DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
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Working Party No. 6 on the Taxation of Multinational Enterprises

MODERNISATION OF THE TRANSFER PRICING LEGISLATION

Note by the United Kingdom - A consultative document

The attached document is submitted to Working Party No. 6 and the Steering Group on Transfer Pricing FOR INFORMATION.

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MODERNISATION
OF THE
TRANSFER PRICING LEGISLATION

A Consultative Document
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ABBREVIATIONS

APA  Advance Pricing Agreement or Arrangement
CTSA  Self Assessment for Companies
FA  Finance Act
ICTA  Income and Corporation Taxes Act 1988
ITSA  Income Tax Self Assessment
MAP  Mutual Agreement Procedure
OECD  Organisation for Economic Co-operation and Development
OTO  Oil Taxation Office
SA  Self Assessment
SI  Statutory Instrument
TMA  Taxes Management Act 1970
UKCS  UK Continental Shelf

Unless otherwise stated, all statutory references in this document are to ICTA 1988.
FOREWORD

by

Dawn Primarolo MP

Financial Secretary to the Treasury

Transfer pricing is one of the key international tax issues of our time. As the globalisation of business activity continues to accelerate, transfer pricing will retain its place high on the agenda for multinationals and tax authorities into the foreseeable future. The UK has played a leading role in addressing this international agenda, in particular at the Organisation for Economic Co-operation and Development. I want this to continue.

Today’s international environment is highly dynamic. Many other developed nations have recognised this by modernising their transfer pricing rules. By contrast, the UK’s own domestic legislation has remained largely unchanged for nearly fifty years. It has served us well. But the time has now come to modernise our regime to maintain our position at the forefront of transfer pricing developments. As part of that exercise, taking an approach consistent with that adopted by the OECD is the right way forward.

The present system puts the onus on the Inland Revenue to substitute arm’s length prices where these have not already been applied. However, it is clearly right that taxpayers should themselves apply the arm’s length principle when they calculate their taxable profits in their tax returns, as indeed most already do. So the Government has now decided to require them to do so. This will make the rules more effective at protecting a substantial proportion of our tax base and allow them to be applied more fairly and consistently.

I know that a great deal of work has already been done to pave the way for these changes. I want to build on that. I fully understand concerns that compliance costs should be kept to the minimum necessary. The proposals set out in this document are intended to do that. Consultation is an essential part of ensuring that they do. I hope that taxpayers and their advisors will take this opportunity to assist us to achieve our objective of having a fair and efficient transfer pricing regime.
CHAPTER 1

INTRODUCTION

1.1. The Government announced on 2 July 1997 that it intends to make changes to the UK's transfer pricing legislation in the Finance Bill following the next Budget. New rules will be introduced requiring taxpayers to apply the arm's length basis for transfer prices in calculating taxable profits in their tax returns. At the same time, and for the reasons set out in Chapter 2 below, the Government has also decided to take the opportunity to modernise the legislation more generally.

1.2. This document fulfils the Government's commitment to consult interested parties about the details. It follows on from a period of informal consultation about the legislation early in 1996 which took place in the context of the previous Government's declared intention of moving to a self assessment system for corporation tax (CTSA). It:-

• describes the context in which the Government has considered the case for change, and sets out the key reasons for change (Chapter 2);

• reports on the outcome of the informal consultation exercise (Chapter 3);

• describes the Government's proposals (Chapters 4, 5 and 6);

• makes available draft clauses (Appendix I);

• makes available draft guidance on documentation (Appendix II);

• makes available a draft revised list of the circumstances in which officers of the Board are required to submit papers relating to transfer pricing enquiries to the Inland Revenue's International Division (Appendix IV).

1.3. The Government invites comments on its proposals. If taxpayers or their representatives wish to discuss the proposals in detail with members of International Division, they should contact:

Kevin Hamer
International Division
Inland Revenue
Melbourne House
Aldwych
London WC2B 4LL

Tel.: 0171-438-7575
Fax.: 0171-438-7518

1.4. If taxpayers or their representatives wish to discuss issues relating to Advance Pricing Arrangements (APAs: see paragraphs 6.38-6.41 below) with members of International Division or to make a submission on APAs separate to any submission on the rest of the proposals in this document, they should contact:
1.5. If taxpayers or their representatives wish to make comments concerning the proposal to remove the need for a Board’s Direction from certain legislation concerning foreign exchange profits and losses or payments and receipts under financial instruments (see paragraphs 5.22 to 5.25 below), they should contact:

Linda Whewell  
Financial Institutions Division  
Inland Revenue  
Room 503  
22 Kingsway  
London WC2B 6NR  

Tel: 0171 438 7010  
Fax: 0171 438 6514

1.8. Written representations should be submitted to Kevin Hamer, Tony Attwood or Linda Whewell at the above addresses not later than Friday 19 December 1997.

1.9. This Consultative Document is available on the Internet at http://www.open.gov.uk/inrev/condoc5.htm. Responses can be sent by email to ahickman.ir.mhl@gtnet.gov.uk.
A. Transfer Pricing and the Arm’s Length Principle

2.1. The term “transfer pricing” describes the process by which members of a group set the prices at which they pass goods, services, finance and intangible assets between each other. There is nothing inherently exceptionable in this process. Indeed, transfer pricing is a fact of business life for multinational enterprises.

2.2. The setting of intra-group transfer prices is a complex and difficult business process. In setting transfer prices, multinationals have to take into account a wide range of factors, of which taxation is only one. Tax authorities on the other hand are concerned to protect the tax base in their own jurisdictions. Transfer pricing affects the amount of taxable profits arising in the jurisdictions concerned, and is therefore of considerable significance to tax authorities. There is a risk, in all these circumstances, that profits may be doubly taxed or, alternatively, may escape appropriate taxation altogether.

2.3. It is therefore highly desirable, both for taxpayers and for tax authorities, that there be an international consensus as to how transfer prices are to be evaluated for tax purposes. Such a consensus is beneficial to all concerned: it enables tax authorities not only to protect their own tax bases, but also to eliminate a potential source of double taxation and to encourage international trade. Ultimately, this is in the interests of taxpayers.

2.4. The internationally agreed standard for setting transfer prices is the “arm’s length principle”. This is that intra-group transfer prices should be equivalent to those which would be charged between independent persons dealing at arm’s length in otherwise similar circumstances. This principle has been incorporated by the Organisation for Economic Co-operation and Development (OECD) in Article 9 of its Model Tax Convention on Income and on Capital. The text of Article 9, which contains the internationally recognised statement of the arm’s length principle, is reproduced at Appendix III. Very similar wording is found in the “associated enterprises” Articles of the many Double Taxation Agreements to which the United Kingdom is party.

2.5. The member countries of the OECD have provided clear and detailed guidance on the practical application of the arm’s length principle: the latest version of this guidance is OECD’s publication Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, the first parts of which appeared in July 1995. The UK has played a leading role in drafting these Guidelines, and the Inland Revenue has stated publicly (Tax Bulletin, Issue 25, October 1996, pp.345-349) that it will be guided by them in applying the transfer pricing legislation in practice.

2.6. The Government attaches great importance to the stable international consensus reflected in this guidance and to the role of OECD in promoting international economic activity. It therefore considers that it would be helpful if the UK’s transfer pricing legislation were to be framed in a way which more explicitly identified it with Article 9 of the OECD Model and with the OECD Guidelines.
B. The International Context

2.7. Since the end of World War II, there has been a marked expansion of international trade and commerce. This trend has intensified in recent years, with wide-ranging changes in the volume, complexity and, thanks to modern telecommunications, speed of international trade leading to the development of a global economy. An increasing proportion of this international activity is carried on between members of multinational groups. For tax authorities, this means that intra-group transfer prices are an ever-increasing focus of attention.

2.8. A number of the UK’s major trading partners have responded to these developments by modernising their transfer pricing legislation, introducing additional compliance powers and in some cases specific penalty provisions. There have been major developments in Australia, Canada, Japan, South Korea, the USA and New Zealand.

2.9. Any consideration of the UK’s transfer pricing regime needs to take these developments into account. The legislation needs to be able to function fully and appropriately in the face of this growth in the volume and complexity of international business, and it makes sense to learn from other countries whose more modern legislation and procedures are designed to deal with contemporary transfer pricing issues.

C. The UK Perspective

2.10. Relative to its GDP, the UK has larger inward and outward flows of trading and investment than any other developed country. A large proportion of these movements takes place within multinational groups. As a result, transfer pricing is of crucial importance in the UK.

2.11. The UK’s existing transfer pricing legislation is now nearly 50 years old. It has generally served its purpose well, and embodies the arm’s length principle, but it is increasingly perceived as falling behind developments in the global economy, international trading and world-wide fiscal practice.

2.12. The existing legislation applies only when the Board of Inland Revenue give a Direction to that effect. As a result, taxpayers are under no obligation to apply the arm’s length standard in their tax returns. This places UK tax at risk and is not only unfair to that majority of taxpayers who take care to apply the arm’s length principle in setting prices and returning profits, but also potentially puts such taxpayers at a competitive disadvantage as against those who do not.

2.13. Growth in the volume and complexity of transactions and arrangements involving multinational enterprises over recent decades has put the UK transfer pricing legislation under increasing scrutiny and some strain. Taxpayers have sometimes pointed to what they perceive as defects or ambiguities in the procedures associated with the rules, or indeed in the rules themselves. Although any concerns have been addressed on an individual basis the apparent lack of certainty about aspects of the current regime is unhelpful to the business community generally. Moreover, as the structures adopted by businesses become ever more intricate, the simple description of relationships between persons undertaking transactions falling to be considered under the current law has not proved adequate to allow the arm’s length rule to operate in all appropriate cases.
D. Self Assessment (SA)

2.14 Income Tax Self Assessment (ITSA) was introduced with effect from the income tax year 1996/97. On 25 September 1996, the previous Government announced that the Appointed Day for CTSA would not be before early 1999, and that a further announcement would be made as soon as possible.

2.15 The Government considers that the directional basis of the present transfer pricing legislation is inappropriate. It takes the view that taxpayers should be required to make their tax returns in accordance with the arm’s length principle. The Government’s present intention is to achieve this objective by removing the current directional requirement and by integrating the transfer pricing rules within the SA framework.

2.16 However, for the reasons set out in this chapter, and in order to encourage voluntary compliance by enabling taxpayers to make their self assessments with confidence, the Government considers it appropriate to go beyond the simple removal of the Direction requirement, and to undertake the modernisation of the legislation described in Chapters 4-6 below.

E. Summary: The Key Reasons for Change

2.17 The Government has therefore concluded that modernisation of the transfer pricing regime is required in order to:

- take account of the increasing globalisation of international trade and commerce and of the increasing concentration of international economic activity in the hands of multinational enterprises;

- respond to the general modernisation of transfer pricing legislation throughout the developed world;

- reinforce the UK’s commitment to the arm’s length principle on which there is international consensus as expressed in Article 9 and the OECD Guidelines;

- encourage voluntary compliance by enabling taxpayers to self assess their profits, taking the transfer pricing rules into account, with confidence;

- ensure fairness between taxpayers in the requirement to apply the arm’s length principle.
CHAPTER 3

THE OUTCOME OF THE INFORMAL CONSULTATIONS

3.1. In a 1995 Budget Day press release\(^1\), the then Chancellor of the Exchequer announced that he had asked the Inland Revenue “to consult interested parties . . . about any procedural changes which might be necessary to the transfer pricing legislation as a result of the introduction of self assessment; and also to keep under review the case for bringing the transfer pricing regime wholly within the self assessment framework”.

3.2. During the first quarter of 1996, representatives from the Inland Revenue’s International Division met with representatives of corporate taxpayers, with tax and transfer pricing practitioners, and with members of various representative bodies, to discuss the options available.

3.3. A number of common themes emerged during this informal consultation period. While some participants saw the case for modernisation, it became clear that there are a number of aspects of the existing transfer pricing legislation which the taxpaying community was anxious to preserve.

3.4. Commentators praised the relative brevity and simplicity of the UK’s transfer pricing legislation. They preferred short purposive legislation of the kind we have now to more detailed prescriptive legislation.

3.5. Taxpayers valued the Board’s Direction procedure. They felt that it ensured central monitoring of potentially contentious transfer pricing cases. This, it was felt, protected the taxpayer from inappropriate enquiries and ensured a degree of consistency in the application of the legislation. It was suggested that, if the legislation were to be made mandatory, central monitoring of cases should continue in some form. The question of central monitoring is discussed in detail in Chapter 6(C) below.

3.6. Concern was expressed about the nature and extent of any transfer pricing documentation requirement and the associated compliance costs. Commentators wished if possible to avoid the enactment of prescriptive and extensive documentation requirements. A legislative requirement that taxpayers should create and retain certain records for tax purposes which they do not require for any other business or commercial purpose was considered inappropriate, as was any documentation provision which might automatically require taxpayers to commission costly reports from economists or other experts in support of their transfer pricing policy. This issue is dealt with in Chapter 6(E) and Appendix II below.

3.7. Similar concerns were expressed about the possible nature and extent of any transfer pricing return requirement and the associated compliance costs. Some commentators were opposed to any requirement to produce a schedule of transfer pricing information in the tax return. Others were more concerned that taxpayers should be able to compile the information required without incurring significant additional compliance costs. However, since current record keeping systems are diverse, it was acknowledged that any return requirement would be likely to produce at least some additional compliance costs. This question is dealt with in Chapter 6(D) below.

3.8. Establishing transfer prices in accordance with the arm’s length principle is not always easy, and taxpayers were particularly concerned about being asked to certify, when signing the return form, that the

\(^1\) Inland Revenue Press Release PR246/95 (28 November 1995)
intra-group pricing reflected in the return satisfied the arm’s length standard. The reference in section 770 to a purchase or sale at a price led commentators to conclude that the person signing the tax return would have to be able to say that the return reflected an arm’s length price for each and every single transaction. They felt that such a requirement would be difficult to comply with. The Government considers that the new basic pricing rule addresses this concern (see Chapter 5(B) below).

3.9. A related concern arose on penalties. Once the application of the transfer pricing legislation is made mandatory, taxpayers will be exposed to the possibility of a penalty for an incorrect return if their transfer prices depart from the arm’s length standard. It was felt that, if a taxpayer had made a reasonable attempt to determine its transfer prices on an arm’s length basis, then it should not be liable to a penalty. There was strong opposition to the possibility of specific penalties for separately defined transfer pricing offences and to “automatic” or “no fault” penalties in relation to understatements of profits as a result of non-arm’s length transfer pricing. The Government’s proposals regarding penalties are set out in Chapter 6(H) below.
CHAPTER 4
THE GOVERNMENT’S PROPOSALS: GENERAL APPROACH

4.1. In bringing forward its proposals, the Government has sought to address the concerns voiced by taxpayers and their representatives during the informal consultation period, and at the same time to further the objectives of encouraging voluntary compliance and protecting the UK tax base in a changing international context. In pursuing these objectives, the Government wishes to minimise the imposition of compliance burdens on taxpayers.

4.2. The Government proposes to:

• remove the directional basis of the legislation, thus requiring taxpayers to apply the arm’s length principle in making their tax returns;

• modernise the legislation more generally;

• modernise the administrative arrangements by integrating transfer pricing within the SA management framework;

• reinforce the UK’s commitment to the arm’s length principle on which there is international consensus expressed in Article 9 and the OECD Guidelines.

4.3. The Government’s proposals are set out in detail in Chapters 5 and 6 below. Chapter 5 describes the main features of the proposed new legislation, while Chapter 6 discusses a number of related administrative issues.
CHAPTER 5

THE NEW TRANSFER PRICING LEGISLATION

A. Introduction

5.1. One of the Government’s objectives in reforming the transfer pricing legislation is to encourage voluntary compliance by enabling taxpayers to make their returns with confidence, and by keeping the costs of compliance as low as possible. The draft clauses have been prepared with this in mind.

B. The Basic Pricing Rule

5.2. If taxpayers are to be able to apply the arm’s length principle with confidence in their tax returns, they and their advisers must be in a position to understand the implications of the basic transfer pricing rule.

5.3. The new rule is intended to reproduce in UK law the effect of Article 9(1) of the OECD Model Tax Convention. There are differences in wording between the new rule and Article 9(1); this is because UK drafting conventions prevent the verbatim reproduction of Article 9(1). However, there is a specific requirement to construe the new legislation in a manner which is consistent with Article 9, and in accordance with the OECD Guidelines.

5.4. The basic pricing rule is included in the draft clauses at paragraph 1 of Schedule 28AA. This refers to “provision” made or imposed between two persons by means of a transaction or series of transactions. It requires the adjustment of income, profits or losses where that provision (being the sum of all the terms and conditions attaching to the actual transaction or series of transactions) departs from the arm’s length standard and has created a potential advantage for the purposes of UK taxation.

5.5. A potential advantage exists if, as a result of the actual provision, the taxpayer’s income or profits are less than, or its losses are greater than, they would have been had the arm’s length provision been made between the affected persons (paragraph 3(1), Schedule 28AA). Through this concept of “advantage”, the new rule permits adjustments only where these will increase taxable income or profits, or reduce allowable losses. In this way, it preserves the “one-way street” approach of the existing legislation and is consistent with the approach of Article 9(1).

5.6. When signing the declaration on the return form, the taxpayer will need to consider whether any provision was made or imposed in its dealings with associates which was other than that which would have existed between independent enterprises. If so, it must consider the tax effect of that provision. If the effect of the “actual provision” is to confer an advantage (as defined) on the taxpayer, it will be required to adjust its tax computation accordingly. The Government expects the person signing the return will be able to do so with confidence, because the new rule is framed by reference to “provision” rather than to transactions.
C. Secondary Adjustments

5.7. The basic pricing rule described above requires that tax computations be adjusted, where necessary, to reflect the position which would have existed had the arm’s length provision been made instead of the actual provision. However, unless the adjustment in the tax computation is matched by payments between the affected parties reflecting the adjustment, the economic circumstances of the parties will be distorted. This distortion can have a significant and continuing impact on capital structure and more generally on profit potential, and thus on future tax liabilities.

5.8. One way of addressing this distortion is to make a "secondary adjustment". Secondary adjustments recognise the fact that funds which would have been retained by one of the parties if the provision had been made at arm’s length have not actually been retained by it. This is done by deeming a secondary transaction, for example a loan or distribution, to have been undertaken. Adjustments of this kind are made by some of our major treaty partners and are discussed in the OECD Guidelines (paragraphs 4.67-4.77). Whilst they do not themselves restore the financial situation of the parties to what it would have been had the provision which gave rise to the transfer pricing adjustment been made at arm’s length, secondary adjustments can be administered to encourage the restoration of funds to their proper place or, failing this, allow adjustment of the tax effects of the distortion which might otherwise arise.

5.9. The Government does not propose to provide for secondary adjustments as part of the modernisation package described in this document. It does, however, wish to encourage the voluntary restoration of funds in the circumstances described above. It will keep the position under review in order to determine whether legislation is needed to ensure that funds are restored following a transfer pricing adjustment. The Government invites comments on how this can best be achieved.

D. Scope of the Legislation

5.10. The current legislation applies to transactions between parties where one party controls the other or both parties are under common control. The parties to the transactions can include companies, partnerships and, in some circumstances, individuals (although transactions between two individuals are not caught). The draft clauses preserve this position.

5.11. Under the present legislation, the test at section 840 is employed to establish whether the requisite control conditions are fulfilled. In applying this test, rights and powers of nominees and connected persons can be attributed to the potentially controlling party. The draft legislation continues to employ the section 840 test for partnerships, but adopts section 416 for companies. The proposed legislation also incorporates a series of attribution rules, including provisions which address situations where trusts or unit trusts are included in a control chain. In addition, the control provisions in the draft clauses bring relationships involving certain joint venture companies within the scope of the legislation. The control provisions are in paragraph 2 of Schedule 28AA.

5.12. The draft legislation uses the concept of “provision made by means of a transaction or series of transactions” to describe those situations in which the legislation will apply. This contrasts with the current wording, which is couched in terms of sales of property and then separately extended to apply to other classes of transaction. The new rule is intended to be comprehensive in its scope. “Transaction” is given a very wide-ranging definition in paragraph 12(1) of Schedule 28AA: it encompasses a wide range of situations, including transactions for which no price has been set, and transactions which would not
have taken place at all at arm’s length. By virtue of paragraph 12(4) and (5) of the Schedule, series of transactions including transactions to which only one of the “affected persons” is a party, or to which neither is a party, are within the scope of the legislation.

E. UK-UK Transactions

5.13. The current transfer pricing legislation is directed primarily against cross-border transactions between associated enterprises on non-arm’s length terms. Nonetheless, although certain transactions between UK resident traders are exempt, the legislation can in some circumstances apply to transactions between two UK taxpayers. In most of the major trading nations, transfer pricing legislation applies only to cross-border transactions or relationships; wholly domestic transactions or relationships are excluded expressly or by implication.

5.14. The Government wishes to take the opportunity afforded by the proposed modernisation of UK transfer pricing legislation to harmonise the regime with international practice by exempting provision made between two UK taxpayers, thus restricting the scope of the legislation to cross-border relations between associated enterprises. The draft clauses embody the new exemption at paragraph 3(2) of Schedule 28AA.

5.15. This new exempting provision will eliminate the difference in treatment between trading and non-trading taxpayers. Moreover, it will mean that those taxpayers who conduct transactions with associates within the UK will not have to consider the transfer pricing implications of those transactions. This will help reduce compliance costs.

5.16. However, “cross-border” relations between two associated UK taxpayers, one of whom carries on business abroad, will not be exempt. This will prevent a potential loss of UK tax which might otherwise result from profits being diverted to the overseas branch of a UK company, where the UK gives double taxation relief for foreign tax paid on the diverted profits. Cross-border relations of this kind which involve transactions in oil are currently within the existing transfer pricing rules (section 771). It is now considered appropriate to apply this to the generality of taxpayers. The draft clauses are at paragraph 3(3)-(5) of Schedule 28AA.

5.17. Where an overseas affiliate of a UK taxpayer suffers a transfer pricing adjustment in its home territory, that UK taxpayer may, provided there is an appropriately worded Double Taxation Agreement in force, claim a “corresponding adjustment”. By contrast, where a transfer pricing adjustment is made to the computations of a UK taxpayer in respect of a transaction between it and another UK taxpayer, there is currently no statutory provision for a similar compensating adjustment in the computations of the other taxpayer. Indeed, the “one-way street” approach of the legislation effectively rules this out. The one exception to this is section 771(4), which is an oil taxation provision.

5.18. In future, where transactions between two UK taxpayers are caught by the new legislation, the Government proposes to provide a mechanism allowing for such compensating relief. The draft clauses are at paragraph 4 of Schedule 28AA. In order to prevent avoidance, the proposals include provisions to restrict the availability of double taxation relief where compensating relief is claimed. These are at paragraph 5 of Schedule 28AA. Put simply, where relief is given under paragraph 4, any double taxation relief will be restricted to that which would have been available had the relevant provision been at arm’s length.
F. Financial Transactions and Arrangements

5.19. As explained above (paragraph 5.12), the proposed new pricing rule is framed in terms of provision made by means of a transaction or series of transactions, with “transaction” defined in very wide-ranging terms. This means that all financial arrangements between or involving “the affected persons” are potentially within the scope of the proposed new legislation.

5.20. The draft legislation applies to non-arm’s length interest rates and discounts. It also applies to transactions which would not have taken place at all between independent persons, as well as to those where the amounts or terms involved would have differed. As a result, the legislation will be consistent with, and complementary to, section 209(2)(d) and (da), which provides for the treatment of “excessive” interest as a distribution, and which will continue to apply. It will also fit well with the Inland Revenue’s current approach to direct and indirect funding arrangements not covered by the distributions legislation but dealt with in the associated enterprises and interest Articles in the UK’s Double Taxation Agreements. The most notable change in this area will affect the relatively small number of direct funding arrangements involving companies with less than a 75% shareholding connection, but which satisfy the new tests of association. Where, previously, disallowance of “excessive” interest has not been sought in such cases, the new rules will lead to automatic disallowance. Where the funding comes directly from a third party, but with the support of a guarantee from a non-UK group member, “excessive” interest will fall to be disallowed, as is sometimes the case now, if the provision between the two affected persons differs from the arm’s length provision.

5.21. As a separate matter, the payer of “excessive” interest which has not been characterised as a distribution but for which no deduction will be due in calculating taxable profits will still have to consider the withholding tax rules (section 349) and the terms of any relevant Double Taxation Agreement. In many cases the “special relationship” provision in the interest Article of the Double Taxation Agreement will deny the recipient of the “excessive” amount the benefit of reduced or nil withholding tax.

G. Foreign Exchange Differences and Financial Instruments

5.22. Transactions which are within the scope of the new legislation may give rise to foreign exchange gains and losses, and to payments and receipts under financial instruments. Special tax rules for such amounts are set out in Chapter II Part II FA 1993 (foreign exchange gains and losses) and Chapter II Part IV FA 1994 (financial instruments). Where amounts are brought into account under those provisions they will be excluded from consideration under the transfer pricing legislation (see paragraph 6 of Schedule 28AA).

5.23. There are at present specific provisions which deal with the adjustments to be made where arrangements which give rise to foreign exchange profits and losses or payments and receipts under financial instruments are other than at arm’s length. These are sections 136, 136A and 137 FA 1993 and section 167 FA 1994. These, together with section 135 FA 1993 (adjustments where a main benefit test is not met), only apply where the Board of Inland Revenue give a Direction to that effect.

5.24. The Government believes that in principle these provisions should be applied when taxpayers self assess their profits, without the need for a Board’s Direction. However, before producing the necessary draft legislation the Government would like to hear from anyone who thinks that this approach might give rise to practical difficulties.
5.25. Assuming that the directional basis is abolished, the Government does not propose any separate return requirement in relation to the arm’s length and main benefit provisions described above. It will, therefore, effectively be adopting the equivalent of the proposed Option B for transfer pricing cases described in paragraph 6.20 below.

H. Oil Companies

5.26. Many of the special rules in section 771 for cross-border transactions by oil companies will not be necessary in the new transfer pricing legislation:

- the provisions which brought oil transactions between the overseas branch of a UK resident and an associated UK resident within the transfer pricing rules will now be subsumed in the general transfer pricing rules (see paragraph 5.16);

- the valuation rules in section 771(6) are not entirely consistent with normal arm’s length principles. Parts of the rules are no longer relevant in current oil markets. It is therefore appropriate to drop these valuation rules and rely on normal arm’s length principles.

5.27. One special rule for cross-border oil transactions will be retained. Section 771(5)(b) applies the transfer pricing rules to sales of oil produced by a company in which the buyer and its associates have an interest of 20% or more. This goes wider than the control test used for section 770 (and for its proposed replacement). Consortium companies with minority interests are common in the oil industry, and oil companies have co-operated in the past for mutual advantage through such ventures. Similar arrangements are less common in other industries. To forestall potential avoidance, this wider control test will be retained for cross-border sales of oil.

5.28. Section 771 applies the current transfer pricing rules to transactions involving a company engaged in UK and UKCS oil and gas activities. This forms part of the CT ring fence which prevents taxable profits from these activities being reduced by losses, reliefs, etc. attributed to other activities. The new legislation will also apply to transactions involving these companies including, as a result of paragraph 5.19 above, all aspects of financial transactions involving these companies. Other proposed modifications are:

- where a company carries on two trades, one of which is a UK/UKCS oil extraction trade, the transfer pricing rules will apply to “transactions” between the separate trades;

- the definitions have been aligned with those used in other CT ring fence provisions;

- transactions between two companies which are both within the CT ring fence rules will be taken out of the scope of the transfer pricing rules.

5.29. No change is being made to the rules for the valuation of disposals of oil and gas extracted from the UK and UKCS. The rules in section 493 will continue to apply to these disposals.
I. Commencement

5.30. On the basis of integration within the SA framework, the Government intends that the new regime for transfer pricing should come into effect at the commencement of CTSA. Accordingly, the new rules will apply for accounting periods ending on or after the Appointed Day for CTSA. The Appointed Day will not be before early 1999. For ITSA, the new rules will apply for the year of assessment in which the Appointed Day falls.
CHAPTER 6
ADMINISTRATIVE ISSUES

A. Introduction

6.1. The Government has decided to integrate the transfer pricing legislation within the SA management framework. This chapter contains proposals which address the administrative issues.

B. Making the Legislation Mandatory

6.2. The existing transfer pricing legislation is discretionary: unlike most of the provisions of the Taxes Acts, it does not apply to any transaction within its scope “unless the Board so direct” (section 770(2)(d)).

6.3. One effect of this is that section 770(2)(d) acts as a trigger for the operation of the legislation. Taxpayers are not required to apply the arm’s length principle in making their returns, because at the time a return is made, the Board are very unlikely to have considered a taxpayer’s transfer pricing arrangements or to have made a Direction for the period covered by the return.

6.4. The Government proposes to abolish the existing Direction requirement. Following abolition taxpayers will be obliged to apply the arm’s length principle in making their returns. This will remove the inequity and potential competitive disadvantage faced under the present arrangements by taxpayers who apply the arm’s length principle in setting their transfer prices and in making their returns as against those who do not. Furthermore, making the legislation mandatory will bring the regime more closely into line with what happens in other countries.

C. Central Monitoring of Transfer Pricing Enquiries

6.5. Central monitoring of transfer pricing enquiries is currently conducted under the responsibility of International Division. (In the case of transactions to which section 771 applies, responsibility lies with the Oil Taxation Office.) This central monitoring function is fulfilled in two ways.

6.6. Firstly, the Board have delegated their responsibility for the statutory Direction procedure to senior officials of the Division (or, as the case may be, of OTO). The involvement of senior officials ensures that the Inland Revenue adopts a consistent approach in this complex, specialised and sensitive area.

6.7. Secondly, cases are brought to the attention of the Division through a more general system of submissions to Head Office, which operates alongside the statutory procedure.

6.8. The Board’s published guidance contains a list of the circumstances in which officers are required to submit transfer pricing cases to International Division. This is at paragraph 4661 of the Inspector’s Manual (IM4661). In addition, officers are encouraged to seek the advice and support of International Division specialists at any stage in an enquiry, and they frequently do so. The specialists in International Division are experienced transfer pricing practitioners who bring a wide range of knowledge.
and skill to bear on their advisory work. The submissions system allows International Division to take the broader view, and to ensure the rules are applied consistently, quite apart from discharging its responsibility for the statutory Direction process.

6.9. During the informal consultation held in 1996, taxpayers and their representatives argued vigorously in support of continuing central monitoring by International Division, on the grounds that this protects taxpayers from inappropriate enquiries and ensures consistency in the application of the legislation. The Government sympathises with these concerns. It is itself concerned to ensure that valuable resources are not wasted in the pursuit of inappropriate enquiries and that the transfer pricing rules are interpreted and applied fairly and consistently. The Government therefore intends that central monitoring of enquiries should continue following the proposed abolition of the Board’s Direction procedure. It wishes, however, to debate with taxpayers and their representatives how central monitoring of transfer pricing enquiries can most effectively be provided.

6.10. The system of submissions to Head Office will continue in any event. However, in order to reinforce its effectiveness in delivering the twin aims of consistency and taxpayer protection within the framework of the proposed new regime, the list of circumstances in which submission is required (IM4661) will be revised and extended. A draft of the revised list is reproduced at Appendix IV, and the Government invites comments on the list.

6.11. The question which remains for debate is whether or not a statutory mechanism is still needed or appropriate. In order to inform this debate, and in recognition of the importance which taxpayers have attached to the statutory mechanism in the past, the Government has included in the draft clauses, as section 30C TMA, a provision for a new statutory mechanism.

6.12. The new mechanism requires the Board’s approval before a transfer pricing adjustment can be included in a notice of closure under section 28A(5) TMA, or in a notice of assessment under section 29(1) TMA. The Board must give their approval in writing, and a copy of the approval must be supplied to the taxpayer.

6.13. The combination of the new Board’s approval procedure and the submissions system will deliver the same degree of taxpayer protection, and the same consistency in the application of the rules, as the existing arrangements.

6.14. If it were to be administered in broadly the same way as the present Directional provision, the new mechanism would be costly in terms of Inland Revenue resources. The Government therefore considers that the continuation of a statutory mechanism can only be justified if it can be shown to provide meaningful additional taxpayer protection over and above what is provided through the system of submissions to Head Office.

6.15. The Government therefore invites taxpayers’ views as to whether the system of submissions to Head Office does not of itself provide for an adequate degree of consistency and taxpayer protection. If not, what are the additional benefits, if any, provided by the statutory mechanism?
D. Return Requirement

6.16. During the informal consultation period, concern was expressed that any additional transfer pricing return requirement would significantly increase compliance costs for some taxpayers - depending on the nature of the information required and the taxpayer’s own record keeping systems.

6.17. The Government therefore asked the Inland Revenue to consider whether a taxpayer’s return should include information relevant to the application of the transfer pricing legislation. There is a legitimate need for the Inland Revenue to be able to identify those returns in respect of which it believes it appropriate to raise transfer pricing enquiries. Clearly, where a taxpayer acknowledges that its pricing is not in accordance with the arm’s length principle, then that taxpayer should include a transfer pricing adjustment to its profits in the tax computation which it submits as part of its return. Equally, that is not necessary where taxpayers have considered their transfer pricing arrangements and have arrived at the view that these arrangements are in accordance with the arm’s length principle.

6.18. The Government has considered two possible options in this area.

6.19. **Option A** is that the Inland Revenue impose a limited return requirement by asking taxpayers to supply a schedule of transfer pricing information with the return. The schedule would be designed to elicit only such information as the Inland Revenue would require to assist it in the selection of cases for enquiry. The Inland Revenue’s experience in requesting this kind of information during the course of transfer pricing enquiries suggests that it would be reasonably accessible from most taxpayers’ record-keeping systems.

6.20. **Option B** is to impose no separate transfer pricing return requirement. The Inland Revenue would select cases for transfer pricing enquiry from the information available to it in returns and other sources much as it does at present.

6.21. The Government has considered the advantages and disadvantages of both options, together with the representations made on this issue during the informal consultation period. It has decided to adopt **Option B**. It does not propose to impose any requirement upon taxpayers to disclose information about transfer prices in their tax returns. However, it has asked the Inland Revenue to keep under review the effectiveness of the administration of the proposed new regime in this respect.

E. Documentation Requirements

6.22. Under SA, the taxpayer is required by section 12B TMA to keep and preserve “all such records as may be requisite for the purpose of enabling him to make and deliver a correct and complete return”. When the transfer pricing legislation is brought within the SA management framework, section 12B will apply to transfer pricing as it does to all other matters covered in a return. Taxpayers will be required to keep and preserve appropriate records in order to demonstrate the arm’s length nature of the transfer prices on which their returns are based.

6.23. In interpreting section 12B for the purposes of the transfer pricing rules, the Inland Revenue will follow Chapter V of the OECD Guidelines. The Inland Revenue will therefore expect documentation to be created or referred to and retained in relation to a taxpayer’s transfer pricing arrangements in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance.
6.24. Taxpayers will be expected to create and retain contemporaneous documentation of their efforts to comply with the arm’s length principle, including the information on which their transfer prices were based, the factors taken into account and the method selected. The Inland Revenue proposes to issue guidance to taxpayers in this area, and a draft Guidance Note is included in this consultative document at Appendix II.

F. Information Powers

6.25. In keeping with its general objective of integrating the transfer pricing rules within the SA framework, the Government proposes to dispense with specific information powers for transfer pricing. The draft clauses do not therefore contain anything to replace section 772(1)-(7).

6.26. Section 19A TMA provides a general information power to support the Inland Revenue’s enquiries into a return under SA. The Inland Revenue will use this power where necessary in transfer pricing cases, and it will also continue to use the general information powers at sections 20-20C TMA and Regulation 10 SI 1994 No. 1811 where this is appropriate.

6.27. In order to ensure that these powers are exercised consistently in transfer pricing enquiries, their use in such cases will be monitored centrally. Officers will be required to refer such cases to International Division when a taxpayer appeals against a section 19A notice, before seeking the consent of a Commissioner to the issue of a notice under sections 20-20C, or before drawing the attention of the Commissioners to their powers to issue notices under Regulation 10.

6.28. The Government will, however, monitor the use of these general information powers in transfer pricing cases to satisfy itself that they are adequate to enable the Inland Revenue to obtain the information it needs to pursue its enquiries. If the absence of specific information powers is seen to be hampering the Inland Revenue’s work, the Government will consider the re-introduction of such powers.

G. Assessments which are not Self Assessments

6.29. With the abolition of the Direction requirement, section 770(3) will no longer be required and will not be replaced. The general assessing rules in TMA will apply in the field of transfer pricing as they do elsewhere. Under SA, the Inland Revenue will be able to make assessments under section 29(1) TMA in order to give effect to transfer pricing adjustments. In cases of fraud or neglect, the Inland Revenue will be able to make assessments after the expiry of the normal time limit for assessing. To ensure consistency in this area, officers will be required to obtain the Board’s approval before making an assessment under section 29(1) to give effect to a transfer pricing adjustment.

H. Penalties

6.30. Because the existing transfer pricing legislation is discretionary in nature, there is no requirement on taxpayers to observe the arm’s length principle in setting their intra-group transfer prices and/or reporting them for tax purposes. One effect of this is that taxpayers who fail to observe the arm’s length principle in making their returns face nothing more - if such a failure is detected - than an
additional liability to tax consistent with the application of the arm’s length principle, plus interest. They are not exposed to penalties.

6.31. This will change when the proposed reform of the transfer pricing legislation is implemented. There will then be an automatic requirement on taxpayers who transact business with associated enterprises within the scope of the legislation to take the transfer pricing legislation into account in completing their returns. If a return does not comply with the transfer pricing legislation, it will be an incorrect return, and if it is incorrect as a consequence of the taxpayer’s fraud or neglect, then the taxpayer will be liable to a penalty.

6.32. The general penalty provisions for incorrect returns, accounts or claims which have been submitted fraudulently or negligently are at sections 95, 95A and 96 TMA. The maximum amount of the penalty exigible under these provisions is equal to the amount of the tax lost as a result of the fraudulent or negligent conduct.

6.33. The Government does not propose to introduce specific penalty provisions to deal with returns or accounts which are incorrect as a result of non-arm’s length pricing. Where a taxpayer negligently fails to consider whether its transfer pricing arrangements are in accordance with the arm’s length principle, or otherwise submits returns, in this respect, negligently or fraudulently, it will be liable to a penalty under section 95, 95A or 96 in the usual way.

6.34. During the informal consultation period, commentators put forward the view that taxpayers should not be liable for a penalty in circumstances where they have demonstrably made a reasonable attempt to reflect arm’s length transfer prices in the figures disclosed in their returns. The Government accepts this, and recognises that the vast majority of taxpayers try to comply with their obligations in completing their tax returns. It therefore agrees that taxpayers should not be penalised if they make a reasonable attempt to comply by observing the arm’s length standard in their tax returns. Clearly, it is important for taxpayers to have appropriate records to demonstrate what they have done in this area.

6.35. However, it is the Government’s objective to encourage voluntary compliance by taxpayers with their obligations and thus to provide a fair system for that vast majority who do. To this end, it is necessary to have an effective system of sanctions to deter, and where necessary to penalise, non-compliance.

6.36. Where there is a liability for penalties, the Board of Inland Revenue, through their officers, will exercise their discretion to mitigate the penalties charged as appropriate. In doing so, they will apply the criteria they use in other cases, which are based on the extent to which the taxpayer has disclosed any irregularities, the co-operation afforded by the taxpayer in the course of the Inland Revenue’s enquiries, and the size and gravity of any offences committed.

6.37. In order to ensure that the penalty provisions are applied consistently in transfer pricing cases, officers will be required to refer any such case in which penalties are being considered to International Division.

I. Advance Pricing Arrangements (APAs)

6.38. Advance Pricing Arrangements (APAs) are a mechanism whereby the setting of transfer prices in respect of specified controlled transactions may be agreed with tax administrations in advance of the
transactions being undertaken and reported. The mechanism offers certainty for the taxpayer that transfer pricing covered by the arrangement will not be challenged during the period of the arrangement, subject to the terms of the arrangement being observed. APAs might be seen, therefore, as a means of assisting taxpayers to comply with their obligations under the existing and the proposed new transfer pricing legislation. The purpose of raising the subject of APAs in this consultative document is to seek comments about whether the UK’s approach to such arrangements should be developed in order further to assist taxpayers, and if so, how.

6.39. APAs have been the subject of considerable discussion in recent years. They are described in detail in the OECD Guidelines (paragraphs 4.124 - 4.166), where certain advantages as well as disadvantages are identified. Features seen as advantages include the enhanced predictability of tax treatment, a less confrontational approach, and an opportunity in the case of bilateral agreements between tax administrations to eliminate double taxation in a more streamlined manner. Disadvantages include the resource implications for all parties.

6.40. Certain countries conduct APAs on the authority of specific legislative provisions. The US is the prime example of this approach. The UK has no such formal authority and the basis on which the UK participates in APAs was set out in a recent Tax Bulletin article (Issue 25, October 1996, page 348). This relies on the authority of the mutual agreement procedure (MAP) Article of the relevant Double Taxation Agreement and involves the Inland Revenue engaging in bilateral negotiations with the other tax administration involved. It has proved to be workable, but may be perceived to have drawbacks. For instance, the arrangements tend to be geared towards the formal procedures established by the other jurisdiction involved.

6.41. General comments arising from this brief overview of APAs would be welcome. In addition the Government invites taxpayers’ views relating to the following questions:

- Is there support for the proposition that the Inland Revenue should make the APA process available to taxpayers? Is that support affected by the proposed legislative changes discussed in this document?

- Is that support qualified by perceived disadvantages in the APA procedure as it is currently understood? What are those disadvantages and how might they be removed?

- Does the Mutual Agreement Procedure afford a satisfactory means by which UK taxpayers may obtain an APA, or would formal domestic legislative provisions be preferable? If preferable, is this essentially in order to establish domestic legal authority or in order to alter the procedure?

- Is there perceived to be a lack of understanding about the procedures by which APAs may be obtained, and would the issue of guidance notes be helpful?

- Is there an interest in applying for APAs on a unilateral basis, that is an understanding with the UK tax administration alone, bearing in mind both that any such arrangements may not eliminate double taxation and that they are informal and non-binding?
New regime for transfer pricing etc. [j451]

1.-(1) For sections 770 to 773 of the Taxes Act 1988 (transfer pricing provisions) there shall be substituted the following section-

"Provision not at arm's length.

770A. Schedule 28AA (which deals with provision made or imposed otherwise than at arm's length) shall have effect."

(2) After Schedule 28A to that Act there shall be inserted, as Schedule 28AA to that Act, the Schedule set out in Schedule {j4511} to this Act.

(3) In the Finance Act 1993-

(a) in sections 136(7) and (8) and 136A(5) (application of arm's length test in computing foreign exchange gains and losses), for the words "has been treated under section 770 of", in each place where they occur, there shall be substituted "falls to be treated in accordance with Schedule 28AA to"; and

(b) in section 136A(6), for "has at any time in that accrual period been treated under section 770 of" there shall be substituted "falls in relation to any time in that accrual period to be treated in accordance with Schedule 28AA to".

(4) In the Finance Act 1996-

(a) in section 100(3) (imputed interest on loan relationships), for the words from "which, in" to "of those sections" there shall be substituted "which, in pursuance of Schedule 28AA to the Taxes Act 1988 (provision not at arm's length), falls to be treated"; and

(b) in paragraph 16 of Schedule 9 (imputed interest)-

(i) in sub-paragraph (1), for the words from "sections 770" to "that Act" there shall be substituted "Schedule 28AA to the Taxes Act 1988 (provision not at arm's length)"; and

(ii) in sub-paragraph (2), for "Those sections" there shall be substituted "That Schedule".

(5) This section and Schedule {j4511} to this Act shall have effect (in relation to provisions made or imposed at any time)-

(a) for the purposes of corporation tax, as respects accounting periods ending on or after the day appointed under section 199 of the Finance Act 1994 for the purposes of Chapter III of Part IV of that Act (self assessment management provisions); and
(b) for the purposes of income tax, as respects any year of assessment ending on or after that day.

Determinations requiring the sanction of the Board. [j4512]

2.- (1) In the Taxes Management Act 1970, the following section shall be inserted after section 30B-

"Determinations requiring the sanction of the Board.

30C.- (1) This section has effect where a determination requiring the Board's sanction is made for any of the following purposes, that is to say-

(a) the giving of a notice under section 28A(5) or 28B(5) of this Act stating the conclusions of an officer of the Board in relation to any self assessment or partnership statement;

(b) the making of an assessment under section 29 of this Act; or

(c) the giving of a notice under section 30B(1) of this Act amending a partnership statement.

(2) If the notice under section 28A(5), 28B(5) or 30B(1) of this Act or, as the case may be, the notice of the assessment under section 29 of this Act is given to any person without-

(a) the determination, so far as it is taken into account in the notice, having been approved by the Board, or

(b) a copy of the Board's approval having been served on that person at or before the time of the giving of the notice,

the notice under section 28A(5), 28B(5) or 30B(1) or, as the case may be, the assessment under section 29 shall be deemed to have been given or made (and in the case of an assessment notified) in the terms (if any) in which it would have been given or made had that determination not been taken into account.

(3) For the purposes of this section the Board's approval of a determination requiring their sanction-

(a) must be given specifically in relation to the case in question and must apply to the amount determined; but

(b) subject to that, may be given by the Board (either before or after the making of the determination) in any such form or manner as they may determine.

(4) In this section references to a determination requiring the Board's sanction are references (subject to subsection (5) below) to any determination of an amount falling to be brought into account for tax purposes in respect of any assumption made by virtue of paragraph 1(2) of Schedule 28AA to the principal Act (provision not at arm's length).
(5) For the purposes of this section a determination shall be taken, in relation to a notice under section 28A(5), 28B(5) or 30B(1) of this Act or an assessment under section 29 of this Act, not to be a determination requiring the Board's sanction if-

(a) an agreement about the matters to which the determination relates has been made between an officer of the Board and the person in whose case it is made;

(b) that agreement is in force at the time of the giving of the notice or, as the case may be, of any notice of the assessment; and

(c) the matters to which the agreement relates include the amount determined.

(6) For the purposes of subsection (5) above an agreement made between an officer of the Board and any person ("the taxpayer") in relation to any matter shall be taken to be in force at any time if, and only if-

(a) the agreement is one which has been made or confirmed in writing;

(b) that time is after the end of the period of thirty days beginning-

(i) in the case of an agreement made in writing, with the day of the making of the agreement, and

(ii) in any other case, with the day of the agreement's confirmation in writing;

and

(c) the taxpayer has not, before the end of that period of thirty days, served a notice on an officer of the Board stating that he is repudiating or resiling from the agreement.

(7) The references in subsection (6) above to the confirmation in writing of an agreement are references to the service on the taxpayer by an officer of the Board of a notice in writing-

(a) stating that the agreement has been made; and

(b) setting out the terms of the agreement."

(2) In section 31 of that Act (appeals), after subsection (2) there shall be inserted the following subsection-

"(2A) The matters that may be questioned on so much of any appeal as relates to a determination the making of which has been approved by the Board for the purposes of section 30C of this Act shall not include the Board's approval, except to the extent that the grounds for questioning the approval are the same as the grounds for questioning the determination itself."

(3) This section shall have effect-
(a) for the purposes of corporation tax, as respects accounting periods ending on or after the day
appointed under section 199 of the Finance Act 1994 for the purposes of Chapter III of Part IV of that Act (self assessment management provisions); and

(b) for the purposes of income tax, as respects any year of assessment ending on or after that day.

Notice to potential claimants. [j4513]

3.-(1) The following section shall be inserted after the section 30C of the Taxes Management Act 1970 which is inserted by section [j4512] above-

"Notice to potential claimants.

30D.- (1) Where-

(a) a relevant notice is given to any person,

(b) that notice takes account of a determination requiring the Board's sanction, and

(c) it appears to an officer of the Board that there is a person who is or may be a disadvantaged person by reference to the subject-matter of that determination,

the officer shall give a notice under this section to the person who so appears to him.

(2) A notice under this section is a notice containing particulars of the determination by reference to which the person to whom the notice is given appears to an officer of the Board to be a person who is or may be a disadvantaged person.

(3) Where, in any case, there is a contravention of subsection (1) above or the notice required by that subsection is given after the giving of the relevant notice, the Board-

(a) shall consider whether, as a result of the contravention, any person has been prejudiced with respect to the making or amendment of a claim for the purposes of paragraph 4 of Schedule 28AA to the principal Act (claim for relief by party disadvantaged by transfer pricing adjustment), and

(b) may, if they think fit, treat the period for the making or amendment of such a claim in that case as extended by such further period as appears to them to be appropriate.

(4) Where, in a case in which a relevant notice is given to any person, there is a contravention of this section, that contravention shall not affect the validity of that notice or of any determination to which that notice relates.

(5) For the purposes of this section a person is a disadvantaged person by reference to the subject-matter of a determination requiring the Board's sanction if, and only if-

(a) he is entitled, in consequence of the making of the determination, to make a claim for the purposes of paragraph 4 of Schedule 28AA to the principal Act;
(b) he is entitled, in consequence of the making of the determination, to amend such a claim; or

(c) he will be entitled, by virtue of paragraph 10(3) of that Schedule, to appear and be heard by the Special Commissioners in any proceedings on an appeal relating to that determination.

(6) In this section "relevant notice" means any of the following, that is to say-

(a) a notice under section 28A(5) or 28B(5) of this Act stating the conclusions of an officer of the Board in relation to any self assessment or partnership statement;

(b) a notice of assessment under section 29 of this Act;

(c) a notice under section 30B(1) of this Act amending a partnership statement.

(7) Subsections (4) to (7) of section 30C of this Act apply for the purposes of this section as they apply for the purposes of that section.”

(2) This section applies to notices given at any time after the day appointed under section 199 of the Finance Act 1994 for the purposes of Chapter III of Part IV of that Act (self assessment management provisions).

SCHEDULE [j4511]

TRANSFER PRICING, ETC.: NEW REGIME [j4511]

Schedule to be inserted as Schedule 28AA to the Taxes Act 1988

"SCHEDULE 28AA

PROVISION NOT AT ARM'S LENGTH

Basic rule on transfer pricing etc.

1.- (1) This Schedule applies where-

(a) provision ("the actual provision") has been made or imposed as between any two persons ("the affected persons") by means of a transaction or series of transactions, and

(b) at the time of the making or imposition of the actual provision-

(i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other; or

(ii) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons.
(2) Subject to paragraphs 6, 8 and 11 below, if the actual provision-

(a) differs from the provision ("the arm's length provision") which would have been made as
between independent enterprises, and

(b) confers a potential advantage in relation to United Kingdom taxation on one of the affected
persons, or (whether or not the same advantage) on each of them,

the income, profits and losses of the potentially advantaged person or, as the case may be, of each of the
potentially advantaged persons shall be computed for tax purposes as if the arm's length provision had been
made or imposed instead of the actual provision.

(3) This Schedule shall be construed (subject to paragraphs 6 to 9 below) in such manner as best secures
consistency between-

(a) the effect given to sub-paragraphs (1) and (2) above; and

(b) the effect which, in accordance with the transfer pricing guidelines, is to be given in cases
where double taxation arrangements incorporate the whole or any part of the OECD
model to so much of the arrangements as does so.

(4) In sub-paragraph (3) above-

"the OECD model" means-

(a) the rules which, at the passing of this Act, were contained in Article 9 of the Model Tax
Convention on Income and on Capital published by the Organisation for
Economic Co-operation and Development; or

(b) any rules in the same or equivalent terms; and

"the transfer pricing guidelines" means-

(a) all the documents published by that Organisation, at any time before 1st May 1998, as part
of their Transfer Pricing Guidelines for Multinational Enterprises and Tax
Administrations; and

(b) such documents published by that Organisation on or after that date as may for the purposes
of this Schedule be designated, by an order made by the Treasury, as
comprised in the transfer pricing guidelines.

Participation in the management, control or capital of a person

2.- (1) For the purposes of this Schedule a person is directly participating in the management, control or
capital of another person at a particular time if, and only if, that other person is at that time-

(a) a company or a partnership; and
(b) controlled by the first person.

(2) For the purposes of this Schedule a person ("the potential participant") is indirectly participating in the management, control or capital of another person at a particular time if, and only if-

(a) he would be taken to be directly so participating at that time if the rights and powers attributed to him included all the rights and powers mentioned in sub-paragraph (3) below that are not already attributed to him for the purposes of sub-paragraph (1) above; or

(b) he is, at that time, one of a number of major participants in that other person's enterprise.

(3) The rights and powers referred to in sub-paragraph (2)(a) above are-

(a) rights and powers which the potential participant is entitled to acquire at a future date or which he will, at a future date, become entitled to acquire;

(b) rights and powers of persons other than the potential participant to the extent that they are required, or may be required, to be exercised in any one or more of the following ways, that is to say-

(i) on behalf of the potential participant;

(ii) under the direction of the potential participant; or

(iii) for the benefit of the potential participant;

(c) rights and powers of any person with whom the potential participant is connected; and

(d) rights and powers which for the purposes of sub-paragraph (2)(a) above would be attributed to a person with whom the potential participant is connected if that connected person were himself the potential participant.

(4) In sub-paragraph (3)(b) to (d) above, the references to a person's rights and powers include references to any rights or powers which he either-

(a) is entitled to acquire at a future date, or

(b) will, at a future date, become entitled to acquire.

(5) In paragraph (d) of sub-paragraph (3) above, the reference to rights and powers which would be attributed to a connected person if he were the potential participant includes a reference to rights and powers which, by applying that paragraph wherever one person is connected with another, would be so attributed to him through a number of persons each of whom is connected with at least one of the others.

(6) For the purposes of this paragraph a person ("the potential major participant") is a major participant in another person's enterprise at a particular time if at that time-

(a) that other person ("the subordinate") is a company; and
(b) the 40 per cent. test is satisfied in the case of each of two persons who, taken together, control
the subordinate and of whom one is the potential major participant.

(7) For the purposes of this paragraph the 40 per cent. test is satisfied in the case of each of two persons
wherever each of them has interests, rights and powers representing at least 40 per cent. of all the interests,
rights and powers which, in relation to any one of the qualifying conditions, are taken into account in
determining that that condition is satisfied in the case of the pair of them.

(8) In sub-paragraph (7) above "qualifying condition", in relation to pair of persons, means a condition
which is satisfied in their case and the satisfaction of which requires the two of them, taken together, to be
regarded as controlling the subordinate.

(9) For the purposes of this paragraph-

(a) the question whether a person is controlled by any two or more persons taken together, and

(b) any question whether the 40 per cent. test is satisfied in the case of a person who is one of two
persons,

shall be determined after attributing to each of the persons all the rights and powers attributed to a potential
participant for the purposes of sub-paragraph (2)(a) above.

(10) References in this paragraph-

(a) to rights and powers of a person, or

(b) to rights and powers which a person is or will become entitled to acquire,

include references to rights or powers which are exercisable by that person, or (when acquired by that
person) will be exercisable, only jointly with one or more other persons.

(11) In this paragraph, references to a person's being connected with another shall be construed in
accordance with section 839, but as if-

(a) in subsection (3)(a) (individual settlor to be taken to be connected with trustees), for
"individual" there were substituted "person";

(b) the word "and" were inserted at the end of subsection (3)(a);

(c) in subsection (3)(b) (person connected with a settlor to be taken to be connected with trustees),
for "an individual" there were substituted "a person"; and

(d) the following were omitted, that is to say-

(i) paragraph (c) of subsection (3),

(ii) subsection (3A),
(iii) in subsection (4), the words from "Except" to "arrangements", and
(iv) subsections (5) to (7).

Advantage in relation to United Kingdom taxation

3.- (1) For the purposes of this Schedule (but subject to sub-paragraph (2) below) the actual provision confers a potential advantage on a person in relation to United Kingdom taxation wherever, disregarding this Schedule, the effect of making or imposing the actual provision, instead of the arm's length provision, would be one or both of the following, that is to say-

(a) that a smaller amount (which may be nil) would be taken for tax purposes to be the amount of that person's income or profits for any chargeable period; or

(b) that a larger amount (or, if there would not otherwise have been losses, any amount of more than nil) would be taken for tax purposes to be the amount for any chargeable period of any losses of that person.

(2) Subject to paragraph 9(2) below, the actual provision shall not be taken for the purposes of this Schedule to confer a potential advantage in relation to United Kingdom taxation on either of the persons as between whom it is made or imposed if the three conditions set out in sub-paragraphs (3) to (5) below are all satisfied in the case of each of those two persons.

(3) The first condition is satisfied in the case of any person if-

(a) he is within the charge to income tax or corporation tax in respect of all income or profits arising from the relevant activities; and

(b) where he is so within the charge to income tax, he is resident in the United Kingdom in the chargeable periods in which he is so within that charge.

(4) The second condition is satisfied in the case of any person if he is neither-

(a) a person with an entitlement, in pursuance of any double taxation arrangements or under section 790(1), to be given credit in any chargeable period for any foreign tax on or in respect of income or profits arising from the relevant activities; nor

(b) a person who would have such an entitlement in any such period if there were any such income or profits or they exceeded a certain amount.

(5) The third condition is satisfied in the case of any person if the amounts taken into account in computing the income, profits or losses arising from the relevant activities to that person in any chargeable period in which he is within the charge to income tax or corporation tax in respect of income or profits arising from those activities do not include any income the amount of which is reduced in accordance with section 811(1) (deduction for foreign tax where no credit allowable).
Elimination of double counting

4.- (1) This paragraph applies where-

(a) only one of the affected persons ("the advantaged person") is a person on whom a potential advantage in relation to United Kingdom taxation is conferred by the actual provision; but

(b) the other affected person ("the disadvantaged person") is a person in relation to whom the condition set out in paragraph 3(3) above is satisfied.

(2) Subject to sub-paragraphs (3) to (7) and paragraph 5 below, on the making of a claim by the disadvantaged person for the purposes of this paragraph-

(a) the disadvantaged person shall be entitled to have his income, profits and losses computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision; and

(b) notwithstanding any limit in the Tax Acts on the time within which any adjustment may be made, all such adjustments shall be made in his case as may be required to give effect to the assumption that the arm's length provision was made or imposed instead of the actual provision.

(3) A claim made by the disadvantaged person for the purposes of this paragraph-

(a) shall not be made unless a computation has been made in the case of the advantaged person on the basis that the arm's length provision was made or imposed instead of the actual provision; and

(b) must be consistent with the computation made on that basis in the case of the advantaged person.

(4) For the purposes of sub-paragraph (3) above a computation shall be taken to have been made in the case of the advantaged person on the basis that the arm's length provision was made or imposed instead of the actual provision if, and only if-

(a) the computations made for the purposes of any return by the advantaged person have been made on that basis by virtue of this Schedule; or

(b) a relevant notice given to the advantaged person takes account of a determination in pursuance of this Schedule of an amount falling to be brought into account for tax purposes on that basis.

(5) Subject to section 30D(3)(b) of the Management Act (which provides for the extension of the period for making a claim), a claim for the purposes of this paragraph shall not be made except within one of the following periods-
(a) in a case where a return has been made by the advantaged person on the basis mentioned in sub-
paragraph (3)(a) above, the period beginning with the making of the return and
ending two years after the latest time for an enquiry into that return; and

(b) in any case where a relevant notice taking account of such a determination as is mentioned in
sub-paragraph (4)(b) above has been given to the advantaged person, the period of
two years beginning with the day on which that notice was given.

(6) In sub-paragraph (5) above, the reference to the latest time for an enquiry into a return is a reference to
the end of the period within which an officer of the Board is entitled to give notice under section 9A, 11AB
or 12AC of the Management Act of his intention to enquire into that return.

(7) Subject to section 30D(3)(b) of the Management Act, where-

(a) a claim for the purposes of this paragraph is made by the disadvantaged person in relation to a
return made on the basis mentioned in sub-paragraph (3)(a) above, and

(b) a relevant notice taking account of such a determination as is mentioned in sub-paragraph (4)(b)
above is subsequently given to the advantaged person,

the disadvantaged person shall be entitled, within the period mentioned in sub-paragraph (5)(b) above, to
make any such amendment of the claim as may be appropriate in consequence of the determination contained
in that notice.

(8) In this paragraph-

"relevant notice" means-

(a) a notice under section 28A(5) or 28B(5) of the Management Act stating the conclusions of
an officer of the Board in relation to any self assessment or partnership
statement;

(b) a notice of an assessment under section 29 of that Act; or

(c) a notice under section 30B(1) of that Act amending a partnership statement;

"return" means any return required to be made under the Management Act for income tax or
corporation tax purposes or any voluntary amendment of such a return; and

"voluntary amendment", in relation to a return, means any amendment in accordance with the
Management Act, other than one made in response to the giving of a relevant notice.

Adjustment of disadvantaged person's double taxation relief

5.- (1) Subject to sub-paragraph (4) below, where-

(a) a claim is made for the purposes of paragraph 4 above, and
(b) the disadvantaged person is entitled, on that claim, to make a computation, or to have an adjustment made in his case, on the basis that the arm's length provision was made or imposed instead of the actual provision,

the assumptions specified in sub-paragraph (2) below shall apply, in the disadvantaged person's case, as respects any credit for foreign tax which the disadvantaged person has been or may be given in pursuance of any double taxation arrangements or under section 790(1).

(2) Those assumptions are-

(a) that the foreign tax paid or payable by the disadvantaged person does not include any amount of foreign tax which would not be or have become payable were it to be assumed for the purposes of that tax that the arm's length provision had been made or imposed instead of the actual provision; and

(b) that the amount of the relevant income or profits of the disadvantaged person in respect of which he is given credit for foreign tax does not include the amount (if any) by which his relevant income or profits are treated as reduced in accordance with paragraph 4 above.

(3) Sub-paragraph (4) below applies if-

(a) a claim is made for the purposes of paragraph 4 above;

(b) the disadvantaged person is entitled, on that claim, to make a computation, or to have an adjustment made in his case, on the basis that the arm's length provision was made or imposed instead of the actual provision;

(c) the application of that basis in the computation of the disadvantaged person's income, profits or losses for any chargeable period involves a reduction in the amount of any income; and

(d) that income is also income that falls to be treated as reduced in accordance with section 811(1).

(4) Where this sub-paragraph applies-

(a) the reduction mentioned in sub-paragraph (3)(c) above shall be treated as made before any reduction under section 811(1); and

(b) tax paid, in the place in which any income arises, on so much of that income as is represented by the amount of the reduction mentioned in sub-paragraph (3)(c) above shall be disregarded for the purposes of section 811(1).

(5) Where in a case in which a claim has been made for the purposes of paragraph 4 above, any adjustment is required to be made for the purpose of giving effect to any of the preceding provisions of this paragraph-

(a) it may be made in any case by setting the amount of the adjustment against any relief or repayment to which the disadvantaged person is entitled in pursuance of that claim; and
(b) nothing in the Tax Acts limiting the time within which any assessment is to be or may be made or amended shall prevent that adjustment from being so made.

(6) References in this paragraph to relevant income or profits of the disadvantaged person are references to income or profits arising to the disadvantaged person from the carrying on of the relevant activities.

**Foreign exchange gains and losses and financial instruments**

6.-(1) Subject to sub-paragraph (2) below, this Schedule shall not require the amounts brought into account in any person's case under-

(a) Chapter II of Part II of the Finance Act 1993 (foreign exchange gains and losses), or

(b) Chapter II of Part IV of the Finance Act 1994 (financial instruments),

to be computed in that person's case on the assumption that the arm's length provision had been made or imposed instead of the actual provision.

(2) Sub-paragraph (1) above-

(a) shall not affect so much of sections 136 and 136A of the Finance Act 1993 (application of arm's length test) as has effect by reference to whether the whole or any part of a loan falls to be treated in accordance with this Schedule as an amount on which interest has been charged or, as the case may be, has been charged at a higher rate; and

(b) accordingly, shall not prevent the assumption mentioned in that sub-paragraph from determining for the purposes of sections 136(8) and (9) and 136A(6) and (7) of that Act how much (if any) of any loan falls to be so treated.

**Special rules for sales etc. of oil**

7.-(1) Subject to paragraph 8 below, this paragraph applies to provision made or imposed by or in relation to the terms of a sale of oil if-

(a) the oil sold is oil which has been or is to be extracted under rights exercisable by a company ("the producer") which (although it may be the seller) is not the buyer; and

(b) at the time of the sale not less than 20 per cent. of the producer's ordinary share capital is owned directly or indirectly by one or more of the following, that is to say, the buyer and the companies (if any) that are linked to the buyer.

(2) Where this paragraph applies to provision made or imposed by or in relation to the terms of a sale of oil, this Schedule shall have effect as respects that provision as if the buyer, the seller and (if it is not the seller) the producer were all controlled by the same person at the time of the making or imposition of that provision.
(3) For the purposes of this paragraph two companies are linked if-

   (a) one is under the control of the other; or

   (b) both are under the control of the same person or persons.

(4) For the purposes of this paragraph-

   (a) any question whether ordinary share capital is owned directly or indirectly by a company shall be determined as for section 838;

   (b) rights to extract oil shall be taken to be exercisable by a company even if they are exercisable by that company only jointly with one or more other companies; and

   (c) a sale of oil shall be deemed to take place at the time of the completion of the sale or when possession of the oil passes, whichever is the earlier.

(5) In this paragraph, "oil" includes any mineral oil or relative hydrocarbon, as well as natural gas.
Disposals of oil to which section 493 applies

8. This Schedule does not apply in relation to provision made or imposed by means of a transaction in relation to which section 493(1) or (3) (disposals of oil treated as made at market value) applies.

Special provision for companies carrying on ring-fenced trades

9.- (1) This paragraph applies where any person ("the taxpayer") carries on as, or as part of, a trade any activities ("the ring-fenced trade") which, in accordance with section 492(1) either-

(a) fall to be treated for any tax purposes as a separate trade, distinct from all other activities carried on by him as part of the trade; or

(b) would so fall if the taxpayer did carry on any other activities as part of that trade.

(2) Subject to paragraph 8 above, where provision made or imposed as between the taxpayer and another person by means of a transaction or series of transactions-

(a) falls, in relation to the taxpayer, to be regarded as made or imposed in the course of, or with respect to, the ring-fenced trade; but

(b) falls, in relation to the other person, to be regarded as made or imposed in the course of, or with respect to, activities of that other person which do not fall within section 492(1),

this Schedule shall have effect in relation to that provision with the omission of paragraph 3(2) above.

(3) Subject to paragraph 8 above, this Schedule shall have effect as respects any provision made or imposed by the taxpayer as between the ring-fenced trade and any other activities carried on by him as if-

(a) that trade and those activities were carried on by two different persons;

(b) that provision were made or imposed as between those two persons by means of a transaction;

(c) a potential advantage in relation to United Kingdom taxation were conferred by that provision on each of those two persons;

(d) those two persons were both controlled by the same person at the time of the making or imposition of that provision; and

(e) paragraphs 3 to 5 above were omitted.

Appeals

10.- (1) Any appeal under section 31 of, or Schedule 1A to, the Management Act which involves any question as to whether or to what extent this Schedule has effect as respects any provision made or imposed as between any two persons shall be to the Special Commissioners.
(2) Sub-paragraph (3) below applies where-

(a) any such question as is mentioned in sub-paragraph (1) above falls to be determined by the Special Commissioners for the purposes of any proceedings before them; and

(b) that question relates to any provision made or imposed as between two persons each of whom is a person in relation to whom the condition set out in paragraph 3(3) above is satisfied.

(3) Where this sub-paragraph applies-

(a) each of the persons as between whom the actual provision was made or imposed shall be entitled to appear and be heard by the Special Commissioners, or to make representations to them in writing;

(b) the Special Commissioners shall determine that question separately from any other questions in those proceedings; and

(c) their determination on that question shall have effect as if made in an appeal to which each of those persons was a party.

Saving for the provisions relating to capital allowances and capital gains

11. Nothing in this Schedule shall be construed as affecting-

(a) the computation of the amount of any capital allowance or balancing charge made under the 1990 Act; or

(b) the computation in accordance with the 1992 Act of the amount of any chargeable gain or allowable loss.

General interpretation etc.

12.- (1) In this Schedule-

"the actual provision" and "the affected persons" shall be construed in accordance with paragraph 1(1) above;

"the arm's length provision" shall be construed in accordance with paragraph 1(2) above and sub-paragraph (6) below;

"double taxation arrangements" means arrangements having effect by virtue of section 788;

"foreign tax" means any tax under the law of a territory outside the United Kingdom or any amount which falls for the purposes of any double taxation arrangements to be treated as if it were such tax;
"losses" includes amounts in respect of which relief may be given in accordance with any of the following enactments-

(a) section 75(3) (excess of management expenses);

(b) section 468L(5) (allowance for interest distributions of a unit trust);

(c) Part X (loss relief and group relief);

(d) section 83 of and Schedule 8 to the Finance Act 1996 or paragraph 4 of Schedule 11 to that Act (deficits on loan relationships);

"the relevant activities", in relation to a person who is one of the persons as between whom any provision is made or imposed, means any of the activities of his in the course of which, or with respect to which, that provision is made or imposed; and

"transaction" includes arrangements, understandings and mutual practices (whether or not they are, or are intended to be, legally enforceable).

(2) Without prejudice to paragraphs 7(2) and 9(3) above, references in this Schedule to a person controlling another person shall be construed-

(a) where the other person is a company, in accordance with section 416; and

(b) where the other person is a partnership, in accordance with section 840.

(3) References in this Schedule to a series of transactions include references to a number of transactions each entered into (whether or not one after the other) in pursuance of, or in relation to, the same arrangement.

(4) A series of transactions shall not be prevented by reason only of one or more of the matters mentioned in sub-paragraph (5) below from being regarded as a series of transactions by means of which provision has been made or imposed as between any two persons.

(5) Those matters are-

(a) that there is no transaction in the series to which both those persons are parties;

(b) that the parties to any arrangement in pursuance of which the transactions in the series are entered into do not include one or both of those persons; and

(c) that there is one or more transactions in the series to which neither of those persons is a party.

(6) For the purposes of this Schedule the cases in which provision made or imposed as between any two persons is to be taken to differ from the provision that would have been made as between independent enterprises shall include the case in which provision is made or imposed as between any two persons but no provision would have been made as between independent enterprises; and references in this Schedule to the arm's length provision shall be construed accordingly.
(7) In determining for the purposes of this Schedule whether a person has an entitlement, in pursuance of any double taxation arrangements or under section 790(1), to be given credit for foreign tax, any requirement that a claim is made before such a credit is given shall be disregarded.

(8) Any adjustments required to be made by virtue of this Schedule may be made by way of discharge or repayment of tax, by the modification of any assessment or otherwise.

(9) This Schedule shall have effect as if-

(a) a unit trust scheme were a company;

(b) the rights of the unit holders under such a scheme were shares in the company that the scheme is deemed to be;

(c) rights and powers of a person in the capacity of a person entitled to act for the purposes of the scheme were rights and powers of the scheme; and

(d) provision made or imposed as between any person in such a capacity and another person were made or imposed as between the scheme and that other person.

(10) In this paragraph, "arrangement" means any scheme or arrangement of any kind, whether or not it is, or is intended to be, legally enforceable."

SCHEDULE {J994}

REPEALS

PART {J451}

TRANSFER PRICING, ETC.

1970 c. 9 The Taxes Management Act 1970. In the Table in section 98-

(a) in the first column, the entry relating to section 772(1) and (3) of the Taxes Act 1988; and

(b) in the second column, the entry relating to section 772(6) of that Act.


These repeals have effect in accordance with section {j451}(5) of this Act.
APPENDIX II

DOCUMENTATION REQUIREMENT

DRAFT GUIDANCE ON THE APPLICATION OF SECTION 12B, TMA 1970 FOR TRANSFER PRICING PURPOSES

1. The new transfer pricing legislation (Schedule 28AA, ICTA 1988) requires taxpayers to apply the arm’s length principle in determining intra-group transfer prices within the scope of the provisions underlying the income, profits or losses reported in their tax returns.

2. Section 12B TMA requires taxpayers to keep and preserve the records needed to make and deliver a correct and complete return for any chargeable period.

3. This guidance note explains the Inland Revenue’s approach to construing this record-keeping requirement for the purposes of the transfer pricing legislation. It sets out the sorts of documents which the Inland Revenue expects taxpayers to prepare and retain for tax purposes. It also gives details of those records which should be retained if (but only if) taxpayers prepare them for their own commercial reasons. And it gives an indication of the records which taxpayers are not expected to prepare or retain.

Documents which taxpayers are expected to prepare and retain

4. The Inland Revenue expects documentation in relation to a taxpayer’s transfer pricing arrangements to be created or referred to and retained in accordance with the same prudent business management principles which would govern the process of evaluating a business decision of a similar level of complexity and importance. These records should show a taxpayer’s efforts to comply with the arm’s length principle and should include the information on which any transfer prices were based, a record of the factors taken into account and details of the method selected.

5. For each period, such records will normally be expected to include:

- a record of the taxpayer’s relevant transactions and the extent of any other commercial or financial relations with associated enterprises within the scope of the legislation;

- a record of the nature and terms of any transactions with associated enterprises within the scope of the legislation, and where the terms of any transaction change during the period, a record of the renegotiation of those terms and the circumstances giving rise to the change;

- all commercial agreements entered into by the taxpayer, whether with associated enterprises within the scope of the legislation or with independent third parties, including:
  - distribution agreements
  - manufacture or supply agreements
  - service contracts
  - agreements relating to research and development
  - loan or other financial agreements
• licence agreements
• cost-sharing agreements,

and any documents relating to the negotiation of the terms of these agreements;

• all investment appraisals undertaken by the taxpayer in relation to an investment in or involving associated enterprises within the scope of the legislation;

• in relation to transactions or series of transactions involving associated enterprises within the scope of the legislation, a record of the information which the taxpayer considered in evaluating its transfer pricing arrangements under the arm’s length principle, including a record of the factors taken into account and of the decision-making process;

• in relation to transactions or series of transactions involving associated enterprises within the scope of the legislation, a record of the transfer pricing method selected and why it was considered it would produce arm’s length pricing; where the application of the transfer pricing method selected relies on comparability data (prices, margins etc.) any such data used by the taxpayer in the application of the method should also be retained;

• a record of any price negotiations with associated enterprises within the scope of the legislation;

• a record of any offsetting transactions taken into account in determining the pricing for any transactions or series of transactions involving associated enterprises within the scope of the legislation;

• a record of the nature, terms and pricing relating to any uncontrolled transactions or series of transactions in which the taxpayer was involved, and which are relevant for determining the arm’s length price for any comparable transactions or series of transactions involving the taxpayer and an associated enterprise within the scope of the legislation;

• a record of any business or management or pricing strategy adopted by the taxpayer and the reasons for adopting it;

• a record of any budgets or forecasts prepared; where budgets or forecasts are prepared by reference not only to the taxpayer’s business as a whole, but also to each separate business, trade or division and/or to each product or product line, these should also be retained by the taxpayer;

• a record of any financial information including profit and loss information prepared; where financial information was prepared by reference not only to a taxpayer’s business as a whole but also to each separate business, trade or division and/or to each product or product line, this should also be retained by the taxpayer.

6. The Inland Revenue considers that most of the records listed above would be prepared by most taxpayers in accordance with the principles of prudent business management without reference to tax considerations. It may, however, be necessary for taxpayers to prepare or refer to documents of the kind listed above which would not have been prepared or referred to in the absence of tax considerations. Taxpayers are only expected to prepare or retain such records if they are indispensable for a reasonable assessment of whether the taxpayer’s transfer pricing arrangements reflected in its tax returns satisfy the
arm’s length principle and can be prepared or retained by the taxpayer without a disproportionately high cost being incurred.

7. Many of the records listed above will be prepared by a taxpayer every year. In some cases, however, taxpayers may not judge it necessary to prepare a new record every year - for example in relation to the transfer pricing method selected and the reasons for selecting it. Where there has been no material change in the relevant circumstances, the Inland Revenue accepts that records prepared in a previous accounting period, which are relevant to the transfer pricing arrangements adopted in the accounting period under review, may satisfy the record keeping requirement.

Documents which taxpayers should retain if they prepare or obtain them

8. Some taxpayers undertake considerable in-depth analysis in developing and implementing an overall group-wide transfer pricing policy, perhaps for other commercial reasons. Where such analysis is undertaken, any documents, reports or other records produced or obtained should be retained by the taxpayer.

9. Such records might include the following:

- a formal written statement of the taxpayer’s transfer pricing policy;
- a pricing appraisal or other report giving consideration to the basis on which a taxpayer’s transfer prices should be set and the factors to be taken into account;
- a comparability analysis, whether by reference to individual transactions or series of transactions;
- a functional analysis.

10. The Inland Revenue does not expect a taxpayer routinely to prepare such documents, reports or other records solely for UK tax purposes. However, it may be necessary for taxpayers to undertake some analysis of this kind during the course of any transfer pricing enquiry.

Documents which taxpayers are not expected to prepare or retain

11. The Inland Revenue will not expect taxpayers to:

- determine which, of a number of appropriate options, is the ‘best’ transfer pricing method;
- consider comparable data (prices, margins, etc.) from any uncontrolled transactions or series of transactions to which the taxpayer or an associated enterprise was not a party, unless such data is available to them.

12. The Inland Revenue will not expect taxpayers to prepare any documents in relation to such considerations.
APPENDIX III

OECD MODEL TAX CONVENTION

ARTICLE 9

1. Where

a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.
APPENDIX IV

REVISED TEXT OF IM4661 (DRAFT)

Submissions to Head Office

International Division 5 is available to give advice on transfer pricing matters at any time. The Division has access to background material (for example, information about particular industries or groups, or about interest rates) which officers may find helpful.

In addition, the file and a brief report should be sent to International Division 5 if:

a. [ ] years have elapsed since the commencement of a transfer pricing enquiry;

b. it is proposed to seek a penalty under section 12B(5), section 95, section 95A or section 96 TMA in the course of a transfer pricing enquiry;

c. the taxpayer appeals against a section 19A TMA notice in connection with a transfer pricing enquiry;

d. it is intended to seek the consent of a Commissioner to the issue of a notice under the provisions of sections 20-20C TMA;

e. it is thought that information or assistance may be obtained from a treaty partner using the exchange of information Article in the relevant Double Taxation Agreement;

f. the case involves a point of principle or interpretation of the legislation;

g. the case involves a point of principle or interpretation of the associated enterprises Article of a Double Taxation Agreement or the OECD Transfer Pricing Guidelines;

h. the taxpayer argues that the provision of funding (inward or outward) was not made by means of a series of transactions or there is disagreement about what the amounts or terms (including interest rates) would have been at arms length;

i. a proposed settlement includes an undertaking or agreement affecting pricing arrangements for future years;

j. a taxpayer requests an Advance Pricing Arrangement in respect of transactions with overseas affiliates;

k. the taxpayer advises that any transfer pricing adjustment in the UK is likely to give rise to a corresponding adjustment claim on the part of an affiliate;

l. the taxpayer claims a corresponding adjustment in respect of a transfer pricing adjustment made by a treaty partner;
m. it is thought that a deduction representing a transfer pricing adjustment made by another fisc may have been included in the accounts;

n. the taxpayer claims relief under paragraph 4 of Schedule 28AA ICTA.