Transfer Pricing Forum

Transfer Pricing for the International Practitioner

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1. To what extent are a multinational enterprise's intra-group contracts respected for transfer pricing purposes?

Statute and Guidance

The UK transfer pricing rules are contained in Part 4 of the Taxation (International and Other Provisions) Act 2010 ("**TIOPA**"). Sections 164(1)(a) and 164(4) TIOPA require that the arm's length principle, as set out in section 147 TIOPA, must be interpreted in such a manner as best secures consistency with "the transfer pricing guidelines". The definition of "the transfer pricing guidelines" was amended by section 75(1) Finance Act 2016 and now includes reference to the BEPS Actions 8-10 2015 Final Report ("**BEPS Final Report**").

According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 ("**OECD guidance**"), the first step in analysing an intra-group contract is "accurately delineating" the actual transaction[1] (see further below). This is explained in greater detail below. The OECD guidance goes on to say that, if appropriate, a transaction can be disregarded and replaced by an alternative arm's length transaction. The transaction may only be disregarded if the arrangements "differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances."[2] In making an assessment of commercial irrationality, "the options realistically available to [the parties] at the time of entering into the transaction" must be taken into account.[3] If the actual transaction is deemed commercially irrational, it can be disregarded. The structure that replaces the disregarded transaction must "comport as closely as possible with the facts of the actual transaction undertaken whilst achieving a commercially rational expected result".[4] Section 151(2) TIOPA provides UK statutory authority for a finding that, in an arm's length setting, no transaction would have been undertaken between independent enterprises. This allows for the actual transaction to be disregarded with no transaction replacing it. The price adjusting rule at section 147(3) TIOPA requires that the taxpayer's profits and losses are to be calculated "as if the arm's length provision had been made or imposed instead of the actual provision." The rule is concerned with pricing, but does not in terms require that the counterfactual is in all other respects identical with the actual transaction. HMRC regard the arm's length principle as "replacing (hypothetically) the actual terms (price, etc.). . . with arm's length terms."[5]

An interesting comparison can be made between the transfer pricing rules and the more recently introduced Diverted Profits Tax (**DPT**), which came into force in April 2015. The DPT legislation, which in a way serves as an extension of transfer pricing rules, targets aggressive tax planning by multinationals shifting profits from the UK and in certain circumstances allows for such transactions to be recharacterised. Recharacterisation of transactions may be seen as a somewhat greater threat under the DPT rules than in the transfer pricing context. The DPT rules allow transactions to be recharacterised if they lack 'economic substance', while under the transfer pricing rules, as set out above, a transaction can only be disregarded if it is commercially irrational. The 'economic substance' test is a lower threshold than the transfer pricing test of commercial irrationality. Transactions that are ostensibly priced on an arm's length basis but made under arrangements lacking economic substance could be caught by the DPT legislation but not the transfer pricing rules.

Case law

The First-tier Tribunal (Tax) demonstrated its willingness to disregard transactions that it considers commercially irrational in its decision in *Abbey National Treasury Services Plc v Revenue and Customs Commissioners* (2015 UKFTT 0341). Abbey National Treasury Services plc (**ANTS**), a UK wholly-owned subsidiary of another UK company, Abbey National plc (**Abbey National**), was a party to several in-the-money interest rate swaps valued at £160 million. It issued 1,000

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tracker shares of £1 each to Abbey National, entitling Abbey National to a dividend equal to each swap cash flow received by ANTS, subject to ANTS having sufficient distributable reserves. ANTS and Abbey National also entered into a compensation agreement which required ANTS to pay compensation to Abbey National if its reserves were insufficient to meet the dividend under the tracker shares. As a result, ANTS derecognised the swaps as assets, in accordance with accounting standard IAS 39, giving rise to a corresponding debit, which it claimed as an expense for corporation tax purposes.

After deliberating on the corporation tax treatment of derivatives (finding for HMRC, the tax administration department, on that score), the tribunal considered transfer pricing principles. The tribunal concluded that the issue of the tracker shares did not "represent commercially rational behaviour" (adopting the OECD's terminology) and that the shares would not have been issued between independent parties.[6] As a result, the tribunal was willing to disregard the transaction in its entirety, giving a debit of nil. Whilst this relates to an equity transaction rather than an intra-group contract, it demonstrates that the courts may be willing to disregard intra-group arrangements if they meet the standard of commercial irrationality. Due to the timing of the transactions, this decision concerned the OECD Transfer Pricing Guidelines from 1995, which have since been updated. However, the decision in *Abbey National* specifically put weight on the transaction not representing "commercially rational behaviour", in turn quoting the 1995 guidance. As the current guidance still uses the language of 'commercially rational', it is likely that a similar approach will be taken if the current guidance is considered.

The transfer pricing analysis has however been clouded by the decision in *Union Castle Mail Steamship Company Limited v HMRC* (2016 UKFTT 526 (TC)). The case concerned a very similar tax avoidance scheme as in the *Abbey National* case. However, on the transfer pricing aspect the tribunal declined to follow *Abbey National* and held that the issue of shares was not a "provision" for transfer pricing purposes. This was partly based on the distinction in the OECD guidelines between shareholder and non-shareholder transactions. Unfortunately, there are now two conflicting UK decisions of equivalent jurisdiction on the issue, leaving the position on equity transactions unclear. However, as the decision in *Union Castle* was silent on non-equity contractual arrangements, it is suggested that the approach in *Abbey National* is in any event applicable to non-equity contractual arrangements.

On occasion, UK courts do refer to relevant decisions of foreign courts and find them persuasive. This is particularly the case if the foreign court is of high authority and in an English-speaking and common law jurisdiction. For example, two Canadian cases, one decided and one currently being heard, may inform the UK courts' approach to transfer pricing disputes in the future.

McKesson Canada Corporation v. Her Majesty the Queen (2013 TCC 404) concerned a transfer pricing adjustment made by the Canada Revenue Agency (**CRA**) relating to trade receivables factoring transactions involving the McKesson Canada Corporation and its immediate parent company, MIH, which was a Luxembourg resident. The CRA argued that, under the Canadian legislation[7], the terms of the receivables transactions should be adjusted. The Canadian legislation in point did not permit total recharacterisation or disregarding of the transaction. The court concluded that the discount rate on the receivables, 2.206%, was outside the range of arm's length discount rates. The court also held that it could make adjustments to both the quantum and the terms of the transaction. The court acknowledged that there is a point beyond which imposing arm's length terms on a transaction could constitute an effective recharacterisation or disregarding (which is only allowed under sections 247(2)(b) and (d) ITA, provisions which were not pleaded by the CRA) but did not explore this boundary further.[8] Whilst the Canadian legislation differs from TIOPA, the willingness of the Canadian court to amend both the quantum and other terms of the transaction, without deeming the transaction 'commercially irrational', may be instructive for English courts.

Another Canadian case, *Cameco Corp. v. The Queen* (2009-2430(IT)G), yet to be decided, may also provide guidance to UK courts. The CRA contends that Cameco Corp. sold uranium to its Swiss affiliate at less than an arm's length price. At an interlocutory hearing, the CRA argued that:

- the transaction should be recharacterised entirely under sections 247(2)(b) and (d) ITA;
- alternatively, the price and terms should be adjusted under sections 247(2)(a) and (c) ITA;
- alternatively, the transaction was a sham.[9]

The court's decision seems likely to shed light on its approach to recharacterisation, which may inform the application of UK transfer pricing law.

2. How much emphasis is placed on related party agreements as part of a taxpayer's transfer pricing documentation, or as an important source of functional analysis information?

OECD Guidance

The BEPS Final Report, which updates certain sections of the 2010 OECD guidance, expands on the importance of contracts in transfer pricing. The revisions to the OECD guidance emphasise the need to "accurately delineate the actual transaction between the associated enterprises".[10] This is the starting point for a functional analysis of the actual transaction and determining its comparability to uncontrolled, arm's length transactions.

It is noted that where a transaction has been formalized by the associated enterprises through a written contract, that contract provides a starting point for delineating the transaction(s) between those enterprises, and how the functions, risks and rewards were intended to be allocated between them at the time of entering into the contract. However, the OECD guidance goes on to state that written contracts alone are unlikely to provide all the information necessary to perform a transfer pricing analysis. If the terms of the contract do not accurately reflect the actual transaction that took place, "the functions they actually perform, the assets they actually use, and the risks they actually assume, considered in the context of the contractual terms, should ultimately determine the factual substance and accurately delineate the actual transaction".[11] The report adds that attention must be paid to the possibility of functional changes over time, which may lead to the actual conduct of the parties to the transaction diverging from that prescribed in the written contract.[12]

The OECD guidance prescribes that "accurate delineation of the actual transaction or transactions between the associated enterprises requires analysis of the economically relevant characteristics of the transaction".[13] The guidance lists the economically relevant characteristics that need to be established as:

- the contractual terms of the transaction;
- the functions performed by each of the parties to the transaction, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE group to which the parties belong, the circumstances surrounding the transaction, and industry practices;
- the characteristics of property transferred or services provided;
- the economic circumstances of the parties and of the market in which the parties operate; and
- the business strategies pursued by the parties.[14]

HMRC Guidance

HMRC's internal manuals contain guidance prepared for HMRC staff and are published online in accordance with the Freedom of Information Act 2010. The guidance is not assumed to be comprehensive, or definitive, but is a reliable source for assessing HMRC's approach to certain issues. Specifically, we refer to the International Manual (**INTM**), updated on 28 July 2016, which contains up-to-date guidance on international tax issues, including practical guidance on working transfer pricing and thin capitalisation cases.

The INTM states that the first stage of confirming the transactions between associated enterprises should be to assess the actual conduct of the associated enterprises. It is stressed that fact-finding, in this respect, should not be restricted by the terms of the written contracts between those enterprises. It gives two primary justifications for this, as follows:

- a contract between associated enterprises may not be as comprehensive as would those between independent enterprises and may be silent on significant elements of the functions performed, assets used and risks assumed by the parties; and
- it may be the case that the actual conduct of the associated enterprises does not fully accord with the contractual terms.[15]

The INTM then goes on to mirror the language of the OECD guidance regarding establishing the economically relevant characteristics of that transaction.[16] Reference is made to the list of economically relevant characteristics as stated by the OECD (and outlined above).

As such, both HMRC and the OECD describe intra-group contracts as a reasonable, and necessary, starting point for the purposes of transfer pricing analysis. However, both sources emphasise the importance of the actual conduct of the parties to the tested transaction in transfer pricing analysis.

The issue of whether intra-group contracts are more important for functional analysis or documentation is not clear-cut. We noted above, the INTM provides that contracts form the initial (and therefore an important) part of transfer pricing functional analysis. The INTM also says that "the most useful reports provide detailed functional analysis. A report lacking in such detail is unlikely to be of any value".[17]As such, intra-group contracts form an important part of both the functional analysis and the transfer pricing documentation set, but this documentation set will also include a review of actual responsibilities and risk-bearing, and this will be accorded more weight than the contractual relationship.

Case law

As set out above, the OECD guidelines encourage the UK courts to take a broad approach to identifying the actual transaction that takes place. One of the rare cases to consider what is now Part 4 TIOPA 2010, *DSG Retail Ltd & others v Revenue and Customs Commissioners* (2009 UKFTT 31), indicates that the UK courts have adopted the OECD's broad approach to defining the actual transaction.[18] This case, which considered the 1995 OECD guidelines, established that transfer pricing rules can apply in situations where there is no contractual relationship between the UK taxpayer and its associated company. The Special Commissioners found that a "provision" (the term used in section 147(1)(a) TIOPA) was in effect between these two group companies, and "the series of contracts was not itself the provision which took effect between those entities, but the means by which the arrangement was given effect".[19] Rather, the provision was the making available of a business opportunity and the ensuing arrangement that a group captive would insure the extended warranty business written in DSG's stores on particular terms.[20]

3. What content is expected to be found in related party agreements?

The actual content of a related party agreement will depend on the type of transaction contemplated. However, to avoid HMRC attempting to substitute the terms of the transaction or disregard the transaction, parties should strive, as far as commercially sensible, to reflect the terms that would be found in an arm's length contract. For instance, in a loan agreement, it would be prudent to include sensible financial covenants or conceivably provide for security. As set out above, the danger of related party agreements falling foul of the transfer pricing regime arises when clauses that would not be agreed in an arm's length transaction are included or clauses that would be agreed in an arm's length transaction are omitted.

The terms of related party agreements should also reflect the actual facts of the transaction as far as possible. If a transfer pricing investigation is launched, a related party agreement that reflects the reality of the transaction will reduce HMRC's scope to include other factors when "accurately delineating" the actual transaction. An accurate agreement therefore increases the taxpayer's certainty over what would be included in the scope of any transfer pricing investigation.

The INTM is not detailed when providing guidance on the expected contents of most types of intra-group agreements. However, it does outline, with specificity, the contents of third party loan agreements, so as to illustrate what may be found in an intra-group loan agreement. It lists the following items:

- drawdown conditions (amounts and dates);
- purpose of the loan;
- repayment (amount and timing);
- interest (how it is calculated, and when and how it is payable);
- security (what security is given, how, and by which date);
- fees;
- costs;
- covenants (financial and operational); and
- default clauses.[21]

These items are listed in the context of providing guidance as to what rights and obligations would be allocated to lenders and borrowers in third party transactions. It is therefore implied that these items should be included, as the economic facts require, in intra-group loan agreements.

A recent update to the INTM also emphasises the need for the repayment term of a loan to be established in situations concerning intra-group cash pooling arrangements.[22] HMRC is wary of the "risk that the contractual arrangements of short term deposits, and borrowing on short term rates, may not represent the substance of the arrangements, which in reality could be long-term for both depositors and/or borrowers". A short term deposit would usually be repayable on demand and have a different interest rate whereas a long term deposit would normally be in the form of a loan with an entirely different interest rate. To avoid potential adjustments by HMRC, the cash pooling arrangements should therefore accurately reflect whether the deposit is either long term or short term in nature. If the deposits change in nature over time (say from short term to long term), the documentation would need to be reviewed to reflect any such changes.

4. To what extent can taxpayers be held to their related party agreements, even if they are not in line with normal commercial arrangements or economic reality?

The UK transfer pricing regime generally works as a one-way street. Under sections 147(2)(b) and 147(4)(b) TIOPA, the taxpayer only calculates its profits and losses using the alternative arm's length provision if the actual provision would have conferred a potential advantage in relation to UK taxation. A potential advantage exists if the actual provision caused lower income or profits, or greater losses, than the arm's length provision would have caused. Therefore, if the arm's length provision would put the taxpayer in a better tax position than the actual provision, the UK taxpayer will be held to the actual provision in the related party agreement.

The ability to make "corresponding adjustments" represents one modification to this rule that applies in the following two situations. If a transaction is carried out between two UK companies, any tax advantage conferred on one of the companies by the non-arm's length provision can in principle cause a tax disadvantage (and a corresponding commercial benefit) for the other company. In this case, under section 174(2) TIOPA, the company at a tax disadvantage can claim to have its tax calculated on the same deemed arm's length terms as the other company. Therefore, the previously tax disadvantaged company can benefit from the more favourable (to it) imposed arm's length transaction.

Similarly, if the transaction is cross-border, a transfer pricing adjustment to a transaction may potentially give rise to economic double taxation. Where a foreign group company's profits liable to tax are increased due to the adjustment, those profits may have already been effectively taxed in the hands of an associated UK company. If this is the case, and there is a double taxation treaty between the UK and the other jurisdiction that incorporates Article 9(2) of the OECD Model Tax Convention, then the UK company can seek an appropriate reduction of its profits to avoid double taxation.

5. Is the situation different for certain transactions? For example, financial ones?

The rules in Part 4 TIOPA are of universal application, and whilst there are clarificatory provisions in relation to certain types of transactions (such as those involving securities and guarantees), the same principles and considerations outlined above apply to all transactions. Certain types of transactions, such as IP licensing transactions, have market templates for documentation. In these circumstances, it may be easier to ensure that related party agreements reflect arm's length provisions as far as possible. This may be more difficult in relation to more bespoke intra-group transactions.

The INTM does however pay particular attention to financial transactions. In providing guidance on information-gathering for new loan cases, HMRC suggest obtaining the following items:

- accounts of the borrower;
- a copy of the loan agreement (if one exists);
- details of any divergence, in practice, from the terms of the loan agreement;
- "background" to the loan (duration and usage);
- details of unsettled trading debts and other balances run up informally; and
- details of third party credit terms, where it is suspected that favorable intra-group trading terms have created a *de facto* loan of extended credit. [23]

This list demonstrates that, whereas in the INTM guidance referred to above the contract is treated as a starting point for further analysis, financial transactions contracts are examined specifically with a view to finding divergence from actual conduct. Crucially, actual conduct is to be analysed in the first instance, to ascertain whether any *de facto* loans are in place.

The same logic is applied by HMRC when assessing claims relating to the "equity function" argument. This argument is sometimes advanced by companies which have provided debt funding at a low (or zero) interest rate, and argued that these funds should be treated as equity. For an outbound loan of this type, HMRC's starting point is to assume that this funding has been provided in the form of a loan, and should be treated as such (i.e. that form and substance are the same). In applying this argument, the existence of a loan agreement is strong evidence in favour of the characterization of the funding as debt, since the drawing up of such an agreement is a positive action.[24]

Transactions in hard-to-value intangibles also merit special mention. The OECD guidance indicates that hindsight, taking into account the income produced by the intangible asset, can be useful in determining whether the transaction was at arm's length at the time it was entered into.[25] The INTM asserts that "*ex post* outcomes can be considered by HMRC as presumptive evidence regarding the appropriateness of the *ex ante* pricing arrangements, the reasonableness of the assumptions used in determining these arrangements and, consequently, the extent to which they comply with the arm's length principle"[26]. As a result, it may be prudent for taxpayers to consider some form of performance-related payment mechanism when transferring such intangible property between associated companies to avoid the transaction falling foul of the transfer pricing rules. To fail to do so may itself lead to a degree of re-writing of the transaction.

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NOTES

[1] Paragraph 1.33 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[2] Paragraph 1.122 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[3] Ibid.

[4] Paragraph 1.124 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[5] INTM 412040 Transfer pricing: legislation: rules: the arm's length principle.ý

[6] Paragraphs 104 and 105 of *Abbey National Treasury Services Plc v Revenue and Customs Commissioners* (2015 UKFTT 0341).

[7] Section 247(2)(a) and (c) Income Tax Act (**ITA**) which state that the tax due should be adjusted to the amount that would have been due if "the terms and conditions made . . . had been those that would have been made between persons dealing at arm's length."

[8] Paragraph 127 of *McKesson Canada Corporation v. Her Majesty the Queen* (2013 TCC 404).

[9] The sham doctrine also exists in English law, e.g. *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 and *Hitch v Stone* [2001] STC 214.

[10] Paragraph 1.33 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[11] Paragraph 1.46 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[12] Paragraphs 1.43-1.47 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[13] Paragraph 1.35 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[14] Paragraph 1.36 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[15] INTM 485020, *"Transfer pricing operational guidance: Evidence gathering: Establish the facts"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm485020, accessed on March 17, 2017.

[16] INTM 485022, *"Transfer pricing operational guidance: Accurate delineation of the actual transaction: Economically relevant characteristics"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm485022, accessed on March 17, 2017.

[17] INTM 484020, *"Transfer pricing: operational guidance: examining transfer pricing reports: report contents"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm484020, accessed on March 17, 2017.

[18] This case was decided before the OECD guidance was amended by the BEPS Actions 8-10: 2015 Final Reports so did not consider the specific meaning of "accurately delineate."

[19] Paragraph 87 of *DSG Retail Ltd & others v Revenue and Customs Commissioners* (2009 UKFTT 31).

[20] Paragraphs 62 and 70 of *DSG Retail Ltd & others v Revenue and Customs Commissioners* (2009 UKFTT 31).

[21] INTM 522010, *"Thin capitalisation: practical guidance: third-party loan agreements: the general form of third-party loan agreements"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm522010, accessed on March 17, 2017.

[22] INTM 503140, "*Cash pooling: short term and long term balances held in the cash pool*", https://www.gov.uk/hmrc-internal-manuals/international-manual/intm503140, accessed on March 17, 2017.

[23] INTM 501030, *"Interest imputation: transfer pricing the lender: information gathering on outward loan cases"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm501030, accessed on March 17, 2017.

[24] INTM 502020, *"Interest imputation: dealing with 'equity function' arguments: HMRC response"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm502020, accessed on March 17, 2017.

[25] Paragraph 6.187 of the guidelines as amended by the BEPS Actions 8-10: 2015 Final Reports.

[26] INTM 440176, *"Types of transactions: intangibles: establishing an arm's length price for valuable intangibles: Hard to Value Intangibles"*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm440176, accessed on March 17, 2017.

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