment contained within the tax computations, noting any departure from normal conditions.

Small and Medium Sized Entities ('SMEs') Exemptions

SMEs are exempt from the Transfer Pricing regime. Broadly an SME is defined as having less than 250 employees and either a balance sheet total of less than €43m or turnover of less than €50m. However HMRC do reserve the power to serve a 'direction notice' on a medium sized entity, bringing that entity into the Transfer Pricing regime. In addition, an SME can elect to bring itself within the Transfer Pricing regime. Such elections are rare, but may be beneficial if for example the SME is being pursued by a foreign tax regime, and seeks the protection of the UK authorities in resolving a dispute.

Avoidance and Resolution of Transfer Pricing Disputes

Companies (or tax authorities) may seek an 'Advanced Pricing Agreement' ('APA'). The effect of an APA is to 'fix' prices for a number of years in respect of a given supply of goods or services. APAs are agreed between the concerned companies and tax authorities and once agreed are binding on all parties. In addition, companies within the European Union may also take advantage of the European Arbitration Commission, which hears Transfer Pricing disputes arising between entities within EU states.

Given the time and resources involved for both companies and tax authorities in dealing with Transfer Pricing matters, APAs and arbitration may well be worth considering.

How can Rawlinson & Hunter help?

Many companies may not be aware of their obligations under the Transfer Pricing Regime and how it affects them. With timely professional advice and careful planning, Transfer Pricing policies together with appropriate documentation can be implemented, that should withstand HMRC scrutiny whilst maintaining competitive advantage.

If you are interested in further information in this regard, please contact the Rawlinson & Hunter partner who normally acts for you. Where you are not one of our regular clients, please contact Craig Davies or Andrew Shilling, who would be delighted to discuss this with you in more detail.

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