Growing globalisation

How does a growing entrepreneurial business comply with the transfer pricing rules? ANDREW COUSINS considers the principles and implications.

We live in a world of increasing globalisation. And as businesses expand beyond national boundaries they are likely to fall, sooner or later, within the compliance net of the transfer pricing regulations in the countries where they operate. But several questions need to be considered. At what stage does transfer pricing become a matter of concern for a growing business? In what way should it approach intra-group pricing and address its compliance requirements? How can certainty be obtained from tax administrations over the acceptability of the pricing? What kind of documentation should be kept? This article seeks to address the transfer pricing issues encountered by the growing entrepreneurial business as it makes its first forays overseas.

Applying the transfer pricing rules

For most small and medium-sized enterprises (SMEs) in the UK, transfer pricing is unlikely to be an issue demanding attention. In theory, transfer pricing starts to be a consideration for a business as soon as it is of a size to have more than one legal entity in the group and transactions begin between the related entities. However, in practice, when those transactions take place within the borders of a single territory, tax is, subject to certain conditions, unlikely to be at stake. But as soon as cross-border transactions take place between related entities in a multinational group (or a branch is formed overseas),

KEY POINTS

- Eventually, expanding businesses will fall within the transfer pricing regime.
- The size at which a group becomes subject to transfer pricing regulations varies between countries.
- Transfer pricing compliance requires adherence to the arm's length principle.
- OECD Guidelines allow flexibility to identify the most appropriate transfer price.
- The base erosion and profit shifting project has led to a three-tiered global standard of transfer pricing documentation.

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differentials in tax rates between jurisdictions mean that the pricing of intra-group transfers can affect the allocation of taxable income among the entities and have an impact on the effective tax rate of the group.

In the EU, it is estimated that only about 5% of SMEs have associated entities creating a situation where transfer pricing comes into play. But, as businesses grow and expand their operations overseas, intra-group trade is likely to grow and transfer pricing becomes a more significant issue. The size at which a group becomes subject to transfer pricing regulations varies from one country to another and it will be necessary to be aware of the individual threshold and transfer pricing requirements in the countries where operations take place. Advice should therefore be taken on the applicable transfer pricing rules relating to any country into which operations are expanded. The breadth and depth of information provided to assist SMEs to comply with these rules varies considerably between tax administrations.

In the UK, notwithstanding any cross-border intra-group activity, SMEs are exempt from transfer pricing rules for most transactions. The exceptions where the growing entrepreneurial business may find itself subject to the transfer pricing rules in the UK are as follows.

- Transactions with related entities located in jurisdictions with which the UK does not have a double tax agreement including an appropriate non-discrimination article.
- Where HMRC has issued a transfer pricing notice to a medium-sized enterprise.
- Where a business elects that the exemption from the transfer pricing rules should not apply.
- Where HMRC has issued a transfer pricing notice to an SME that is party to a transaction relevant to a patent box claim.

From a UK perspective, a group will be treated as a large business and therefore subject to transfer pricing regulations if it exceeds a staff headcount of 250 and one (or both) of:

- an annual turnover of €50m; and
- a balance sheet total of €43m.

The arm's length principle

Once a group is considered large, it will need to be fully compliant with transfer pricing statute in the UK, requiring adherence to the arm's length principle, as explained in TIOPA 2010, Pt 4, consistent with the definitive articulation of the concept set out in Art 9 of the OECD Model Tax Convention and its development in the commentary and in the OECD's *Transfer Pricing Guidelines for Multinational Companies and Tax Administrations* (the OECD Guidelines at tinyurl.com/7vz7jmm). The arm's length principle effectively requires that pricing between related parties of a group should not differ from the pricing that would be found between independent enterprises engaged in comparable transactions.

Other countries may stipulate different thresholds from the UK in the application of their transfer pricing legislation, not necessarily providing exemption to SMEs from all transfer pricing regulations. In this case it will be necessary, when embarking on any overseas expansion, to review the transfer pricing legislation of the overseas territory entered to ensure compliance. In France, for example, SMEs are expected to adhere to the arm's length principle and may be required in the course of a tax examination to provide information on their transfer pricing policy. However, there are simplified procedures to agree prices with the tax administration in advance.

Creating a transfer pricing policy

Although UK transfer pricing rules apply to transactions where both related party entities are UK resident, as well as to cross-border intra-group transactions, the situations where UK/UK transfer pricing is likely to be of concern are limited, primarily to cases where the results of the entities cannot be consolidated for tax purposes.

In practice, the first time that a group will need to put in place a formal transfer pricing policy is when it starts any kind of cross-border activities as it expands its business internationally. In a growing entrepreneurial business, where little specialist resource is perhaps devoted to tax and even less to transfer pricing, considerations on the latter are likely to be subsumed to commercial interests.

Although the arm's length principle applies to all multinational enterprises exceeding the qualifying criteria, the amounts involved at this initial stage may be considered too minor and the available resource too limited for many groups to devote serious attention to the creation of an appropriate transfer pricing policy. A higher degree of difficulty is to be anticipated for the smaller group in developing and implementing such a policy as a consequence of its lack of specialist in-house transfer pricing resource and budget.

Nonetheless, as the business grows beyond its original jurisdiction, serious thought should be given to developing and implementing a transfer pricing policy from the outset. Ideally, this should be designed, implemented and documented early in the development of any overseas expansion to ensure its consistency with the business model and commercial objectives. To this end it should continue to be tracked over time (although the initial entry into a market may require a temporary policy and this will certainly need to be recorded as such at the time). Addressing a policy in the early stages of business expansion has the further benefit of allowing consideration to be given to the tax effectiveness of the pricing.

A transfer pricing policy that is soundly developed and consistently applied will go a long way to help minimise the group's risk of transfer pricing adjustments and the potential for double taxation. As well as contributing to the profitability of a group by limiting its transfer pricing risk exposure, a global policy will help groups to meet their documentation requirements and serves as important evidence in negotiations with tax authorities when transfer pricing disputes occur.

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Setting the transfer price

The design of a transfer pricing policy need not be over-complicated, but it should be sufficient for the demands of the business. As a first step, it will be necessary, when developing the policy, to obtain all the relevant details of the specific intra-group transaction or transactions to which it will apply. The information that is relevant to a proper understanding of the transactions will be concerned with the functions, assets (whether tangible or intangible) and risks associated with the transactions and their allocation between the parties to them.

The performance of the functional analysis represents the next stage. First, identify which party is responsible for which function. For example, at the highest level, the manufacturing function or the sales and distribution function, the provision of services such as research and development (R&D), procurement, legal or marketing, strategic leadership etc. It is necessary also to identify which party bears material risks for the transactions under examination and the assets they contribute, say in the form of plant and machinery or intangible property such as trademarks or patented technology.

Based on this analysis, the nature and contribution of the parties can be used to classify each of them into a kind of business; for example, a contract manufacturer, a sales agent, a full risk distributor. From this, a comparison may be made to independent companies that are party to similar transactions operating free from related-party constraints in the open market.

It will then be necessary to identify the best transfer pricing method to be used to set an appropriate price for the intra-

group transaction. Given the difficulty of identifying an exact independent third-party equivalent for the majority of related-party transactions, the renamed OECD Guidelines, which serve as a widely accepted bible of transfer pricing guidance, describe a number of different approaches to allow flexibility in identifying the most appropriate transfer price to the circumstances of the case. Most jurisdictions (though not all) follow this guidance or a similar approach, but reference should always be made to local legislation and practice to ensure that the methodology employed is recognised in that jurisdiction.

> *“In today’s environment there is an increasing level of detail required to meet each country’s transfer pricing documentation requirements.”*

Obtaining certainty of pricing

Many growing businesses will frequently want the certainty of establishing an arm’s length transfer price for a transaction that will be acceptable to one or more tax authorities in advance of executing the transaction. This is generally achieved by way of an advance pricing agreement (APA) whereby the taxpayer and the tax authority or authorities agree a set of principles for determining a transaction’s transfer price. Because, in many countries, there exist limitations on who may apply for the APA process, through the charging of a fee or the requirement that the transaction meets a certain level of complexity thresholds or fees, APAs may be beyond the reach of the smaller business.

In the UK there are no special rules or processes specifically for SMEs, but the APA programme is open to all taxpayers seeking certainty on transfer pricing. In other jurisdictions the tax authority may try to make the APA programme more accessible to all taxpayers. The IRS and the French tax administration, to take two examples, operate simplified APA procedures for smaller businesses. Under these simplified rules, the APA process is accelerated and streamlined. Tax authorities that offer simplified procedures will often provide the smaller business with more assistance than they do for a standard APA.

Alternative methods are available from some authorities for obtaining varying degrees of certainty of treatment of transfer prices for tax purposes. These may range from non-binding opinions on the appropriate transfer pricing method to a binding view from the tax authority through a form of clearance or ruling which agrees the actual transfer price of the transaction.

Documentation

Once the transfer pricing policy has been designed, the pricing of the intra-group transactions requires documenting and the transfer prices must be implemented and subsequently monitored on an ongoing basis.

In addition to the formal creation of legal agreements to accompany any intra-group transactions, the preparation of contemporaneous documentation for tax purposes when setting the transfer price should be considered best practice and is indeed a legal requirement in many jurisdictions. It is important for any multinational group to be able to demonstrate that its intra-group pricing is at arm’s length at the time of the setting of the prices. In many countries, the absence of adequate documentation to support the transfer pricing employed will result in penalties, while rendering audit defence extremely difficult.

In today’s environment there is an increasing level of detail required to meet each country’s transfer pricing documentation requirements. Documentation requirements vary from country to country and it will be necessary to take advice on the requirements of each jurisdiction in which the growing business operates. The UK, for example, has not issued specific instructions on the type of documents that should be maintained in respect of transfer pricing.

There are, however, certain classes of document that are widely held to provide evidence that the pricing established in the group complies with the arm’s length principle. The OECD has released new guidance on recommended transfer pricing documentation, which has already been adopted in some jurisdictions, and this is described further below.

A tree-tiered global standard

As a consequence of the OECD and G20 base erosion and profit shifting (BEPS) project, the OECD has introduced a new three-tiered global standard of transfer pricing documentation. This was finalised in October 2015 and comprises a master file, local files and a country-by-country report. This new standard is now enshrined in the OECD Guidelines, Chapter V. Each of these documents is designed to serve a specific and complementary purpose, although few jurisdictions have yet to adopt the full OECD package. Further, it remains to be seen how widespread will be the uptake of all three of the individual elements.

The country-by-country report serves as a transfer pricing risk assessment tool for tax administrations that will contain certain information relating to the global allocation of the multinational’s income and taxes paid together with indicators of the location of economic activity within the group. Country-by-country reporting has been widely introduced for groups with a turnover of at least €750m.

Although this puts such reporting beyond the immediate scope of the typical growing entrepreneurial business, the

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turnover threshold for the introduction of the master file and local file is very much lower in a number of jurisdictions. However, the UK has yet to join the ranks of nations specifying a requirement for preparation and filing of a master file and local file in advance of a tax audit.

The master file, as conceived by the OECD, contains standardised information relevant for all of the multinational group's members, designed to assist tax authorities in evaluating the presence of significant transfer pricing risk. It should contain a high-level overview of:

- the group's business, including the nature of its global business operations;
- its overall transfer pricing policies; and
- its global allocation of income and economic activity.

The local and master files

The local file refers specifically to material transactions of the local taxpayer and provides more detailed information relating to specific inter-company transactions. The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting a specific jurisdiction. The local file focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system, collating, among other things:

- a description of the local business and business strategy, and key competitors;
- details of the material intra-group transactions in which it is involved;
- copies of inter-company legal agreements;
- functional and comparability analysis of the entities involved;
- a description of the most appropriate transfer pricing method used to test the arm's length nature of the inter-company transactions and reasons for the choice of method;
- financial analyses of the comparables as well as the tested party;
- the reasons for concluding that the transactions are priced at arm's length; and
- relevant financial information on the transactions and details of any tax rulings.

Although in the UK HMRC has not yet introduced a requirement for a master file or local file, it takes the view that it has the power to ask for such documents during the course of an audit. In the meantime, other countries, such as the Netherlands, have already introduced the OECD documentation standards into their local regulations. In the case of the new Dutch law, which takes effect with respect to periods commencing on 1 January 2016, master and local file submissions will be required from Dutch entities that are part of a multinational group with a consolidated revenue of at least €50m.

Monitoring

When implementing a transfer pricing policy, it is important to ensure that the design is correctly applied. It should be verified that the legal agreements are an accurate reflection of the transactions that they document and that they have indeed been signed and implemented. It is normal that staff roles and responsibilities develop with the changing needs of the business and it will be necessary to ensure, on an ongoing basis, both that the transfer pricing is appropriate for the actual functions, assets and risks of the parties to the transactions, and that the prices remain valid in the future. As the business grows, changes may take place in the relationships between related-party entities, restructuring of the business may occur, and market and industry conditions almost inevitably change and evolve. Any and all of these changes can affect the arm's length pricing. Monitoring will be required to assess whether the pricing remains valid or whether adjustments are necessary.

The more fundamental changes to the operation of the growing business, involving mergers and acquisitions, significant changes to the operating structure of the business, rationalisations or major changes in the regulatory environment, may require wholesale change in the group's transfer pricing policy, but that lies beyond the focus of the current article. ■

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