



HMRC APPROACH TO TRANSFER PRICING FOR LARGE BUSINESS.

CONSULTATION DOCUMENT
20 JUNE 2007

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EXECUTIVE SUMMARY

- This consultation is about the proposal in the 2006 Review of Links with Large Business for a new approach to transfer pricing enquiries.
- Effective transfer pricing rules are an essential part of UK tax policy, protecting the tax base and ensuring fairness between companies and between countries.
- Businesses want to achieve greater and earlier certainty and are concerned about the cost of complying with transfer pricing rules.
- Addressing HMRC's and businesses' shared objective for improved efficiency and effectiveness involves the whole administration of transfer pricing and not just enquiries into returns.
- HMRC is developing new ways of working to deliver this objective, building on the compliance risk assessment framework and litigation and settlement strategy.
- To achieve the objective, businesses must also play their part in a constructive and transparent relationship, for example by providing information without unnecessary delays.
- The new approach will involve greater specialisation and team work on transfer pricing, engagement with companies that wanted on pre-return risk assessment, a focus on issues of higher risk, action plans for enquiries agreed where possible with companies, and active monitoring of progress.
- The balance of advantage appears to remain strongly against the introduction of "safe harbours".
- When the new approach is fully introduced, it is proposed to abolish Board's approvals.
- Information will be published on the number of transfer pricing enquiries open and the time taken to resolve closed ones.
- In the international community, the UK will advocate the wider adoption of the principles of the new approach to transfer pricing.

HMRC APPROACH TO TRANSFER PRICING FOR LARGE BUSINESS

THIS DOCUMENT

1.1 This document is part of a consultation being conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice¹. Further details are in Annex A.

1.2 Responses to this document should be sent to Roy Warden roy.warden@hmrc.gsi.gov.uk by 15 September 2007.

1.3 A note about the confidentiality of responses is at Annex B.

BACKGROUND

1.4 The 2006 Review of Links with Large Business² set out the outcomes that business and HMRC wanted to see from a relationship based on trust and transparency and a shared commitment to efficient and effective collection of the right tax at the right time. These were:

- greater certainty;
- an efficient risk based approach to dealing with tax matters;
- speedy resolution of issues; and
- clarity through effective consultation and dialogue.

HMRC made a commitment to deliver the proposals in the Review, including a proposal about transfer pricing enquiries which is the subject of this document.

1.5 An outline delivery plan for all of the Review proposals was published in March 2007³. This was accompanied by the publication of a compliance risk assessment framework⁴. The outline delivery plan said that specific proposals on transfer pricing would be put out for consultation over the summer. This document meets that commitment. It also sets out how the compliance risk assessment framework might apply in the particular area of transfer pricing.

1.6 HMRC has adopted a litigation and settlement strategy which can be found at [<http://www.hmrc.gov.uk/practitioners/lss.pdf>]. This sets out principles for bringing tax disputes to a conclusion, whether by agreement with the taxpayer or by litigation. Under the strategy, HMRC:

- seeks to administer the tax system fairly and efficiently without unnecessary compliance costs for the taxpayer;
- seeks non-confrontational solutions where possible;
- seeks to resolve disputes in a way which best serves the goal of reducing the tax gap;
- takes decisions based on the wider impact of the disputed issue as the amount of tax immediately at stake;

¹ www.cabinet-office.gov.uk/regulation/Consultation/Code.htm

² HMRC (November 2006) 2006 Review of Links with Large Business HMSO

³ HMRC (March 2007) Making a difference: delivering the review of links with large business HMSO

⁴ HMRC (March 2007) HMRC approach to compliance risk management for large business HMSO

- where there is a strong case, seeks full value from settlement or takes the matter to litigation;
- does not pursue weak arguments;
- uses team-work for cases.

THE TRANSFER PRICING PROPOSAL

1.7 The Review promised the introduction, by 31 December 2007, of a more efficient approach to undertaking transfer pricing enquiries. A greater focus on high risk businesses and transactions would mean that enquiries for businesses with less complex affairs would be resolved more quickly. Those with complex transfer pricing issues would also have the opportunity to benefit from swifter resolution and would have more certainty as to how and when matters would be concluded.

1.8 The Review envisaged that, where businesses promptly provided the information needed for an enquiry, transfer pricing enquiries should normally be completed within 18 months. It was recognised that some enquiries that were both particularly complex and high risk might take longer even where businesses made full and transparent disclosure of supporting facts and commercial intent and promptly provided information. It was expected that these enquiries would take no longer than 36 months to resolution or the point where preparation for litigation started.

UK TRANSFER PRICING RULES

1.9 The UK's transfer pricing rules have some important features:

- they are based on the internationally recognised “arm’s length” principle promulgated by the OECD; this can involve the exercise of judgement rather than the application of precise rules;
- they ensure fairness between taxpayers and help to achieve a fair division between countries of the tax base relating to corporate profits enabling international double taxation to be addressed;
- they help to protect the UK tax base by preventing the artificial diversion of profits;
- they have the potential to impose a significant compliance burden on companies to demonstrate, by assembling evidence, that arm’s length results have been used in the calculation of taxable profit;
- they can involve complex analysis and specialist knowledge which can make disputes difficult and lengthy to resolve;
- where the nature of the issues merits it, Advance Pricing Agreements can be reached to deliver earlier and greater certainty⁵.

1.10 UK transfer pricing rules place two broad kinds of requirements on a company that has transactions with a business with which it is related. These relate to tax returns and to requests by HMRC for information. There are also rules that place a requirement on HMRC if an adjustment is to be made.

(a) making a correct return

⁵ Statement of Practice (SP 3/99) Advance Pricing Agreements (APAs) HMRC

1.11 The law requires a company to ensure in its tax return that the results of relevant transactions are adjusted to arm's length results. In making a correct tax return, a company must have appropriate evidence to substantiate the figures it contains. There is no requirement to provide the evidence to HMRC at the time the return is made. Indeed, in the absence of an enquiry the evidence might never be provided. But evidence has to exist by the time the return is made in order to provide confidence that the return is correct. Having insufficient evidence may indicate negligence and attract a tax-gearred penalty. There is no separate penalty for transfer pricing; the general rules about making an incorrect return apply.

1.12 There is no standard form in which transfer pricing evidence needs to be recorded. The company can keep documentation containing evidence in any form it chooses. (This analysis draws a distinction between evidence and documentation; evidence refers to proof of a fact or to the strength and logic of an argument while documentation refers to the format and medium in which the evidence is contained.) The main principle underlying the cost to be incurred in assembling evidence and recording it in documentation is that it should be commensurate with the risk involved in arriving at the arm's length result. Complex and high value transactions would generally require greater attention by the company than simple and high volume ones.

1.13 A suggestion for standardised transfer pricing documentation within the EU has been made by the Commission⁶ based on the work of the Joint Transfer Pricing Forum. This has been adopted by the Council as a code of conduct under the title "EU Transfer Pricing Documentation". It is a recognition of good practice and not binding legislation. It is optional for companies. Tax administrations can also require more evidence to be supplied than is contained in any standardised documentation.

(b) requests for information

1.14 When an enquiry has been opened into a return, HMRC can request from a company documents or other particulars relating to a potential tax liability. If necessary, HMRC can issue a written notice requiring the provision of the information within a specified time.

(c) Board's approvals

1.15 When UK transfer pricing rules were enacted in 1951, they included a provision that no adjustment could be made to an actual result to make it an arm's length result unless the Board (of Inland Revenue) gave a direction. The power to give a direction was delegated only to senior officials in Head Office. This ensured that all transfer pricing adjustments were reviewed by such an official. This measure was intended to address concerns that businesses might be faced with responding to enquiries initiated by officials in local offices who might not appreciate the nature and complexity of applying the arm's length principle.

1.16 This rule was changed in 1998 because it was incompatible with the self-assessment system that was introduced at that time. The current rule is that a closure notice or discovery assessment incorporating an adjustment to taxable profit must be approved by a senior official to whom authority has been delegated by the Board (of HMRC).

INFORMAL CONSULTATIONS

1.17 Since the publication of the Review, further informal consultations have taken place about the administration of transfer pricing rules involving HMRC, companies, professional advisers and other interested parties. Those consultations have informed the discussion in this document.

⁶ Commission of the European Communities (November 2005) Proposals for a Code of Conduct on transfer pricing documentation for associated enterprises in the EU Brussels

1.18 Many general and detailed points were made. The main conclusions were:

- it was confirmed that the priority for businesses was to achieve greater and earlier certainty;
- the cost of complying with transfer pricing rules was an even greater concern for businesses than the time taken to resolve enquiries;
- the main issues for businesses involved knowing what sort of evidence HMRC would find acceptable and how to apply a risk based approach in assembling it;
- “EU Transfer Pricing Documentation” is the result of an encouraging debate to improve the position on an international basis but does not provide a complete answer;
- businesses were generally keen for an improved relationship with HMRC based on trust and transparency including involvement with HMRC before returns were made and, where appropriate, real time auditing;
- some businesses, however, pointed out that they already did everything necessary for compliance and wanted to see a clear advantage from any increased pre-return involvement;
- HMRC was one of the best national tax administrations in the application and auditing of transfer pricing, although there was still considerable scope for improvement;
- improvements in the performance of HMRC, while welcome, would have limited impact without equivalent improvements in other countries;
- Advance Pricing Agreements were good in principle although in practice they could take a long time to negotiate.

1.19 From this discussion, it seems clear that the key factors for achieving a more efficient approach to transfer pricing administration involve the basis (including timeliness) on which evidence is assembled by businesses and provided to HMRC. These factors are not confined to what happens when an enquiry has been initiated but also involve “real time” activities and the process of making a return.

1.20 The next section of this document sets out some options for approaching the assembling and provision of evidence to achieve both a more efficient and a more effective application of transfer pricing rules for businesses and HMRC. Some of the options would involve legislative changes which would require the agreement of Ministers and the approval of Parliament.

OPTIONS ABOUT ASSEMBLING AND PROVIDING EVIDENCE FOR TRANSFER PRICING

1.21 *Option 1: Introduce a requirement that all companies (or a defined sub-set of companies) with relevant transactions with related businesses during a period should, at the time a return is made for that period, provide HMRC with all of their transfer pricing documentation.*

1.22 This option is included only for the completeness of the analysis. The disadvantages far outweigh any advantages and it can be rejected.

1.23 The advantage of the option is that it would provide HMRC with a comprehensive set of information at the time a return is made to enable a full risk assessment to be undertaken to decide whether an enquiry should be initiated and the particular issues on which any enquiry should focus.

1.24 It would be very difficult, however, to specify what was meant by all transfer pricing documentation. At a minimum, this would need to include all documentation containing evidence that relevant amounts were arm's length amounts. In practice, the required amounts might be the amounts recorded for transactions in the accounting system of the business, or might involve adjustments to such amounts for the purpose of making a tax return. It might need to include extracts from the accounting system (which might only be in electronic form rather than documents) recording the details of transactions. It would need to include evidence based on comparability demonstrating that the results were arm's length results. And it would need to include documents, including documents from earlier periods, setting out the terms on which the relevant parties transacted with each other during the period (for example, which party bore relevant risks).

1.25 Even if the relevant documentation could be specified with the precision necessary in a statutory requirement, a very significant additional compliance burden would be imposed on the companies that would be required to provide it. Companies might feel obliged to create documentation for the purpose, for example in relation to low risk transactions, where they would not otherwise choose to do so. And companies would have to incur costs in copying the documentation or converting it into a format in which it could be provided to HMRC. No attempt has yet been made to quantify the additional burden that would be involved.

1.26 It would be most unlikely to be feasible for HMRC to review properly all such documentation if it were provided. To attempt to do so would go against the compliance risk assessment framework which aims to focus attention selectively on the areas of highest risk. And HMRC would need to incur costs in storing the documentation in a way in which it could be accessible.

1.27 *Option 2: Recognise "EU Transfer Pricing Documentation" as best practice, retaining its optional status for companies; the documentation would be provided to HMRC, if requested, after a return had been made; HMRC would have the right to request more information than that contained in the documentation (or would have been contained if the company had prepared it).*

1.28 This is essentially the present position and would require no changes, although it would give "EU Transfer Pricing Documentation" a higher profile in the UK than it currently enjoys.

1.29 A standardised format is both a strength and a weakness. On the one hand, it sets out a common standard for all companies for the whole range of relevant transactions. On the other hand, standardisation is difficult to combine with a selective risk based approach, including HMRC's compliance risk assessment framework.

1.30 This option addresses a major problem identified for Option 1 in that it specifies in some detail the documentation that HMRC might expect a company to keep. Moreover, it does so in a way that has been recognised as good practice throughout the EU (but not more widely in the world). The informal consultations have confirmed, however, that the specific details of "EU Transfer Pricing Documentation" have not so far been found to be particularly helpful for companies in the UK.

1.31 This option should, in principle, avoid imposing additional compliance costs on companies. All companies have to have appropriate evidence for transfer pricing purposes. Since "EU Transfer Pricing Documentation" is optional, a company would only assemble its evidence in this standardised format if it saw advantages in doing so. Comments would be particularly welcome on the extent to which companies already use "EU Transfer Pricing Documentation", how useful they find it, whether they might choose to use it in the future, and whether it involves additional compliance costs compared with what they would otherwise do.

1.32 This option would not, however, by itself give companies any assurance of greater or earlier certainty. Nor would it give any guarantee to a company that produced documentation in the specified format that it would not incur a penalty for making an incorrect return in respect of transfer pricing. Whether a penalty is appropriate depends much more on the quality of the evidence than on the format of the documentation.

1.33 A variant of this option would be to require all companies (or a defined sub-set of companies) to provide HMRC with “EU Transfer Pricing Documentation” at the time a return is made. This would, in effect, be Option 1 with a specified set of documentation. It would depart in a significant way from the basis on which “EU Transfer Pricing Documentation” was recommended by the Joint Transfer Pricing Forum and the Commission, and accepted by the Council, since the optional status of the material was regarded as essential.

1.34 **Comments are invited on the extent to which companies find “EU Transfer Pricing Documentation” helpful, how far they currently use it or might plan to use it, and whether it imposes any compliance costs in excess of what they would have to incur in any event.**

1.35 *Option 3: Introduce a requirement that all companies (or a defined sub-set of companies) with relevant transactions with related businesses during a period should provide HMRC at the time a return is made for that period with a standardised form with details of specified transactions to which transfer pricing rules apply.*

1.36 This is an approach that has been adopted by some countries, including Australia and Denmark. The standardised form used in those countries is much shorter and more precise than “EU Transfer Pricing Documentation”. They require companies to show the value of transactions with related parties during a period and give selected further information about those transactions (such as whether they relate to goods, services, financing or intangible property).

1.37 Like Option 1, but unlike Option 2, this option would impose a new requirement on companies to provide HMRC with documentation at the time a return is made. This would involve a compliance cost although, because the scope of the information required would be narrower, the cost should be less. The information would predominantly consist of extracts from documentation that companies should already be keeping.

1.38 Also like Option 1, but unlike Option 2, HMRC would receive the documentation at the time a return was made. This would enable the information to be used for the purpose of deciding whether an enquiry should be initiated and the particular issues on which any enquiry should focus. There would be less information than with Option 1, which would make it easier to review, although it is unlikely that there would be sufficient to conduct a fully-informed risk assessment. The provision of such standardised documentation would make it less likely that HMRC would initiate enquiries in low risk cases, saving companies the associated compliance costs.

1.39 Like Option 2, but unlike Option 1, this option would involve standardised documentation but only of a limited range of the relevant evidence. It would, however, be standardised within the UK and not, like Option 2, within the EU.

1.40 Like Options 1 and 2, this option would not give companies any assurance of greater or earlier certainty. And there would still be an exposure to penalties for failing to make a correct return.

1.41 This option would be attractive if companies thought that the compliance cost in preparing simple standardised documentation and submitting it with a tax return would be small and if the contents contributed significantly to improved risk assessment.

1.42 Comments are invited on whether companies would see an advantage in the introduction of a requirement to provide basic transfer pricing information at the time a return was made and what the compliance costs would be of doing so.

MOVING TO A NEW APPROACH

1.43 The discussion of the options about assembling and providing evidence for transfer pricing suggests that standardisation or new requirements at the time a return is made would not provide a complete answer to the issue of greater and earlier certainty, and might not provide any answer at all. HMRC is, therefore, developing a new approach to the administration of transfer pricing rules. This approach will not, however, be confined to enquiries but will extend to the whole process of administering the rules.

1.44 The approach could be combined with any of the options about assembling and providing evidence, although its focus on high risk would mean that it would not fit comfortably with the comprehensive approach under option 1.

1.45 As well as building on the improved relationship between HMRC and large businesses envisaged by the Review, the new approach will be shaped by HMRC's compliance risk assessment framework and litigation and settlement strategy. It will also aim to provide much more consistency in respect of the selection of enquiries, the conduct of those enquiries, and their resolution. It will recognise that transfer pricing has significant differences from other, non fact-intensive, corporation tax issues. These differences have particular implications for compliance costs incurred by companies and the conduct of enquiries.

1.46 Under the new approach, HMRC will devote more specialised resource to transfer pricing, especially for larger businesses. Teams will be set up that will be able to draw on investigators who will tend to specialise in transfer pricing work and who will be able to get to grips with issues quickly and in depth. This will require appropriate training for the investigators involved, including appreciation of general commercial considerations. Where the risks and costs justified it, HMRC will be prepared to buy in expertise from outside.

1.47 The compliance risk assessment framework will apply for transfer pricing as for other issues. HMRC will invite companies to take part in the process before a return is made. The objective will be to reach an agreed view about the issues that are higher risk and the issues that are lower risk. In some circumstances, real-time auditing might be appropriate. Some elements of the risk assessment, however, will not include the involvement of companies, including a decision whether to initiate an enquiry.

1.48 Companies engaging in the risk assessment process will stand to benefit from:

- the opportunity to discuss with HMRC at an early stage the relative risk of different transfer pricing issues;
- an early indication of the issues HMRC regarded as higher risk;
- a lower chance of being subject to enquiries where pre-return discussions had dealt with the issues;
- speedier enquiries, where they took place, to the extent that the issues to be addressed had been identified from the start;
- the opportunity to reduce compliance costs in obtaining and keeping evidence relating to lower risk issues.

1.49 The compliance costs incurred by companies that chose not to engage in a dialogue with HMRC would not change, but HMRC would still conduct a risk assessment and there might be a higher chance, especially where large companies were involved, that such companies would be the subject of an enquiry and requests to provide documentation.

1.50 Under the new approach, HMRC will set up new procedures for managing transfer pricing enquiries. Before any enquiry is initiated, the HMRC team will identify the specific risks to be investigated, estimate the amounts involved, identify the information that was available and would be required, estimate the resources and expertise required, consider any special factors about the relationship with the company involved and propose a timetable.

1.51 Initiation of any transfer pricing enquiry will require approval. New arrangements involving representatives from CT & VAT, the Large Business Service, and Local Compliance will be put in place to ensure consistency. If the necessary approval were given, an action plan would be derived from the information assembled by the HMRC team and discussed with the company. One aim of the discussion would be to agree on any further information required and a timetable for the whole enquiry. One outcome is that fewer enquiries would be likely to be initiated than in the past, but these would be better focussed on higher risks.

1.52 The progress of a transfer pricing enquiry would be monitored by HMRC representatives against the action plan. Any significant departures from the plan would be discussed with the company and appropriate actions taken to maintain progress.

1.53 Under the new approach, all new transfer pricing enquiries ought to be well focused with a clear plan. On that basis, HMRC will be more prepared to use formal information powers, and to use them at an earlier stage in an enquiry, where a business does not co-operate timeously in providing the necessary material.

1.54 The way transfer pricing enquiries will be resolved will be subject to the litigation and settlement strategy. [<http://www.hmrc.gov.uk/practitioners/lss.pdf>].

1.55 Annex C contains a draft of the amendments that will be made to HMRC guidance in implementing the new approach.

1.56 **Comments are invited on the advantages for companies engaging in pre-return risk assessment discussions with HMRC on transfer pricing and on whether companies would want to do this.**

1.57 **Comments are invited on the extent to which the new approach would lead to a reduction in compliance costs in respect of lower risks.**

OTHER ISSUES

(a) "safe harbours"

1.58 Transfer pricing rules require the application of the arm's length principle to the results of relevant transactions between related parties. There has been some debate over the possibility of introducing "safe harbours" which, in defined circumstances, would specify an amount to be used. This could be, for example, a fixed percentage to be added to the cost of selected recharged services.

1.59 The advantage of a "safe harbour" would be to provide certainty to companies and to obviate the need to provide evidence about the arm's length pricing of the transactions.

1.60 There are, however, several disadvantages:

- because the approach departs from the arm's length principle, it would not necessarily ensure a level playing field between companies, and it might not be accepted by foreign tax administrations which could lead to double taxation;
- there would remain a need to define the circumstances in which the approach applied which could lead to disputes over whether particular transactions qualified and so uncertainty would not be removed;
- the approach is more suited to low risk transactions, which cause fewer problems, and would not be appropriate for higher risk transactions;
- if the approach was set at a level that was generous to companies, there could be a significant tax cost; if the level was sufficient to protect the tax base, it might have few attractions for companies.

1.61 The balance of advantage appears to remain strongly against the introduction of “safe harbours”.

1.62 Comments are invited on whether the balance of advantage is against the introduction of “safe harbours”.

(b) Information powers

1.63 To conduct transfer pricing enquiries effectively, HMRC requires appropriate information from companies provided efficiently and on time in an accessible format. An improved relationship with large businesses offered by the Review would help to achieve this where companies co-operate. In other circumstances, the power to require the provision of information will be critical. Better focussed enquiries may well lead to an increased, and earlier, use of those powers in particular cases.

1.64 There may well be advantages to both HMRC and businesses in information being provided electronically.

1.65 HMRC will monitor how powers are used to ensure they are used effectively and to consider the case for amending or strengthening them. Any proposals for change would be consistent with the conclusions of the Review of HMRC Powers, including the proposals for a new approach to compliance checks set out in a consultative document issued on 17 May 2007⁷ and would be subject to consultation.

1.66 Comments are invited on whether information powers are currently used appropriately and effectively in transfer pricing enquiries.

1.67 Comments are invited on any existing difficulties for companies in providing HMRC with necessary information, for example where the information is not in the company's possession because it is held by another, possibly foreign, group member.

(c) Advance Pricing Agreements

1.68 UK legislation provides for unilateral APAs, which are binding agreements between a UK business and HMRC. Such an agreement can only provide a partial resolution of cross-border transfer pricing issues because it does not determine how the issues are to be resolved in the other country and, consequently, does not eliminate the risk of double taxation. Where an appropriate tax treaty is in place, a bilateral agreement can be negotiated between HMRC and the tax

⁷ HMRC (17 May 2007) HM Revenue and Customs and the Taxpayer: Modernising Powers, Deterrents and Safeguards; A new approach to compliance checks

administration of the treaty partner. The advantage of a bilateral APA is that it addresses double taxation directly by committing the other tax administration.

1.69 APAs are intended to offer assistance in resolving complex transfer pricing issues. In the absence of significant doubt as to the manner in which the arm's length principle should be applied, APA negotiations are not a sensible use of resources. HMRC may, therefore, decline to accept applications that do not satisfy a complexity threshold. HMRC may also decline a request where a business does not co-operate in providing timeously the information necessary to consider the request properly.

1.70 If ways could be found to address the resource cost of negotiations and the time taken to complete them, a greater use of APAs would offer a route to greater and earlier certainty for transfer pricing issues.

1.71 **Comments are invited on whether companies would see an advantage in a greater use of unilateral APAs, which could be negotiated more quickly because a foreign tax administration would not be involved, as a means of achieving greater and earlier certainty.**

1.72 **Comments are invited on whether companies would make more use of APAs if the complexity threshold were lowered.**

(d) Board's approvals

1.73 The intention of Board's approvals for transfer pricing adjustments (and Board's directions before them) was to attempt to protect businesses from misconceived enquiries. A problem with the process, however, is that the control is applied at the end of an enquiry. The review by senior officials at the beginning of a potential enquiry under the proposed new approach would arguably be more appropriate and effective. It would be excessive, however, to make this a statutory requirement. When the new approach is introduced, with its action plan based on a business case approved at an appropriately senior level, it is proposed that the process of Board's approvals should be abolished. This would require a minor piece of legislation.

1.74 **Comments are invited on the proposal to abolish Board's approvals.**

MEASURING OUTCOMES

1.75 The main indicators of how successful a new approach to transfer pricing has been will be:

- whether companies and HMRC feel that the risk assessment process is focusing on the appropriate high risk issues;
- whether companies feel that they are adequately engaged in risk assessment;
- whether HMRC is satisfied that it is provided timeously with the information that it needs;
- whether companies are satisfied with the management of enquiries by HMRC;
- whether HMRC and companies together ensure that enquiries are resolved according to the timetable set out in the plan;
- whether the way risk assessment and enquiries are conducted contribute in an appropriate way to closing the tax gap.

1.76 HMRC will publish quarterly statistics about transfer pricing enquiries. Significant improvements to management information systems are being made to enable this to happen.

1.77 During 2006-07, about 1,000 transfer pricing enquiry issues were resolved. There was a smaller number of enquiries since one enquiry can involve more than one issue. The time taken to resolve these issues varied widely from a few months to over five years. At the end of 2006-07, there were about 580 transfer pricing enquiry issues open involving groups dealt with by HMRC's Large Business Service. These had been open for an average of 21 months. Again, this average involves a wide spread. Steps are being taken to improve the management information available about enquiries involving large businesses in other HMRC offices.

1.78 Under the new approach, HMRC will prioritise its use of investigative resources according to risk, informed where agreed by the participation of companies. This will have an impact on the statistics for resolved and open enquiries. This impact will require careful interpretation. If existing open enquiries are resolved more quickly, the effect could be an increase for a period in the average time recorded to resolve them, especially if priority were given to resolving the oldest enquiries. The average length for which open enquiries had been open would, however, come down. In the longer term, the aim would be to reduce both measures.

1.79 **Comments are invited on the information to be published to assess performance.**

THE INTERNATIONAL DIMENSION

1.80 As has already been noted, improvements in the performance of HMRC, while welcome, would have limited impact without equivalent improvements in other countries. The UK will advocate, through the OECD and the EU Joint Transfer Pricing Forum, the wider adoption of the principles of the new approach to transfer pricing set out in this document, including the advantage of a full dialogue with business representatives.

1.81 **Comments are invited on how the achievement of shared objectives might be pursued in a global context.**

OPERATIONAL IMPACT ASSESSMENT

1.82 Annex D contains an operational impact assessment.

1.83 Comments are invited on any aspect of the operational impact assessment.

SUMMARY OF POINTS FOR CONSULTATION

1.84 *Comments would be welcomed on any of the issues discussed in this document. Comments are particularly invited on:*

- *the extent to which companies find "EU Transfer Pricing Documentation" helpful, how far they currently use it or might plan to use it, and whether it imposes any compliance costs in excess of what they would have to incur in any event;*
- *whether companies would see an advantage in the introduction of a requirement to provide basic transfer pricing information at the time a return was made and what the compliance costs would be of doing so;*
- *the advantages for companies engaging in pre-return risk assessment discussions with HMRC on transfer pricing and on whether companies would want to do this;*
- *the extent to which the new approach would lead to a reduction in compliance costs in respect of lower risk;*
- *whether the balance of advantage is against the introduction of "safe harbours";*

- *whether information powers are currently used appropriately and effectively in transfer pricing enquiries;*
- *any existing difficulties for companies in providing HMRC with necessary information, for example where the information is not in the company's possession because it is held by another, possibly foreign, group member;*
- *whether companies would see an advantage in a greater use of unilateral APAs, which could be negotiated more quickly because a foreign tax administration would not be involved, as a means of achieving greater and earlier certainty;*
- *whether companies would make more use of APAs if the complexity threshold were lowered;*
- *the proposal to abolish Board's approvals;*
- *the information to be published to assess performance;*
- *how the achievement of shared objectives might be pursued in a global context;*
- *any aspect of the operational impact assessment.*

A

CONSULTATION CODE OF PRACTICE

Under the consultation code of practice, HMRC:

- consults widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- is clear about who may be affected, what questions are being asked, and the timescale for responses;
- ensures that consultation is clear, concise and widely accessible;
- gives feedback regarding the responses received and how the consultation process influenced the policy.
- monitors HMRC's effectiveness at consultation, including through the use of a designated consultation co-ordinator;
- ensures the consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact –

Duncan Calloway

Better Regulation Unit

020 7147 2389 or duncan.calloway1@hmrc.gsi.gov.uk

B

CONFIDENTIALITY

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HMRC.

HMRC will process your personal data in accordance with the DPA and, in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

Introduction and scope

- a) *The draft guidance below outlines the practices and procedures HMRC are proposing to adopt in the course of a transfer pricing enquiry in order to achieve the aims of Proposal 5 of the 2006 Review of Links with Large Business. It is primarily intended to provide guidance to HMRC officers on working practices that ensure that transfer pricing enquiries are worked most effectively. It also outlines the practices and behaviours HMRC will expect businesses to adopt in order to achieve a more efficient and speedy working of transfer pricing enquiries.*
- b) *This guidance applies primarily to enquiries involving the application of the transfer pricing rules found at Schedule 28AA ICTA 1988, but will apply also where similar principles are applied in determining the attribution of profit to a permanent establishment. This includes some thin capitalisation cases. (Further details of the application of this guidance to thin capitalisation is at paragraph f below.) The approach articulated in the guidance will not apply to enquiries that are not primarily concerned with establishing arm's length results, but where Schedule 28AA is nevertheless relevant. For example, this guidance will not apply in respect of enquiries into an avoidance scheme where Schedule 28AA is one of a number of the points at issue.*
- c) *The term "enquiry" in this guidance refers to an enquiry into a tax return under the provisions of Part IV Schedule 18 FA 1998 or Section 12 AA TMA 1970.*
- d) *There is substantial existing guidance on the conduct of transfer pricing enquiries, found at INTM 460100 et seq and in Tax Bulletin 60. This guidance supplements existing material by introducing additional guidance on conducting transfer pricing enquiries in an efficient and timely manner.*
- e) *Much of the guidance below represents best practice and will apply to existing as well as new enquiries. Other parts of the guidance represent a marked change in the way that transfer pricing enquiries are currently conducted and will be introduced in conjunction with changes to the way in which transfer pricing enquiries are managed.*
- f) *In thin capitalisation cases, negotiations leading to agreements between HMRC and a business on the deductibility of interest payments generally take place over a shorter timescale than "mainstream" transfer pricing enquiries. HMRC has no wish to prevent the continued successful operation of this aspect of transfer pricing work and as a result, the following will not be subject to this guidance:*
 - *Discussions between HMRC and a business in relation to a thin capitalisation (or similar) agreement in conjunction with an application under a double taxation agreement (DTA) for relief from UK withholding tax on interest.*
 - *Discussions between HMRC and a business in relation to an advance thin capitalisation agreement under the procedures resulting from the consultation, begun in May 2007 ("Changes to Clearance Processes for Financial Transactions"), relating to thin capitalisation agreements outside the DTA clearance process.*

This guidance will thus apply to the application of Schedule 28AA to the deductibility of interest only in cases where the issue is considered for the first time in the context of a formal enquiry into a return. As mentioned in paragraphs C25 and C31 below, the detail contained in a business case

and enquiry timetable should not be out of proportion to the complexity of the enquiry and expected resource input. Enquiries involving only the deductibility of interest are often relatively straightforward and can be expected to require a less detailed business case and enquiry timetable.

Enquiry Governance and Management

C.1 All transfer pricing enquires will incorporate common key elements. These are:

- Risk assessment. This is described below in paragraphs C12 to C21 below.
- Business Case. This is described in paragraphs C22 to C28 below.
- Timetable and action plan. Further details about this are included at paragraphs C29 to C39 below and at Appendix A (1)
- Six monthly reviews. These are described in more detail at paragraphs C7 below.
- Resolution decision. This is described at paragraph C8 below.

C.2 All cases will pass through a series of “stage gates”, each of which correspond to one of the enquiry elements described above and will each be subject to review. The key features of each of the gates are:

- They ensure a consistent approach to all transfer pricing enquires
- They provide a structure for the management and governance of transfer pricing enquiries and ensure that transfer pricing enquiries are actively managed from their inception
- They indicate what needs to be achieved by the time the stage gate is reached
- They leave flexibility for the conduct of transfer pricing enquiries between each of the stage gates.

[The decision at each stage gate will be subject to review and approval. This will mean that the case team will need to prepare a recommendation on the key decision to be made at each stage gate and that the decision will be subject to management or specialist approval. It will be necessary for case teams to keep a file record of these approvals at each stage gate. HMRC is reviewing how transfer pricing enquiries will be organised and managed and it is still to be decided where responsibility will lie for a) seeking and b) giving approval at each stage gate.]

C.3 Each stage gate centres on a key decision that needs to be made and approved before the enquiry proceeds towards the next gate. These are described below.

C.4 *Stage Gate 1.* This is the risk assessment described in detail below. The key decision at this stage is: Do we progress to the development of a business case to justify an enquiry? This decision is made in the light of the information available, and analyses carried out, during the risk assessment. If this gate is passed, the case team will develop a business case. Further guidance on the development of a business case is provided at paragraphs C22 to C28 below.

C.5 *Stage Gate 2.* The key decision at this stage is whether, in the light of the business case, an enquiry should be opened. If this gate is passed, the enquiry will be opened. At this stage HMRC will commit resource to the enquiry and work with the business to develop an agreed enquiry timetable and action plan.

C.6 *Stage Gate 3.* The key decision at this stage is whether the enquiry timetable and action plan is acceptable. Further guidance on the development of an action plan and timetable is provided at paragraphs C29 to C39 below. This would normally be developed in collaboration with the business. Once this gate is passed, the enquiry will continue in accordance with that timetable and action plan. A particular issue to consider at this stage is whether the enquiry is “particularly complex and high risk”. If it is, then the timetable may extend beyond 18 months. In some cases, it will not be possible to take a view at this stage on whether the case is “particularly complex and high risk”. This might be the case, for example, if HMRC has not had access to detailed information regarding transfer pricing at the risk assessments and business case stages. In such cases, the timetable would normally not extend beyond 18 months, but the issue may be reconsidered at a further point in the enquiry. Further guidance on the meaning of “particularly complex and high risk” is provided at paragraphs C34 to C37 below.

C.7 *Stage Gates 4.* These are a series of review points, built into the timetable. The reviews should normally be held every 6 months during the enquiry. The key decision to be made at these stages is how the enquiry should continue. The main options are:

- To continue in accordance with the timetable/action plan;
- To continue in accordance with a revised timetable/action plan;
- To close the enquiry;
- To progress towards resolution.

The objective of this stage is to ensure that the case is progressing in accordance with the action plan/timetable and to explore whether the enquiry strategy should be revisited. A particular point to be considered at this stage is whether, in the light of the progress to date, the case has, exceptionally, become “particularly complex and high risk”, with the effect that the timetable may extend beyond 18 months.

C.8 *Stage Gate 5.* This stage occurs at the point at which sufficient information is available, and sufficient analysis has been carried out, for HMRC to take a view over the acceptability of the pricing under enquiry and what adjustments, if any, are necessary. HMRC should also understand at this stage whether there is sufficient common ground with the business to reach a negotiated settlement. The key decision to be made at this stage is whether to seek a resolution of the enquiry and, if so, how to progress towards resolution. The options at this stage are:

- to close the enquiry without adjustment;
- to seek a negotiated settlement with the business;
- to progress to litigation.

Conduct of the Enquiry

C.9 The enquiry will be project managed where it warrants it and HMRC will make use of appropriate project management tools.

[HMRC wants to ensure that its processes achieve a consistent approach to transfer pricing and to ensure that its resources are deployed on those cases that represent the highest risk. In order to ensure that consistency HMRC are considering developing decision making tools such as Decision Tree Analysis.]

C.10 A team will be formed to conduct the transfer pricing enquiry. The size and make-up of this team will be dependent on the scale and complexity of the enquiry. The team will be responsible for seeking specialist input, where appropriate, from International Issues Managers, transfer pricing specialists from LBS or Specialist International, economists, Trade Sector Advisors or other HMRC specialists. The team will have regular meetings to assess progress and decide on next steps. HMRC will ensure effective management of the team to ensure continuity where the officer conducting the enquiry, or a member of the enquiry team, leaves the case.

C.11 HMRC will be clear and open about the transactions that are to be subject to the enquiry. HMRC will make explicit:

- which transaction(s) is(are) to be the subject of the enquiry;
- what aspects of the transaction and its pricing is to be tested;
- the criteria by which the transaction is to be tested and
- what HMRC needs to understand in order to achieve this. (The information specified at this stage cannot be regarded as final and HMRC may need to make further or more detailed information requests as the enquiry progresses.)

An example is provided at Appendix C(2). The case team will aim to provide, and seek to agree, this analysis at the beginning of the enquiry. However, there will be cases in which additional significant transfer pricing issues emerge during the course of the enquiry and, in such cases, HMRC will provide these details as the new issue(s) emerge.

Risk assessment

C.12 It is essential that a full risk assessment is carried out to ensure that a) businesses are subject to enquiry only in appropriate cases and b) any enquiry is properly focused on identified high risk transactions.

C.13 Risk assessment in relation to transfer pricing will normally be part of a wider risk review. HMRC has set out its intentions with regards to risk review in the document “HMRC approach to compliance risk management for large business” (published March 2007). The document recognises that, for more complex and higher risk large businesses, we will gain a deeper understanding of tax risk from our direct engagement with business (supplemented by additional data where appropriate). It recognises that it is best practice to engage in open discussion about tax strategy, how tax impacts upon operations and the business approach to risk management. The practices and principles described in that document apply to transfer pricing risk in the same way that they apply to other risks.

C.14 There will normally be three elements to a risk assessment in relation to transfer pricing.

C.15 The first is the “quantum risk”. This is the value of tax at risk. In this context, to categorise a transaction as “high risk” does not necessarily imply that the pricing of the transaction is considered to be other than at arm’s length. Rather, a transaction will be “high risk” if the value of the transaction is such that incorrect pricing could lead to a significant understatement of taxable profit.

C.16 The second is behaviour risk. This is aligned with the HMRC risk framework described in paragraph C13 above. In line with the approach described in the paragraph above, the risk assessment in respect of transfer pricing should include an understanding of the system and processes the business has in place in order to manage its transfer pricing issues and ensure compliance. For more complex and higher risk businesses, we should seek to understand:

- the business approach to, and strategy for, transfer pricing compliance and tax planning;
- the processes the business has in place for identifying and understanding transactions that fall within the transfer pricing regime;
- the systems in place for capturing pricing and other terms in place for such transactions and for assessing whether they meet the arm's length principle;
- the approach taken by the business for testing actual pricing against the arm's length standard and for making computational adjustments in the company tax return;
- the business systems in place with regards to transfer pricing. For example, is there a policy under which the various parts of the business are required to use demonstrably arm's length pricing? Or are parts of the business free to set their own pricing policy? How does the tax function capture and test pricing information and what part does it play in setting business pricing policy? What processes are in place for auditing pricing compliance policies?

C.17 The third is the transaction risk. This is concerned with the nature of the transaction and such issues as its complexity and whether it involves points of principle.

C.18 It is in the interests of business as well as HMRC that risk assessments in relation to transfer pricing are carried out thoroughly and with full information. Where there is a full understanding of the business and the transactions it undertakes, HMRC can identify those areas of highest risk and focus attention on those areas. This enables HMRC to be clear about the particular transactions to be tested in an enquiry and for information requests to be targeted. Furthermore, an early consensus between HMRC and the business on the high risk areas will also enable the business to focus its compliance efforts and analyses (including documentation) on those areas. HMRC will seek pre-return and/or pre-enquiry discussions with businesses in order to allow HMRC to work with them to understand and identify the key areas of transfer pricing risk. In many cases, such discussions already take place. HMRC will seek to expand these so that they become the norm.

C.19 Transfer pricing enquiries frequently rely on factual information relating to periods some years before the enquiry. This can present difficulties with obtaining reliable information, as records become difficult to locate and interpret and business personnel change. It is thus often advantageous for businesses to provide HMRC with real time information. This might be by means of presentations and other meetings. HMRC will discuss with businesses whether, and in what form, information on transfer pricing might be provided to HMRC.

C.20 There is substantial existing guidance on risk assessment in relation to transfer pricing at INTM 461010 et seq which should be referred to when carrying out the risk assessment.

C.21 In order to carry out a detailed and informed risk assessment, case teams need good quality information. As part of the risk assessment, HMRC will normally invite businesses to take part in pre-return and pre-enquiry discussions and relevant information would be provided to HMRC at this stage. However, HMRC cannot require businesses to provide information until an enquiry has been formally commenced and there will be cases where businesses are unwilling or unable to take part in pre-return or pre-enquiry discussions. In such cases, HMRC may not have the full information needed in order to carry out a fully informed risk assessment and it may be necessary to open an enquiry in order to obtain the information required to carry out a full assessment of transactions with affiliates. That is, at least part of the risk assessment phase will be carried out in the enquiry. In such cases, businesses should be asked, at the commencement of the

enquiry, to provide their documentation⁸ (in relation to transfer pricing) to support their return and self assessment.

[This consultation document includes a number of options for addressing the issues raised when detailed information is not available at the risk assessment stage.]

HMRC recognises that transfer pricing enquiries are diverse and not all require the same input. Accordingly methods will be developed to match resource input to the needs of the enquiry. These methods will take account of the three risks described above. That is, quantum risk, transaction risk (e.g. nature, complexity, etc) and behaviour risks.

Profiling cases in this way will foster consistency of approach, informing key decisions such as whether an enquiry is appropriate at all; and if an enquiry is appropriate, how this will be structured, resourced and managed going forward.]

Business case

C.22 The outcome of the risk assessment described above would normally be a decision as to whether there are transfer pricing issues that would justify further investigation. If there are such issues, the next action would be to develop a business case for opening an enquiry into one or more of those issues.

C.23 The key question addressed in the business case is: is there enough evidence that the case is of sufficient value and importance to HMRC to open an enquiry, given the resource commitment needed to conduct the enquiry?

C.24 The business case is the formal justification for opening an enquiry and should include:

- a description of the issues in point, including points of principle;
- the amount of tax potentially at stake, in both the year of enquiry and other years that will be affected by HMRC intervention, including likely tax adjustment and yield (if known);
- other issues that impact upon the risk. This would include whether the case would create a precedent (or is a test case), the risk assessment of the business (behaviour risk) and the risk assessment of the transactions in point (the transaction risk);
- risks involved in settling the case;
- the resource required to conduct the enquiry, including the input that will be required from transfer pricing and other specialists;
- an estimate of the timescale for completing the enquiry.

C.25 The level of information and analysis contained in the business case should be commensurate with (a) the degree of risk inherent in the transaction and (b) the expected complexity of the enquiry. Where an enquiry is expected to be relatively straightforward and not engage significant resource, the business case need not be detailed.

⁸ Paragraph 21 Sch 18 FA 1998 requires companies to maintain documentation in support of their return and self assessment. Guidance on documentation with regards to transfer pricing is contained in Tax Bulletin 37 and the International Manual at INTM433030.

C.26 The amount of information available at this stage will vary between cases and, in some instances, it may be difficult to estimate the impact an enquiry is likely to have on tax yield.

C.27 In most cases, the risk assessment will be carried out in collaboration with the business and there will be substantial information available to inform the business case. In such cases, it will be possible to include a relatively accurate assessment of the transactions in point and potential tax adjustment and yield. In cases where it is not possible to engage the business in the risk assessment, HMRC may have very limited details of the nature and value of transactions with affiliates, and of the methods used to set prices and test them against the arm's length standard. Such cases, however, may still represent a very real risk, even if it cannot be quantified. This will be the case, for example, if it is known from the nature of the business that there are likely to be high value transactions with affiliates, but there is no information available on how the pricing of those transactions is arrived at. In such cases it will still be possible to develop a business case based on the known potential risk, but acknowledging that it will not be possible to fully assess the risk until further information becomes available during the course of the enquiry.

C.28 The business case is an internal HMRC document and there is no expectation that it will be provided to businesses.

[HMRC is considering how transfer pricing enquiries are to be managed and is expected that such enquiries will be subject to more central review and monitoring than at present. It is yet to be decided who will have responsibility for drafting, reviewing and approving the business case.

This consultation document also provides details of a number of options available to address the issue raised where there is insufficient information available to carry out a full case assessment.]

Enquiry Timetables and Action Plans

C.29 An important feature of this guidance is the use of enquiry action plans and timetables, which act as “roadmaps” for the enquiry, and ensure active management of enquires. These will specify a timescale in which an enquiry will be expected to be completed. For these purposes, an enquiry will normally be treated as commenced at the time HMRC gives notice of enquiry into a company tax return. There will be cases, however, where transfer pricing issues arise within the scope of an existing enquiry at a point of time after HMRC has given notice of the enquiry. In such cases, the enquiry can be considered to have commenced when HMRC first introduces a transfer pricing issue within the scope of the enquiry.

C.30 A transfer pricing enquiry will be treated as completed at the point at which adjustments to taxable profits are agreed between HMRC and the business, or the point at which it is agreed no adjustments are due, or the time at which it is established that no agreement can be achieved and that the enquiry will be subject to formal proceedings. There will be cases in which an enquiry into transfer pricing is finalised (and treated as closed for the purpose of this guidance) but a closure notice cannot be issued. This will be the case, for example, where other issues continue to be the subject of an open enquiry or a group relief claim is awaited. There will also be cases where the progress of an enquiry is dependent upon the outcome of another case. In such cases, the timescale will need to be extended.

C.31 HMRC will seek to agree with the business an enquiry timetable at an early stage in the enquiry. This timetable will provide for key stages of the enquiry, including details of the phases of the enquiry, dates for regular progress meetings or calls with the business, issue of information requests, time limits for the business to respond and for key meetings. Further guidance on the development of a timetable is included in Appendix C (1). The timetable will include agreed timescales for the submission of information by the business to HMRC. The detail and complexity of the enquiry timetable will be commensurate with the size and complexity of the enquiry.

C.32 As mentioned above, the enquiry timetable and action plan will specify a timescale for the completion of the enquiry. In most cases, this would be expected to be no longer than 18 months. However, a longer timescale (but no more than 36 months) may apply in exceptional cases which are both particularly complex and high risk. In those exceptional cases, HMRC will still conduct the enquiry to the same standards as cases to which an 18 month timescale applies.

C.33 Where the business does not wish to agree an enquiry timetable and framework, HMRC will take a view as to whether the case is particularly complex and high risk and will inform the business of its view and the timescale in which it aims to complete the enquiry. In such circumstances HMRC will use formal powers as necessary to progress the enquiry in line with the timescale.

C.34 Whilst it would be virtually impossible to provide an exhaustive definition of what “particularly complex and high risk” means in the context of transfer pricing enquiries, HMRC considers that the factors described in the following paragraphs would be indicative of cases that would meet these criteria. This list of indicators is not intended to be prescriptive in limiting the definition of these terms and it should be noted that not all of these indicators will need to be present to make a case “particularly complex and high risk”. Some of the factors (such as business restructuring) will be common to both categories but no repetitions have been made in the lists below.

C.35 The level of complexity of a case will need to be gauged by reference to both procedural elements of the enquiry that will affect the ability of HMRC to meet its expected normal timescale and the nature of the transactions under consideration.

The following would be seen by HMRC as indicators of particular complexity.

- Cases involving business restructuring (that is, cases that involve a major change to the way that the business is conducted).
- Cases involving transactions relating to the use of intellectual property.
- Cases where the point at issue is whether the characterisation of entities is properly reflected in the pricing methodology applied.
- Cases where HMRC needs to use formal information powers and formal proceedings to force progress towards settlement.
- Cases where information is difficult to obtain either because of legal impediments, the relationship between the parties or the necessity of using Exchange of Information procedures under Double Taxation Conventions.

C.36 As regards the definition of high risk no attempt will be made to apply a fixed value in terms of tax or price to transactions that would automatically make a case “high risk” but the amount at stake will generally be a consideration for HMRC in both risk assessment and in “categorising” a case.

The following would be seen by HMRC as indicators of high risk.

- The behaviour of the business, measured in line with HMRC’s risk assessment framework, and consideration of culpability (if any).
- Cases involving transactions with low tax jurisdictions.
- Cases with a precedent value.

C.37 In terms of applying the appropriate timetable to an enquiry, in exceptional cases it may be obvious at the commencement of an enquiry that the case is particularly complex and high risk and that a longer timescale than the normal target of a maximum of 18 months should be applied. HMRC will inform the business where this is the case. There may also be cases where it becomes clear during the course of the enquiry that there are elements of the case that bring it within the scope of being particularly complex and high risk. In these circumstances it will be necessary for HMRC to review the timetable to establish whether it will be possible to still meet the normal time limits for resolution or whether a longer period should apply. The result of the review will be discussed with the business so that the appropriate timetable can then be applied.

C.38 The enquiry timetable should be monitored during the course of the enquiry and (in discussion with the business) updated as needed. This will occur at the review points within Stage Gate 4 described above, but the timetable should contain the flexibility to be reviewed and revisited as necessary during the course of the enquiry.

C.39 As mentioned above, the timetable will include a target date for the completion of the enquiry. It should be made clear that an enquiry will not be closed down for the sole reason that a target date has been, or is expected to be, missed.

Obtaining relevant information

C.40 HMRC will routinely use existing information powers if the business does not provide full and relevant information in a timely manner. This will include cases in which the business is unable to agree to an enquiry timetable or does not submit information in accordance with an existing timetable. Those powers include Paragraphs 27 Schedule 18 FA 1988 and Section 20(1) TMA 1970 (for “first party” particulars and documents) as well as third party enquiries under Section 20 (3) TMA 1970 (for documents). These powers will be used in accordance with published instructions in the Enquiry Manual (at EM 1550 and 2201 et seq). In addition, the Exchange of Information provisions of the relevant DTA will be used where necessary.

C.41 If HMRC considers that Exchange of Information is required through its competent authority, then this should, where possible, be undertaken at an early stage of the enquiry, because of the built in time lapse involved. An exchange will be considered only where there is a significant risk to the UK tax base in connection with the business under enquiry and the information sought cannot be obtained by alternative means.

Responsibilities of the Business

C.42 HMRC will aim to work and complete transfer pricing cases within a defined timescale. However, the speed at which HMRC is able to conduct a transfer pricing enquiry will depend in part on the co-operation of the business concerned. Where such co-operation is not forthcoming, HMRC will still apply the practices described in the paragraph above, and seek to complete the enquiry within a specified timescale, but can be expected to use the formal powers open to it in order to achieve this.

C.43 In order to be able to complete an enquiry in the most effective and speedy manner, HMRC will expect the following from businesses.

C.44 At an early stage in the enquiry, businesses should endeavour to agree with the HMRC enquiry team a documented enquiry plan and timetable (as described in paragraphs C29 to C39 above). Once agreed, businesses (as well as HMRC) should make every effort to act fully in accordance with that timetable. If, due to unforeseen circumstances, it is not possible to keep to the timetable, businesses and HMRC should seek to agree a revised timetable.

C.45 Businesses are required to maintain relevant documentation (in accordance with published guidance) that can be made available to HMRC on request during an enquiry⁹. As described above, HMRC will seek pre-return discussions with businesses in order to understand the latter's business processes and to agree between them the most important transactions and risks. These discussions should enable the business and HMRC to agree on those transactions which warrant in-depth analysis and documentation and those transactions which, because they are agreed to be lower risk, require less extensive documentation. Such discussions should also provide an indication of the type and form of documentation that would be most useful and acceptable to HMRC. If, for whatever reason, the business and HMRC are not able to hold such discussions or reach consensus on the scope and type of documentation needed, HMRC will expect documentation, in accordance with CTSA requirements and published guidance, to be made available, on request, at the beginning of an enquiry. If such documentation is not available at that time, HMRC will seek to apply penalties for failure to maintain adequate documentation. In addition, failure to maintain documentation may be regarded by HMRC as evidence of neglect. This will affect the question of whether penalties may be applicable, and, if so, the amount of such penalties, in the event of an adjustment to taxable profit.

C.46 Businesses are expected to fully resource the enquiry.

C.47 Businesses should provide a response to information requests in accordance with an agreed timetable.

C.48 As mentioned above, transfer pricing enquiries often require an in-depth understanding of the way in which a business operates and this frequently entails detailed fact-finding. This is usually best achieved through meeting with business personnel. In such cases, HMRC will expect businesses to provide access to relevant business personnel.

⁹ Paragraph 21 Sch 18 FA 1998 requires companies to maintain documentation in support of their return and self assessment. Guidance on documentation with regards to transfer pricing is contained in Tax Bulletin 37 and the International Manual at INTM433030.

APPENDIX C (1)

Further Guidance on enquiry action plans and timetables.

C.49 As mentioned in paragraphs C29 to C39, above, HMRC will seek to agree an enquiry action plan with the business at the beginning of any enquiry. This would include a statement of the key features of the enquiry and a timetable for the conduct of the case.

C.50 *Key features:*

The enquiry action plan should include:

- details of the transaction or transactions subject to the enquiry;
- details of the resource commitments the business and HMRC agree to be available for the working of the enquiry;
- details of the HMRC and business teams working the enquiry, together with named primary contacts (including the CRM, where there is one);
- a statement of the objectives of the enquiry. This might include, for example, a statement that “HMRC and the business will either agree whether an adjustment is due (and, if so, its quantum) or establish that the issue will move to litigation, by [date]”;
- a broad statement of how that objective is to be achieved;
- details of the communications processes to be put in place. For example, it might be agreed to set up a shared internet workspace.

C.51 *Timetable*

An example of the timetabling of a transfer pricing enquiry is set out below. Rather than set a rigid timeline for the enquiry process, the aim of this purely illustrative example is to show the elements of the enquiry that will need to be considered in drawing up a timetable. As mentioned above, the commencement of a formal enquiry should not normally be the first steps in the enquiry process and should, under best practice, follow on from pre-enquiry discussions between the HMRC and the business.

C.52 After the risk assessment and business stage gates have been completed, in each appropriate case, HMRC will give notice of an enquiry into a return (which includes transfer pricing issues). Best practice will be for HMRC to give the notice of enquiry and to issue its initial clarification of which transactions are to be tested (see paragraph C11 above) and requests for information at a meeting with business to establish:

- The appropriate timetable within which the enquiry is intended to be completed, and
- The design of that specific timetable.

C.53 The timetable will need to include all of the elements set out below. Given variations in information systems, staff availability etc, the timetable and each element within it will need to be individually designed, taking into account the factors affecting both the business and the HMRC team involved.

C.54 Having agreed the length of the enquiry period (which may be up to thirty-six months based on the level of risk and complexity of the issues) the first stage of the enquiry process will be the gathering of relevant information by HMRC. The amount of information to be requested,

including site visits and meetings with personnel from the business, will often depend on what has been made available to HMRC during the risk assessment period. If the business held discussions with or made a presentation to HMRC during this period, the request might be restricted to information to verify the facts and further information required to fully understand the nature of the transactions and the transfer pricing applied in respect of them. Where no such discussions have taken place, the request would be expected to be more extensive and the time period allocated for gathering and providing the information would need to be set with this factor in mind. Such a request would usually include the documentation (relating to transfer pricing) maintained in accordance with the requirements of the CTSA regime, if this has not been provided during pre-enquiry discussions.

C.55 Setting the time period for the provision of information will also need to be based on the ability of the business to access and provide the relevant information and will be the result of discussion and agreement. To ensure that the timetable is kept to throughout the process, best practice will be to timetable regular discussions of progress against the plan and allow flexing of the timetable where appropriate.

C.56 The next element of the timetable that will need to be defined is the length of the period in which HMRC will review the information provided. The setting of the timescale for this stage will be usefully informed by discussion of both the format and volume of information that the business will provide. The timetable should include a meeting at the end of the information review period at which HMRC can set out its findings and seek any necessary clarifications of the information provided. It should be noted at this point that HMRC's findings, at the end of any information review stage, might be that further information is required. The timetable will thus need to build in a flexibility that allows for further information gathering and review, where it is appropriate to the case.

C.57 Once the review of all relevant and appropriate information has been completed, HMRC will discuss the results of its review with the business in a meeting. The results of HMRC's review will range across a spectrum from the enquiry being settled on the grounds that all of HMRC's concerns have been addressed to a situation where HMRC's concerns have not been satisfied and the enquiry must continue. Given the range of possible outcomes, best practice is that the timetable should be drawn up based on the assumption that the enquiry will continue past the information gathering and review stages. As a result, both the business and HMRC will be prepared for the ongoing enquiry to be appropriately resourced.

C.58 The timetable will need to include a period by the end of which the business will respond to any concerns on the part of HMRC arising from its review of all of the information provided. At the end of the information review process, HMRC will clearly set out its areas of continuing concern so that the business is aware of which specific issues and areas need to be addressed. The timetable should incorporate the possibility of revision here, if appropriate, based on how best to progress the enquiry. During the period in which the business is preparing its response or seeking further information, the timetable should provide for regular update discussions to ensure that the plan for completion will be met. The timetable should include a meeting at the end of this period, at which the business will be able to make any further representations and clarifications that it wishes HMRC to consider.

C.59 *The remainder of the agreed timetable will concentrate on resolution of the enquiry. Regular discussions and meetings should be planned with a view to completing the enquiry within the agreed timescale. In this context, "completion" will include the situation where it is decided to resolve the case through litigation but not the completion of the litigation itself.*

C.60 The timetable will normally include agreed dates for regular update meetings or conference calls.

APPENDIX C(2)

Further guidance on informing the business of the points at issue

C.61 As described in Paragraph C11 above, HMRC will be clear and open about the transactions that are to be subject to a transfer pricing enquiry. The following example illustrates the approach described in that paragraph. That is, HMRC will specify:

- which transaction(s) is(are) to be the subject of the enquiry;
- what aspect(s) of the transaction and its pricing is to be tested;
- the criteria by which the transaction is to be tested, and
- what HMRC needs to understand in order to achieve this.

Example

C.62 This example concerns a UK company (UK Ltd) engaged to provide research and development activities on behalf of an overseas affiliate (Non-UK Ltd). The method the group employs to set the pricing is a cost-plus method, under which Non-UK Ltd pays UK Ltd a sum consisting of UK Ltd's costs, plus a mark-up of 10%. This is characterised in UK Ltd's transfer pricing documentation as a "contract research" arrangement.

C.63 *The transaction(s) subject to enquiry.*

The transaction to be tested is the provision of research and development facilities by UK Ltd to Non-UK Ltd.

C.64 *The aspect(s) of the transaction and its pricing to be tested.*

HMRC will test whether cost-plus is an appropriate method to set the pricing between UK Ltd and Non-UK Ltd.

C.65 *The criteria by which the transaction is to be tested.*

HMRC will consider whether the actual functions carried out by UK Ltd and Non-UK Ltd are consistent with their respective characterisations as low-risk research provider and research contractor.

C.66 *What HMRC needs to understand in order to achieve this.*

HMRC will need to understand:

- I. How decisions are made concerning the identification and prioritisation of research projects, who makes these decisions and where the people making them are located.
- II. How R&D projects are financed, the process by which funding is allocated to projects and how such funding is approved. Who is involved in making these decisions and where are they located?
- III. The ownership of any value (including IP) arising from the R&D.
- IV. The process for reviewing and assessing R&D projects. Who is involved in this and where are they located?

In order to achieve this HMRC will issue a detailed information request and will wish to meet with key people from the business.

2006 REVIEW OF LINKS WITH LARGE BUSINESS

PROPOSAL 5: TRANSFER PRICING ENQUIRIES

Policy objective

D.1 The objective of the proposal is, in the administration of transfer pricing rules, to provide greater certainty and speedier resolution of issues for companies through clear dialogue and an efficient risk based approach.

Background

D.2 Transfer pricing rules must be applied, where appropriate, by companies when making a tax return for a period. Companies must have evidence to demonstrate that the results of relevant transactions are what would have happened at arm's length. Tax returns are made to HMRC who can make enquiries into returns and request documents or other particulars

Rationale for government intervention

D.3 The 2006 Review of Links with Large Business a joint review involving HMRC and representatives of large business, agreed on a number of proposals to improve the relationship between HMRC and companies for the benefit of all parties and to maintain and enhance the attractiveness of the UK as a place to do business in and to do business from.

Consultation

D.4 The Review was conducted on a consultative basis and the conclusions were agreed by HMRC and representatives of large business. The proposal concerning transfer pricing enquiries was subject to informal consultations between January and March 2007 with companies, professional advisers and other interested parties. The main conclusions were:

- it was confirmed that the priority for businesses was to achieve greater and earlier certainty;
- the cost of complying with transfer pricing rules was an even greater concern for businesses than the time taken to resolve enquiries;
- the main issues for businesses involved knowing what sort of evidence HMRC would find acceptable and how to apply a risk based approach in assembling it;
- EU Transfer Pricing Documentation is the result of an encouraging debate to improve the position on an international basis but does not provide a complete answer;
- businesses were generally keen for an improved relationship with HMRC based on trust and transparency including involvement with HMRC before returns were made and, where appropriate, real time auditing;
- some businesses, however, pointed out that they already did everything necessary for compliance and wanted to see a clear advantage from any increased pre-return involvement;

- HMRC was one of the best national tax administrations in the application and auditing of transfer pricing, although there was still considerable scope for improvement;
- improvements in the performance of HMRC, while welcome, would have limited impact without equivalent improvements in other countries.

Options involving evidence

D.5 The options concerning the basis on which evidence is assembled by businesses and provided to HMRC were:

- Option 1: Introduce a requirement that all companies (or a defined sub-set of companies) with relevant transactions with related businesses during a period should provide HMRC, at the time a return is made for that period, with all of their transfer pricing documentation.
- Option 2: Recognise EU Transfer Pricing Documentation as best practice, retaining its optional status for companies; the documentation would be provided to HMRC, if requested, after a return had been made; HMRC would have the right to request more information than that contained in the documentation (or would have been contained if the company had prepared it).
- Option 3: Introduce a requirement that all companies (or a defined sub-set of companies) with relevant transactions with related businesses during a period should provide HMRC at the time a return is made for that period with a standardised form with details of specified transactions to which transfer pricing rules apply.

D.6 Option 1 would impose a significant additional compliance cost on all companies that were required to provide HMRC with documentation. Almost all large companies, some medium companies and a few small companies are affected by transfer pricing rules. Medium and small companies could be exempted from the requirement. The option would provide HMRC with comprehensive information at the time a return is made to enable a full risk assessment to be undertaken to decide whether an enquiry should be initiated and the particular issues on which any enquiry should focus.

D.7 Option 2 should impose no additional compliance cost compared with what is required in any event. It would not automatically provide HMRC with any more or earlier information than it gets at present.

D.8 Option 3 would impose an additional compliance cost on all companies that were required to provide HMRC with a standardised form. The amount of the cost would depend on the scope of the standardised form, but would be less than for Option 1. Medium and small companies could be exempted from the requirement. The option would provide HMRC with some information at the time a return is made to assist risk assessment and a decision whether an enquiry should be initiated and the particular issues on which any enquiry should focus.

Proposed new approach

D.9 The new approach being developed by HMRC would involve greater specialisation of staff on transfer pricing and greater use of team working. Improved training would be given and outside expertise would be brought in where appropriate. HMRC would aim to work with companies in some aspects of risk assessment to arrive at a shared view of areas of higher and lesser risk so that attention could be focussed on the former. Where enquiries were taken up, HMRC would aim to agree action plans with the companies and would actively monitor progress.

D.10 Some companies might choose to engage in a dialogue with HMRC before a return was made. Such companies would stand to benefit from the opportunity to influence HMRC's views at an early stage about the relative risk of different transfer pricing issues, an early indication of the issues HMRC regarded as higher risk, a lower chance of being subject to enquiries where pre-return discussions had dealt with the issues, speedier enquiries, where they took place, to the extent that the issues to be addressed had been identified from the start, and the opportunity to reduce compliance costs in obtaining and keeping evidence relating to lower risk issues. HMRC would benefit from the ability to conduct a well informed risk assessment with these companies.

D.11 The compliance costs incurred by companies that chose not to engage in a dialogue with HMRC would not change, but HMRC would still conduct a risk assessment and there might be a higher chance, especially where large companies were involved, that such companies would be the subject of an enquiry and requests to provide documentation.

Other options

D.12 The possibility has been considered of introducing "safe harbours" which, in defined circumstances, would specify an amount to be used for transfer pricing purposes. There is a wide variety of ways in which this might be done. This option is not being pursued further at present.

D.13 It is proposed that the requirement to obtain the Board's approval for transfer pricing adjustments should be abolished when a new approach to transfer pricing enquiries is implemented. This would require legislation. It would involve a small efficiency saving for HMRC. In effect, the time spent on Board's approvals would be redeployed on the management of transfer pricing enquiries.

Measuring outcomes

D.14 The statistics for transfer pricing enquiries in 2006-07 are:

transfer pricing issues resolved during year: about 1,000

transfer pricing issues open at 1 April 2007: 580 (LBS only)

average time issues open: 21 months.

Small firms

D.15 Small and medium-sized enterprises are exempt from transfer pricing rules except for transactions where the other party is in a country with which the UK does not have a bilateral double taxation treaty containing a suitable non-discrimination article.. In the case of medium-sized enterprises, the exemption is subject to a reserve power under which HMRC can require a business to calculate its taxable profits on the basis of arm's length results. This power is exercised only in exceptional circumstances where there is a blatant manipulation leading to a significant loss of UK tax..

Competition

D.16 The new approach to transfer pricing enquiries will have no adverse effect on competition.

Implementation

D.17 HMRC will draw up implementation plans including a review of current enquiries, putting in place action plans and gateways, introducing specialisation, redeploying staff, training, and enhancement of management information systems.