

A tiger with teeth — approach to transfer

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Transfer pricing — for a long time the preserve of specialist tax technicians and economists — is increasingly being tagged as a key weapon for the authorities against what they see as tax avoidance. It is a technical area of law, but it has received detailed attention recently in the national broadsheets and the specialised tax press. Most recently, it was the subject of close focus from *The Guardian* in its 'Tax Gap' series, highlighting tax 'avoidance' by major corporations.



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Without transfer pricing rules, a multinational group could save substantial tax by the very simple step of making a payment from a group company in a high-tax jurisdiction to one in a low-tax jurisdiction. The payment reduces taxable profits in the high-tax jurisdiction, and it is then taxable in the low-tax jurisdiction, but only at the lower rates. This is not tax avoidance, if the payment is for legitimate goods or services. But there is obvious room for manipulation.

In simple terms, transfer pricing is the exercise of setting the price to be paid in transactions between related companies. For the taxman, the right price is the price that would have been negotiated at 'arm's length': the price which two unconnected parties would have agreed. The 'arm's-length' concept is simple to digest, but applying it in practice can be a very difficult exercise. This involves a close analysis of the transaction itself, and then application of an economic theory — chosen from an approved short-list — to that analysis. There is significant room for interpretation and debate. What is also crucial, especially following an Organisation for Economic Co-operation and Development (OECD) publication last autumn, is analysis and documentation of the intra-group transactions. To comply with the rules, the group is required to address, up-front, contractual terms and allocations of risk that it would otherwise not have needed to consider at all.

None of this would matter if the rules were not enforced. For a long time, enforcement in the UK was low-key at best. An international-standard set of transfer pricing rules was only introduced in 1998. For many years after that, the enforcement process did not match the sophistication of the underlying rules. But HM Revenue & Customs (HMRC) have been working for some time now on revamping the operational side of the UK regime.

HMRC had been using generalist tax inspectors to deal with the specialist economic concepts. This meant long-running enquiries and relatively little extra tax collected. HMRC recognised that this was not working and that tackling transfer pricing issues required a specialised and dedicated enquiry team, and an effective enquiry and compliance process. After a planning phase, HMRC started to implement practical changes around 12 months ago. Much of the new-model system is now in place. The upshot is that when a tax return is filed showing dealings with related companies (especially overseas) the risks from a formal enquiry from HMRC are now greater than ever. And if HMRC do enquire,

for perhaps the first time businesses really do have to take those enquiries seriously.

HMRC's new approach

The starting point for HMRC's new approach came in 2007. They launched a consultation on a new regime for conducting transfer pricing enquiries. This resulted in the publication, in June 2008, of the Guidelines for the Conduct of Transfer Pricing Enquiries. The aim of these was to improve the transfer pricing enquiry regime. Since then, significant changes have been implemented. In practice, the changes that will have the biggest effect are as follows.

- Setting up an overarching Transfer Pricing Group with specialist knowledge and skill, and specialist Panels in local tax offices and in the Large Business Service. The aim of the group is to ensure consistency in the approach to transfer pricing enquiries and also to face up to the astute transfer pricing players on the market.
- Setting up of a transfer pricing board. The aim of the board is to constantly review the work of HMRC in relation to transfer pricing.
- Putting in place a new structured process with five 'stage gates' for dealing with enquiries. In particular, a risk assessment will be carried out in determining whether an enquiry is necessary. HMRC will also need to have a business case to support an enquiry, which means that any enquiry which has been launched is one which they will take seriously.
- A commitment to resolve enquiries quickly: 18 months for all normal enquiries, and 36 months at the outside except in very unusual circumstances.

Until this change of approach, HMRC often shied away from playing their full hand in settlement negotiations. They rarely invoked the threat of refusing to settle where they felt their case to be particularly strong. However, if they are not satisfied with the outcome of negotiations they are now showing signs of being prepared to take issues all the way to the tax tribunal. This also ties in with HMRC's Litigation and Settlement Strategy, also published in summer 2007. This is a public commitment that where they see a prospect of success in the tribunal of at least 51 per cent, HMRC will think seriously about simply taking a case through to the tribunal rather than reaching an agreement. This would have been impossible in recent years but with the glut of 'banker's bonuses' avoidance schemes processed, HMRC also now have the resource to follow through.

Prevention is better than cure

Importantly, HMRC are seeking to challenge transactions across the board. This is where transfer-pricing can bite a company unawares. It does not cover only tax-structured transactions. For instance, suppose that a group had

HMRC's new pricing

transferred key strategic intangible assets to a group company in a tax haven, which then charges the main operational companies a substantial royalty for the use of the assets. As above, the royalty reduces taxable profits in the UK, or whichever jurisdiction the operational companies are resident in. It is taxable in the hands of the new company, but only at tax haven rates. In recent years, the authorities have moved on to investigate the pricing of much more conventional intra-group transactions. This means that there is a real business need to have a robust position on the arm's length status of all intra-group arrangements.

A 2008 publication by the OECD, the international body that sets global transfer pricing standards, takes things further. The OECD's views matter in the UK, because they are directly referred to in the UK legislation. This publication makes a number of practical points. In order to 'price' a transaction it is crucial to analyse it and allocate the risks between the parties. This must all be closely documented. And documents are only the starting point: evidence of how arrangements have been operated in practice will also be crucial to check that the pricing was correct.

In addition to the issues above, preparation to be able to present a full 'story' to HMRC will also be important. HMRC's new teams are being staffed — at least in part — by individuals with experience of investigating other tax issues. This means that reaching settlement with HMRC will often involve — whether or not this is strictly relevant from a technical perspective — being able to give a persuasive narrative so that they can be comfortable that there is nothing 'going on'.

Recent changes highlight the hard-edged reasons not to leave a group exposed, eg a new corporation tax penalties regime introduced in April 2009 seeks to punish careless mistakes by taxpayers (charging a penalty of up to 30 per cent on top of any tax adjustment). The practical impact is that businesses must ensure that appropriate records are maintained, in particular documents which are likely to be of interest to HMRC. Without that if an adjustment is agreed, there is a substantial risk of being considered 'careless'. A full transfer pricing disclosure package with the appropriate economic analysis is likely to be needed. Data setting out the parameters and detailed terms of intra-group transactions should also be accurately recorded, and the rationale behind decisions clearly documented.

There is also an associated issue on time limits for HMRC to raise an enquiry. Recent case-law indicates that unless the taxpayer discloses the weaknesses in its filing position, HMRC will always have four years after the tax return is filed to consider issues, rather than the traditional one year window to open an enquiry. This means that in the normal course of things a challenge can start up to six years after the transaction takes place. This is another reason to collect evidence up-front. This is always simpler, cheaper, and more efficient than doing so six years after the event.

In other words a prudent approach to transfer pricing rules

forces closer analysis and documentation of review of intra group transactions than would ever be needed for pure commercial reasons.

Every company will take a different approach. But many will want to feel that they are in the driver's seat rather than trying to control any HMRC challenge by catching the process by the tail.

The future

Much has changed in the transfer pricing world and there are more changes to come soon. For instance, the OECD is currently reviewing its policy on the transfer pricing aspects of business restructurings and profits of permanent establishments. The first of those in particular is very relevant to the reorganisation activity which is an integral part of business in 2009.

Of course in the post credit crunch environment, HMRC's approach may soften. For international groups that are making a loss on a consolidated basis, HMRC will be under less political pressure to challenge transfer-pricing arrangements as there will be less concern that the UK is missing out on a 'fair slice' of the group's profits. But there will be fewer profits to tax so hard-edged arrangements set up now will be under review in years to come when groups are profitable, and HMRC will also be applying their new approach to profits made in recent years, the final 'good years', before the global financial crisis really struck home. It is important for any group to have a strategy.

Transfer-pricing may be a technical area but it is no longer a sleeping tiger and in 2009 it is a tiger with very real teeth.

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