

Non-transferable?



This month marks the first anniversary of the changes in UK transfer pricing legislation. Sally Ramage looks back at how the revisions in the law came about

Transfer pricing is remuneration for the transfer of goods, intangibles and the provision of services and loan capital among related enterprises. The concept and definition of transfer pricing is relevant for business economics and taxation purposes.

Almost 70 per cent of cross-border trade in the world takes place between related enterprises. Because companies move their profits to subsidiaries in countries with low tax rates in order to pay less tax, many countries, including the UK, have updated their laws on transfer pricing.

Hungary recently introduced new transfer pricing regulations, as did the Netherlands, Argentina, Brazil, Columbia, Venezuela, Peru, Russia and Kazakhstan. The US and Mexico have also made transfer pricing amendments of recent.

In April 2004, the UK made changes to the law relating to transfer pricing that not only deterred company moves for tax gains, but also corrected the UK breach of EU law.

A case in point

The trial of the case *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt (Case C-324/00) [2003] STC 607* revealed that the UK transfer pricing rules, in force since 1951, were illegal and in breach of the European Treaty.

Lankhorst-Hohorst (LH) was a German company whose ultimate shareholder was a Dutch firm called LTBV. In December 1996, LH borrowed DM3 million* (£1.07 million) from LTBV repayable over ten years in annual instalments. In its corporation tax assessment notices of June 1999, with regard to 1997/8, the German tax authorities decided that the interest paid to LTBV for the loan was equal to a covert distribution of profits within the meaning of Para 8a(1) of the *Körperschaftsteuergesetz* (German

law on corporation tax).

The government quickly changed the law so that from 1 April 2004, UK to UK business transactions were no longer exempt from tax on the difference in prices, except for relevant transactions between small- and medium-sized enterprises (SMEs).

New rules

Under the new rules, companies who have borrowed from a UK or overseas parent will need to show that the loan could have been made on a stand-alone basis, or face possible transfer pricing penalties.

This means that if a branch of a company incurs a loss on its profit and loss account of £1,000, it cannot carry forward this loss to another UK branch. It must restrict carry-forward losses made in the UK to other branches of the same company only. If a branch in the UK paid interest to a parent company based outside the UK, the interest on the loan is treated as the parent company's dividend – if the borrowing exceeded a given debt-to-equity ratio.

The legislation applies to all overseas parent companies with branches in the UK, as well as to all branches of UK-based companies. This is effectively a repeal of the old rules governing 'thin capitalisation', which allowed related companies to assess their borrowing capacity on a consolidated basis.

SMEs not wholly exempt

SMEs are exempt from this new regime but, with medium-sized businesses, the Inland Revenue will have the power to require transfer pricing adjustments in what it calls 'exceptional cases', but what constitutes 'exceptional' is not defined. There could be significant amounts of tax at stake.

Types of documentation for cross-border

transactions include:

- Records of any adjustments made for tax purposes
- A record of the transaction covered by the legislation
- Evidence that there has been no compromise as per the 'arm's length' principle

The arm's length transaction (see footnote) documentation only needs to be produced if the Revenue requests it in the course of an investigation. If a company incurs a penalty, there is a two-year period of grace, so no penalty is to be paid until 1 April 2006.

Alternatively, a UK company can agree its pricing policies in advance with its local Inspector of Taxes. The old transfer pricing law allowed a UK corporate group to be treated as a single entity to determine what level of debt it could carry, but with the revised law, a company's debt capacity is considered in isolation.

Management might consider conducting a transfer pricing study to help focus on the overall value of the company's transfer pricing activities and locations, and to improve decision-making aimed at maximising total returns. □

*FOOTNOTE: Any companies that became dormant after 31 January 2004 were caught by the transfer pricing rules. The solution is to document, as evidence of proper compliance, why a UK company believes its transfer pricing policy is as close as possible to the arm's length standard. *DM obsolete*

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