Analysis

Reviewing HMRC's consultation on transfer pricing reform

Speed read

As part of the proposed reforms announced on Tax Administration and Maintenance Day 2023, the UK government is consulting on potential changes to the UK legislation on transfer pricing, permanent establishments and diverted profits tax. The consultation is the most significant review of the UK's core transfer pricing legislation since the early 2000s. The government proposes to align the UK legislation taxing the profits of non-residents' UK permanent establishments more closely with the OECD rules. The consultation also proposes replacing the UK's diverted profits tax with a 'diverted profits assessment' within the corporation tax rules.

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On 19 June 2023, the government published a consultation document entitled *Reform of UK law in relation to transfer pricing, permanent establishment and diverted profits tax*, which includes an extensive package of proposals that touch most areas of the UK's transfer pricing, permanent establishment (PE) and diverted profits tax (DPT) legislation. The consultation is the most significant review of the UK's core transfer pricing legislation since the early 2000s. In this article, we review the proposals and consider how they will impact businesses if they are pursued.

Transfer pricing

The section of the consultation document that deals with transfer pricing covers three areas.

Framework

The consultation advances several proposals aimed at simplifying and clarifying the framework legislation that governs when arm's length transfer pricing must be applied.

Provision: The UK transfer pricing rules apply where a 'provision' is made or imposed between two associated enterprises, which differs from article 9 of the OECD Model Tax Convention (the MTC) which refers to 'conditions' made or imposed. The consultation observes that this different wording leaves some scope for uncertainty as to the scope of the matters to which the UK legislation applies, which is relevant to the question of how broad a group of transactions (some of which may offset others) may be considered when testing whether a group's transfer pricing deviates from the arm's length principle (ALP). The government therefore proposes to align the UK language with article 9. It also proposes to issue guidance to clarify the operation of the 'one-way street' rule, that applies the transfer pricing legislation only in situations where a mispriced provision gives rise to a UK tax advantage.

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Participation condition: Article 9 of the MTC applies arm's length transfer pricing to transactions between enterprises where one participates in the management, control or capital of the other or where the same person participates in the management, control or capital of both. The concept of participation in management, control or capital is not further defined in the MTC, and there is little in the Commentaries on the MTC to clarify it further. In practice, then, it has been left to countries to define appropriate participation conditions in their domestic law. The UK approach is to apply a test of effective control. In relation to bodies corporate the basic rule, in CTA 2010 s 1124 tests whether a person has power to secure that the company's affairs are conducted in accordance with their wishes (whether through shares, voting rights or powers conferred by the company's governing documents). In relation to partnerships, s 1124 tests whether a person has the right to more than half of the firm's income or assets – although how this determination is to be made is not specified (for example, is it necessary to hypothesise a winding-up?). The consultation document identifies different approaches taken in other countries, including:

- the US approach of testing whether taxpayers are 'acting in concert', which allows all relevant factors to be considered and does not focus solely on shareholder-type influence; and
- the Swiss approach, which does not define connectedness but instead tests whether the conditions imposed between taxpayers were distorted because of their special relationship.

The document assesses, and asks for respondents' views on, the relative merits of each approach. It might be assumed that the government would raise this issue in response to instances in which it had been identified that the current legislation did not apply to controlled transactions. However, the document strikes an open tone and does not suggest a firm direction. It does not identify any specific deficiencies in the current approach, other than noting it does not apply to situations in which a major creditor has effective control of an entity (and it is unclear whether that is a specific government concern or merely an illustration of the limits of the current approach).

UK/UK transfer pricing: Since 2004, the UK transfer pricing legislation has applied to transactions between two UK resident entities in the same way that it applies to cross-border transactions. This approach was introduced to ensure compliance with EU law, which prohibits member states from discriminating between domestic and intra-EU commerce. Now that the UK is no longer a member of the EU, the government proposes to remove requirements for UK/UK transfer pricing in situations where non-arm's length pricing would not affect the amount or timing of UK tax liabilities (for example in relation to transactions between two profitable members of a group, both of which are taxed at the main CT rate of 25%). This will tend to reduce compliance burdens for businesses, although that reduction may not be significant in practice.

Governance: Finally, the government proposes to remove the requirement that transfer pricing determinations are accompanied by a 'Commissioners' sanction', on the basis that it duplicates other HMRC governance processes that have been introduced since the current transfer pricing legislation was designed.

These proposals are mostly benign. The only one that might materially widen the scope of the UK's legislation is the possible re-casting of the participation condition: adopting a more expansive approach along the lines of that in Switzerland could leave businesses having to consider the relevance of transfer pricing to whole categories of transactions that they do not currently. It is not clear that specific deficiencies have been identified that justify taking that approach rather than (say) refining the existing control definitions.

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Likewise, the benefits of the proposed limitation on UK-UK transfer pricing seem modest. Given the increasing number of UK corporate tax regimes that apply on a group-wide basis (for example, the CIR, the corporate loss restriction and, for the largest groups, Pillar Two), it is arguably time for a more fundamental review of whether CT should be applied on a group basis as in some other countries.

Financial transactions

The government is also considering amending the UK's substantive transfer pricing rules to better align the treatment of financial transactions with the most recent OECD Transfer Pricing Guidelines (TPG).

The transfer pricing legislation contains several special rules that apply to financing transactions. Those rules provide that, in relation to lending transactions:

- guarantees from companies with which the borrower has a participatory relationship must be disregarded in determining arm's length price and borrowing capacity; and
- to the extent disregarding such guarantees reduces a UK borrower's interest deductions, the guarantor may claim to be treated for tax purposes as if it had issued the debt (and made any payments) itself, and thereby obtain a deduction from its own taxable profits.

In this context a 'guarantee' is widely defined and includes informal relationships or understandings.

There is a disconnect between this legislation and the 2022 edition of the TPG, which in Chapter X includes new, more detailed guidance on the treatment of financial transactions. In particular, the 2022 TPG draw a distinction between explicit support (by way of a formal guarantee) and implicit support (either through the effect of being a group member or a 'letter of comfort'). In very broad terms, the TPG indicate that while implicit support is a factor that an independent lender would consider, and which should likewise be taken into account when pricing financing transactions, it is an incidental benefit from passive association and would not ordinarily be an intra-group service for which an independent party would be willing to pay. On the other hand, a formal guarantee represents a legally binding commitment on the part of the guarantor to assume a specified obligation of the guaranteed debtor if the debtor defaults on that obligation. Subject to accurately delineating a financial guarantee transaction, formal financial guarantees may permit the borrower to borrow at more favourable interest rates, access to larger funds or both. Explicit support would be an intra-group service and therefore should be priced accordingly.

The consultation document indicates that the government intends to amend the legislation to allow implicit support to be taken into account, but that it will maintain the current approach of disregarding the effects of an intragroup guarantee on borrowing capacity while permitting a corresponding adjustment to the guarantor's profits.

Implicit support and formal guarantees affect both the cost of borrowing and the borrowing capacity when pricing financing transactions, and the interaction between implicit support and formal guarantees can vary depending on the facts and circumstances. The consultation document is not clear as to how the proposed new legislation would deal with that interaction while delivering the government's intention described above. The government will need to consider the practical issues with the current legislation and may need to consider alternative policy options to ensure alignment with the TPG.

Interaction with other areas of legislation

Finally, the consultation explores how the core transfer pricing rule in TIOPA 2010 Part 4 interacts with specific charging legislation such as the loan relationships and intangible fixed assets (IFA) regimes.

Such interactions can sometimes be difficult or give rise to complexity. For example:

- the loan relationships regime applies transfer pricing to foreign exchange gains and losses indirectly, and in a way that arguably does not capture all of the potential adjustments that might be required by the ALP; and
- the IFA regime generally prices transactions between connected parties according to the ALP but in certain circumstances also applies a market value (MV) rule which can produce different valuation results (and which may differ from the valuation basis applied for treaty purposes).

Reviewing these rules is sensible maintenance of the tax system and may result in some simplification. Establishing the arm's length price as the sole valuation standard in the IFA regime should, for example, reduce the valuation work that must be done by taxpayers and HMRC (although the simplification would only be partial: the MV rule would still apply to 'pre-FA 2002' intangibles that are taxed under the chargeable gains regime). It would also help ensure consistency between the allocation of businesses' profits from intangibles and the pricing of capital disposals of those intangibles.

Permanent establishment

The government proposes to update the UK legislation that charges tax on the profits of non-residents' UK PEs to align it more closely with the PE provisions in articles 5 and 7 of the MTC. The current UK PE legislation was originally enacted in 2003 and differs from the OECD Model in two main respects:

- it does not incorporate the changes to the definition of a deemed dependent agent PE (DAPE) in article 5 of the MTC that were proposed under action 7 of the OECD BEPS project; and
- it does not reflect changes to the provisions in article 7 of the MTC governing attribution of profits to PEs made in 2010, following the development of the authorised OECD approach to profit attribution (the AoA).

As well as changing domestic law, the government proposes to use the reformed article 5 as its basis for future treaty negotiations. The article 5 DAPE changes were included in the multilateral instrument (MLI) that countries used to amend their bilateral tax treaties following the original BEPS project. However, the UK (in common with a number of other countries) exercised an option in the MLI not to apply the DAPE changes to its treaties and has continued to use the old article 5 wording in treaties entered into since then.

While it may seem natural for the government to want to bring relatively old UK legislation into line with the latest OECD practice, not adopting the reformed DAPE definition was a deliberate choice. We understand that decision reflected a concern that lowering the DAPE threshold could lead to a proliferation of inadvertent PEs, and a view that DAPE avoidance risks (for example in relation to certain commissionaire arrangements) could be addressed through other means. In our view that concern was a valid one, and it is possible that over time adopting the new article 5 wording will increase the scope for other countries to assert taxing rights over the profits of UK outbound businesses.

DAPE issues can be particularly relevant in the financial services sector, for example to UK fund managers that make investment decisions for third-party investors overseas. Helpfully, the government has stated it intends to maintain the current investment manager exemption (IME), which provides certainty as to circumstance in which the UK will not assert that an investment manager constitutes a DAPE of its principal.

Diverted profits tax

Diverted profits tax (DPT) was introduced in 2015. It sought to combat international tax planning by multinationals in two ways:

- Firstly, by unilaterally asserting a UK taxing right over certain arrangements which the UK was prevented from taxing under existing double tax agreements (DTAs). The government argued that DPT was able to achieve this because it was designed as a new tax that (in its view) was not covered by those DTAs.
- Secondly, by introducing a novel compliance framework that was intended to accelerate resolution of disputes with businesses, including by requiring advance payment of disputed tax and imposing a higher tax rate (currently 31% compared to the main CT rate of 25%) to disputed profits if a taxpayer does not reach agreement with HMRC during a 12-month 'review period'.

Although designed as a separate tax, the policy objective of DPT was to strengthen HMRC's hand in corporation tax transfer pricing disputes and change taxpayer behaviour. It has largely proven to be effective in that regard. That effectiveness is typically attributed to the compliance framework which creates compelling economic incentives for taxpayers to engage on an accelerated basis with HMRC and settle transfer pricing disputes.

In contrast, the unilateral taxing rights are arguably of limited importance. Since 2015 international tax rules have been reformed to address many of the issues that motivated DPT. In any case, it is widely considered in the tax profession that DPT is a covered tax for DTA purposes – although HMRC continues to argue to the contrary.

> Incorporating the DPT compliance framework into general CT legislation might present a model that could be broadened to other transfer pricing or general CT disputes in the future

The consultation proposes removing DPT as a separate tax and replacing it with a 'diverted profits assessment' within the corporation tax rules. This broadly aims to preserve the DPT compliance framework while abandoning the unilateral taxing rights. Currently HMRC may issue a DPT charging notice where:

- there are arrangements that lack economic substance (the insufficient economic substance condition, or IESC); or
- a non-UK company avoids a UK PE,

and the effect is to achieve a tax saving of at least 80% of the UK tax that would otherwise be paid (an effective tax mismatch outcome, or ETMO). As outlined in the consultation document the diverted profits assessment would apply only in the former situation, and then only by reference to the ALP and not to the more expansive recharacterisation approach reflected in the DPT 'relevant alternative provision' (RAP) rules. Abolishing the avoided PE limb and the RAP reflects an apparent government view that, following the BEPS reforms, the OECD MTC and the ALP adequately address profit-shifting risks and do not need to be supplemented with unilateral measures.

As a charge to corporation tax, the diverted profits assessment will be incontrovertibly in scope of DTAs. This is a welcome change that should reduce the scope for double taxation by giving taxpayers a clear route to challenging an assessment (or obtaining a corresponding adjustment) through the mutual agreement procedure of a DTA. However, while for now the government intends to maintain the IESC and ETMO, incorporating the DPT compliance framework into general CT legislation might present a model that could be broadened to other transfer pricing or general CT disputes in the future by removing or amending those conditions.■

The consultation document is available on Gov.uk and via bit.ly/TPDTDPE. Comments are invited by 14 August 2023.

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▸ Tax and the City review for July 2023 (M Lane & Z Andrews, 13.7.23)