

Transfer Pricing

In 16 jurisdictions worldwide

Contributing editor
Charles S Triplett



2015

GETTING THE
DEAL THROUGH 

GETTING THE
DEAL THROUGH 

Transfer Pricing 2015

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Transfer Pricing Solutions Ltd

Overview

1 Identify the principal transfer-pricing legislation.

The primary UK transfer pricing legislation is contained in Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010), which applies from 1 April 2010, for companies. It was formerly contained in Schedule 28AA of the Income and Corporation Tax Act 1988 (ICTA88).

2 Which central government agency has primary responsibility for enforcing the transfer pricing rules?

Her Majesty's Revenue & Customs (HMRC) deals with transfer pricing and all other tax matters.

3 What is the role of the OECD Transfer Pricing Guidelines?

The OECD Guidelines are tantamount to being UK law. This is because section 164 TIOPA 2010 states that the UK transfer pricing rules are to be read in such a manner as best secures consistency with the OECD Transfer Pricing Guidelines. When the Guidelines are revised by the OECD, the law is updated to specify that the new version of the Guidelines shall apply.

As a result, UK law does not go into any detail about how to apply the arm's-length test (except in the case of thin capitalisation, as the Guidelines say little about this). There is no mention of transfer pricing methods, comparability or the use of data about comparable uncontrolled transactions.

4 To what types of transactions do the transfer pricing rules apply?

The rules apply (section 147 TIOPA 2010) where there is 'provision' between two associated persons which is different from the 'arm's-length provision' and which confers a 'potential advantage' in relation to UK tax on one or both of those persons, namely a reduced tax liability or increased tax losses. The term 'person' includes companies, partnerships, individuals and other legal entities.

The term 'provision' can often be read as meaning 'transaction', though strictly a provision is what is brought about by a transaction or series of transactions. (In the case of a series of transactions, each constituent transaction need not necessarily have both or even one of the persons as a participant.) The term 'transaction' includes 'arrangements, understandings and mutual practices (whether or not they are, or are intended to be, legally enforceable)'.

The UK transfer pricing legislation does not use the term 'associated'; rather it refers to where 'the participation condition' is met. However, here we will refer to this as being associated.

Broadly speaking, the UK threshold of association for transfer pricing purposes is that, at the time of the making or imposition of a provision between two persons, one of those persons controls the other person, or they are under common control by another person or persons.

The rules for determining control are complex, but generally speaking a person controls a company if that person directly or indirectly has voting power of more than 50 per cent in that company. A person controls a partnership if that person has the right to a share of more than half of the assets, or of more than half of the income, of the partnership. The controlling person can be an individual, charity or trust, as well as a company or firm.

There are special control rules aimed at joint ventures, and in some circumstances as little as 40 per cent control can be sufficient to create association. There are further special rules to ensure that private equity investments are subject to transfer pricing and thin capitalisation

requirements in relation to the high levels of debt which they typically inject into their investments. Private equity investments are structured in such a way that businesses are acquired and controlled by syndicates of investors, none of whom individually exceeds the 40 per cent threshold that would normally apply to determine control. However, where loans are made by persons acting together, control of each of those persons is assessed by amalgamating the rights and powers of all those persons.

The rules apply to domestic transactions as well as cross-border transactions.

There are exemptions for UK taxpayers that are part of small and medium-sized multinational groups.

5 Do the relevant transfer pricing authorities adhere to the arm's-length principle?

Yes.

Pricing methods

6 What transfer pricing methods are acceptable?

HMRC accepts all OECD methods. Rather than quibbling about terminology, it is much more interested in whether the method is appropriate and reliable for the specific controlled transaction.

HMRC's views on methods are orthodox, although it is sceptical about whether the arm's length test is met when businesses set prices for high-value services based on a mark up of the service provider's costs, though in practice it will often accept that there is no other practicable method.

7 Are cost-sharing arrangements permitted? Describe the acceptable cost-sharing pricing methods

HMRC would, like most countries, refer to cost contribution arrangements (CCAs) rather than cost-sharing arrangements. It accepts all approaches blessed by the OECD Guidelines. It pays particular attention to whether the contributions reflect the expected benefits. If it considers that there is no mutuality of benefit, it may challenge whether unrelated parties would have agreed a CCA rather than a simple service arrangement.

Further HMRC comments on CCAs are available in its International Manual, at www.hmrc.gov.uk/manuals/intmanual/INTM421090.htm. This Manual represents its internal instructions to tax inspectors. It is not binding on taxpayers, and they are free to adopt a position contrary to the Manual, though they should normally expect significant resistance from HMRC in such cases.

8 What are the rules for selecting a transfer pricing method?

HMRC applies the OECD Guidelines, so there is no hierarchy. In practice, however, it should be noted that HMRC considers that many taxpayers are too ready to dismiss potential comparable uncontrolled transactions on the grounds of less-than-perfect comparability, instead accepting what HMRC often sees as much poorer comparability under a US comparable profits method-style transactional net margin method using the profitability of comparable companies derived from a database search.

9 Can a taxpayer make transfer pricing adjustments?

The taxable profits are based on the profits shown in the accounts. The accounting profits may be adjusted at any time until the accounts are

finalised, as long as the adjustments are appropriate from an accounting perspective.

Once the accounts are final, any adjustment would have to be made in the tax return. The taxpayer is required to make a transfer pricing adjustment if the accounting profit is too low (or losses too high), as a result of non-arm's length transfer pricing. Downward transfer pricing adjustments are not permitted unless the transaction is domestic or it has been agreed by the UK competent authority under mutual agreement procedures.

10 Are special 'safe harbour' methods available for certain types of related-party transactions? What are these methods and what types of transactions do they apply to?

No, although HMRC does accept that the amount of analysis that the taxpayer should be expected to carry out should reflect the tax risks, including the tax at stake. The risk assessment is often discussed with HMRC as part of annual reviews. HMRC uses a similar risk assessment to decide its priorities for transfer pricing examination.

Disclosures and documentation

11 Does the tax authority require taxpayers to submit transfer pricing documentation? What are the consequences for failing to submit documentation?

There is no explicit documentation requirement in the legislation, though it is certainly expected. Taxpayers generally behave as if it were mandatory.

12 Other than complying with mandatory documentation requirements, describe any additional benefits of preparing transfer pricing documentation.

Taxpayers are required to self-assess whether they have complied with all tax rules, including whether a transfer pricing adjustment is needed. If they are unable to show that they have done this, they may incur penalties for being careless (or worse). In practice, a record of the transfer pricing analysis that was done (ie, transfer pricing documentation) would be necessary, otherwise it would be difficult to show that reasonable care has been taken.

The result is that adequate documentation gives penalty protection. That is, of course, as long as it documents an analysis that is reasonable. If it documents an analysis that is slipshod or unreasonable, penalties could still apply. What matters is whether the evidences that reasonable care was taken, not the mere existence of a document labelled 'Transfer Pricing Report'.

Documentation also has the benefit that a well-argued, thorough analysis is, of course, more likely to convince HMRC that the transfer pricing is appropriate.

13 When must a taxpayer prepare and submit transfer pricing documentation to comply with mandatory documentation requirements or obtain additional benefits?

There is no specific deadline, as what matters is whether the taxpayer took reasonable care in applying the transfer pricing rules. Inherently, this means that the reasonable care must have been taken at the time the taxpayer filed the relevant tax return. The best way to evidence this is to have contemporaneous documentation as at the filing date. Documentation that was prepared after the filing date might be queried as representing an after-the-fact justification, though HMRC would be willing to consider explanations of why the analysis was not documented until after filing the return.

Documentation must be submitted only if and when requested by HMRC. There is no specific period for submitting it following such a request, but any significant delay is likely to be interpreted as indicating that the documentation does not exist. HMRC might adopt the (rebuttable) presumption that proper consideration was not given to transfer pricing before filing the tax return, and therefore increase its scrutiny of the transfer pricing. If a transfer pricing adjustment is made, penalties would be likely.

14 What content must be included in the transfer pricing documentation? Will the tax authority accept documentation prepared on a global or regional basis or must it conform to local rules? What are the acceptable languages for the transfer pricing documentation?

There are no formal rules on this. The documentation should be sufficient to evidence that proper care was taken in applying the transfer pricing rules. HMRC will not penalise the omission of anything that they agree is irrelevant.

HMRC will not reject any documentation just because it is global or regional. However, they will expect to be satisfied that the analysis is relevant to the UK specifically. If they feel that there are material differences between UK members of the group and other group members that are subject to the same transfer pricing policy and that these differences have not been adequately taken into account, they would expect adjustments and perhaps penalties.

Adjustments and settlement

15 How long does the authority have to review a transfer pricing filing?

Although a risk assessment review is the first informal step, if HMRC has reason to examine transfer pricing in a particular tax return it must open an enquiry. The window for doing so is usually 12 months after the relevant tax return is filed, unless the return was filed late (ie, more than 12 months after the year-end), in which case the window is 12 months following the calendar quarter in which the return was filed.

Generally speaking, if a transfer pricing enquiry has not been opened within the enquiry window, no transfer pricing adjustment may be made to the tax return. However, if HMRC subsequently learned that the transfer pricing was misstated (for instance, as a result of an enquiry in a subsequent year) it might be able to make a 'discovery assessment' to adjust the transfer pricing of the earlier year, though there are tight criteria to be able to do this.

16 If the tax authority proposes a transfer pricing adjustment, what initial settlement options are available to the taxpayer?

HMRC may informally propose adjustments during the course of an enquiry. The taxpayer is free to counter-argue against this or to agree the proposal and then pay the resulting tax adjustment, plus interest and perhaps penalties. Negotiation and discussion may proceed for some time, although HMRC does now set time limits for enquiries and will manage negotiations so that negotiations will not be allowed to drag on indefinitely.

If agreement cannot be reached, HMRC must decide whether to close the enquiry without adjustment or to litigate. Either option must be approved by an internal review carried out by a special board. It aims to do this within 18 months of opening the enquiry, or 36 months in complex cases.

17 If the tax authority asserts a final transfer pricing adjustment, what options does the taxpayer have to dispute the adjustment?

Other than litigation, the main approach would normally be competent authority procedures (or, rarely, EU arbitration). Judicial review is not an approach that is used in the UK for transfer pricing disputes, though this is not to say that there are no circumstances when it might be possible or appropriate.

Relief from double taxation

18 Does the country have a comprehensive income tax treaty network? Do these treaties have effective mutual agreement procedures?

The UK's double taxation agreements (DTA) network is one of the most extensive, and the agreements almost always have a mutual agreement article. The only major economy (ie, G20 member) with which there is no substantive DTA is Brazil.

19 How can a taxpayer request relief from double taxation under the mutual agreement procedure of a tax treaty? Are there published procedures?

To activate the Mutual Agreement Procedure (MAP), a taxpayer should write to HMRC setting out its case. Contact details are, at the time of

Update and trends

Campaigners have had great success in portraying a number of multinationals as abusing transfer pricing rules to reduce their UK tax liabilities. This has had a very high public profile in the UK in recent years, including hearings by the Finance Select Committee of the UK Parliament and press 'exposés' about the 'tax gap'. The level of understanding of the issues is not always very sophisticated or nuanced, but these campaigns have, nevertheless, successfully made it politically necessary for the government to take action. The government has been one of the keenest sponsors for the base erosion and profit shifting project, encouraging HMRC to contribute fully to it.

HMRC officials have, however, stated that they will not attempt to anticipate the new Intangibles chapter of the OECD Guidelines based on drafts of the chapter. They will wait until it is finalised.

Another consequence of this trend is that companies are now concerned about being seen by the general public as paying their fair share of tax, and may refrain from some entirely legitimate transfer pricing if it is at too high a risk of appearing (rightly or wrongly) to be abusive. Starbucks went as far as voluntarily paying extra UK tax.

writing, set out at www.hmrc.gov.uk/international/map.htm. Further commentary by HMRC is provided in Statement of Practice SP1/11, which, at the time of writing, is to be found on page 329 of the following document: www.hmrc.gov.uk/agents/sop.pdf.

20 When may a taxpayer request relief from double taxation?

The MAP may be initiated before or after an enquiry is closed, although it does not supplant an enquiry. It may be initiated before, during or after litigation in the UK, but if initiated while such litigation is ongoing the litigation would have to be suspended. The DTA will set out time limits for making a claim, but there is a minimum of six years under domestic law. It is common to make 'protective claims' if the time limit is about to expire and the taxpayer is not yet clear whether they wish to use the MAP.

21 Are there limitations on the type of relief that the competent authority will seek, both generally and in specific cases?

There are no limitations. It is worth noting that there can be compatibility problems with countries that are unwilling to accept the UK view that thin capitalisation is a matter involving the arm's-length test and therefore something to which the MAP may apply.

22 How effective is the competent authority in obtaining relief from double taxation?

HMRC is generally accepted as devoting significant good faith effort to ensuring that double taxation is eliminated. It has a high level of success. However, a small minority of cases do result in failure to agree, most notoriously in the *GlaxoSmithKline* case, where several billion pounds sterling of double tax was reportedly left unrelieved.

Advanced pricing agreements

23 Does the country have an advanced pricing agreement (APA) programme? Are unilateral, bilateral and multilateral APAs available?

There has been a formal APA programme since 1999. Bilateral and multilateral APAs are encouraged, but unilateral APAs will be considered if necessary.

24 Describe the process for obtaining an APA, including a brief description of the submission requirements and any applicable user fees.

The process is described in Statement of Practice SP2/10. At the time of writing, it can be found on page 315 of the following document: www.hmrc.gov.uk/agents/sop.pdf. Generally, HMRC is very flexible. There are no fees.

25 How long does it typically take to obtain a unilateral and a bilateral APA?

According to the latest published statistics, 50 per cent of APAs agreed in 2012/13 were agreed within 15 months. The average time was 26 months.

26 How many years can an APA cover prospectively? Are rollbacks available?

Typically, APAs cover three to five years, but a longer period may be considered depending on the characteristics of the transaction covered by the APA. Rollbacks are available.

27 What types of related party transactions or issues can be covered by APAs?

There are no restrictions.

28 Is the APA programme widely used?

In 2012/13, 45 applications were made and 27 APAs were agreed (four were withdrawn). (Source: www.hmrc.gov.uk/international/transfer-pricing-stats.pdf.)

29 Is the APA programme independent from the tax authority's examination function? Is it independent from the competent authority staff that handle other double tax cases?

The APA programme is independent from the inquiry staff. Applying for an APA can sometimes offer a way to set entrenched positions in an inquiry to one side and start with a clean sheet, then roll back to cover the inquiry years. However, inquiry staff will be consulted as part of the APA process. Competent authority staff may be involved in handling an APA.

30 What are the key advantages and disadvantages to obtaining an APA with the tax authority?

The advantages and disadvantages are similar to most countries. Advantages include:

- certainty;
- reduced scrutiny going forward;
- better understanding of the business on the part of HMRC; and
- the possibility of an improved relationship with HMRC.

Disadvantages include:

- the possibility of substantial external professional fees;
- an APA demands significant time of key executives;
- delay;
- there is no guarantee that HMRC will agree terms that are acceptable to the taxpayer; and
- a large amount of information must be volunteered to HMRC.

Special topics

31 Is the tax authority generally required to respect the form of related-party transactions as actually structured? In what circumstances can the tax authority disregard or recharacterise related-party transactions?

The OECD Guidelines apply. HMRC generally eschews recharacterisation, except in cases of what it considers aggressive transfer pricing. Its comments are included in the following document: www.hmrc.gov.uk/manuals/intmanual/INTM440200.htm.

32 What are some of the important factors that the tax authority takes into account in selecting and evaluating comparables? In particular, does the tax authority require the use of country-specific comparable companies, or are comparables from several jurisdictions acceptable?

HMRC is reasonably pragmatic about the selection of comparable companies (in cases where transactional comparability data is unavailable or unsuitable). In practice, it would rarely quibble about pan-European comparables as long as the profitability of the UK company seems reasonable. If it considers the UK profitability to be too low, it might insist on UK comparables if this would have given what it sees as being a more appropriate level of profits. However, it is unlikely to waste time on such arguments if, as is often the case, it sees the vulnerabilities as lying in the characterisation of the parties or the choice of method or the failure to reward the UK taxpayer for key value-drivers that it contributes.

33 What is the tax authority's position and practice with respect to secret comparables? If secret comparables are ever used, what procedures are in place to allow a taxpayer to defend its own transfer pricing position against the tax authority's position based on secret comparables?

Secret comparables have no formal role, although there is anecdotal evidence that they may informally influence the initial expectations of individual tax inspectors about what is a 'normal' transfer price, and therefore play a role in directing scrutiny. They cannot be used to prove a case.

34 Are secondary transfer pricing adjustments required? What form do they take and what are their tax consequences? Are procedures available to obtain relief from the adverse tax consequences of certain secondary adjustments?

Generally, secondary adjustments are not required.

35 Are any categories of intercompany payments non-deductible?

No, although of course the normal deductibility criteria apply, so for instance capital expenditure is not deductible from profits.

36 How are location savings and other location-specific attributes treated under the applicable transfer pricing rules? How are they treated by the tax authority in practice (if different)?

The OECD Guidelines apply.

37 How are profits attributed to a branch or permanent establishment (PE)? Does the tax authority treat the branch or PE as a functionally separate enterprise and apply arm's-length principles? If not, what other approach is applied?

The Authorised OECD Approach applies.

38 Are any exit charges imposed on restructurings? How are they determined?

There are no specific exit charges on restructurings, though disposals of assets are subject to capital gains tax.

39 Are temporary special tax exemptions or rate reductions provided through government bodies such as local industrial development boards?

No.

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