Are you up to date on Transfer Pricing?

The topic of transfer pricing seems to be everywhere at the moment – there are newspaper articles written about it, television programmes produced on the topic and conferences dedicated to exploring the concept.

At a basic level it appears to be a simple idea – taxpayers must apply arm's length remuneration of all their inter-company transactions. Those transactions may be the provision of goods, services, intangible assets or finance.

Taxpayers need to prepare robust and detailed documentation to explain why all their transactions are conducted on an arm's length basis and importantly include evidence proving that the pricing applied is at market rates.

The topic of transfer pricing is an issue on the agenda of many property and construction businesses. It is a function of the business model typically applied in this industry that a UK property owning company may have acquired assets with a significant level of debt finance. If that financing was provided by a related party (and that term is broadly interpreted) then the paying company may need to adjust its UK tax returns to reflect the arm's length quantum of debt and interest rate that could have been provided by an independent lender. Not only does the taxpayer have to show that it could have been able to secure the agreed level of funding, it also has to show that at arm's length a reasonable taxpayer in its position would have consented to take out that debt on the terms provided.

To the extent that the UK taxpayer has taken on more than the arm's length level of debt (and there is usually no one answer to what is "arm's length" but typically there is a range of answers), the party lending the money has to consider whether there is any redress available to it, to avoid double taxation on the interest payments receivable from the borrower. Much depends on where the lender is located, the size of the group and whether the UK's network of international treaties with overseas tax authorities can be invoked.

An announcement made by the Chief Secretary to Treasury in mid-September this year has added a new layer of complexity to the subject. It was proposed, per the announcement that legislation would be passed such that there will no longer be a compensating adjustment available to UK taxpayers where one party is a UK individual and the other party is a UK corporate entity. The announcement was followed by the consultation period and then a Technical Note issued on 25 October setting out the draft legislation to be introduced in the next Finance Bill.

The legislation is scheduled to take effect from 25 October 2013. There were two changes made to the original proposal based on the consultation period. The first change provides that the excess interest will be characterised for income tax purposes as a dividend, taxed in the hands of the individuals at dividend rates. The second change relates to the treatment of interest accrued but not paid at the time the legislation takes effect. The draft legislation excludes the accrued but not yet paid interest from the new rules.

The proposed legislation will apply prospectively to interest accruing in the period after the legislation comes into effect. Thus the draft legislation suggests that where a UK individual lends funds to a related corporate entity, the lender may be taxed on the interest income even if the borrower is not allowed a tax deduction.

Transfer pricing (and specifically the rules about arm's length level of debt, known as the thin capitalisation rules) is an area of growing interest to both tax authorities and the general public. Many tax authorities are investing heavily in transfer pricing specialists and transfer pricing is a hot topic for tax enquiries.

Who should I contact for assistance?

If you would like further information about transfer pricing please contact:

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