More than a decade has passed since the introduction of new transfer pricing legislation in the UK. This article discusses recent developments that are changing the way practitioners and taxpayers need to think about transfer pricing.

**HMRC’s stance**

In 2007, HMRC released its Litigation and Settlement Strategy, which sets out principles for bringing tax disputes to a conclusion. The main thrust of this strategy is for HMRC to focus on cases where a significant amount of tax is at stake (either directly or through a deterrent or policing effect on taxpayers generally), and to pursue rigorously those cases that are opened, either by settling at full-value, or by litigating. Implementing the strategy has involved HMRC entering into pre-return discussions as part of the new risk assessment procedure followed since July 2008.

HMRC appears to have been true to its word. In 2008/09, for instance, the UK tax authority is reported to have opened less than one third the number of the approximately 350 transfer pricing cases that it settled during the same period. HMRC has not indicated what types of industries or transactions it considers high risk, but cases involving valuable intangibles can be expected to be the subject of particular focus.

At the same time as adopting the Litigation and Settlement Strategy, HMRC has also sharpening its focus on transfer pricing. In 2008, it created a specialist Transfer Pricing Group. This group was merged the following year with a separate team that dealt with permanent establishment issues, financial services and finance related transfer pricing. HMRC is understood to have expanded the number of specialists it devotes to transfer pricing (including economists), and has invested significantly in training.

Speculation abounds about where things will go from here. Are Dixons and other current cases, for instance, representative of a trend or isolated examples? A point made extensively in the academic literature on the economics of crime and punishment is that deterrence is the product of two factors – the likelihood of being called to account and the magnitude of sanctions applied. The implication if the Litigation and Settlement Strategy is to achieve its goals is that Dixons and other current cases will indeed represent a trend.

**Recent cases in transfer pricing**

A great deal of attention has been paid to the landmark case involving captive (re)insurance arrangements entered into by the retailer, DSG Retail Ltd (Dixons), and an associated company in the Isle of Man, Dixons Insurance Services Ltd (DISL). HMRC’s challenge to the Dixon’s position focused on premiums paid to DISL for carrying out its (re)insurance function, even though there were actually no direct transactions between Dixons and DISL.

Following confirmation *inter alia* that a ‘provision’ existed between Dixons and DISL (which is clear from an economic perspective), the arm’s length remuneration payable to DISL was considered. Here comparable uncontrolled price (CUP) and transactional net margin method (TNMM) data put forward by Dixons were subject to a great deal of scrutiny by HMRC’s expert economist witness. Based on his analysis, the Special Commissioners rejected each of the purported CUPs on grounds of inadequate comparability. In the case of the TNMM observation, the Special Commissioners found that the comparator had considerably greater bargaining power. Therefore, and since it was found not to be possible to make reliable adjustments, the comparable was dismissed.

In the absence of reliable CUP/TNMM data, the Special Commissioners agreed with HMRC’s expert that a residual profit split method was appropriate. This conclusion was noteworthy given that profit split is usually seen as appropriate in cases where more than one party to the transaction contributes significantly, whereas DISL was found to bear relatively little risk and play a relatively ‘routine’ role. Either way, the Special Commissioners left determining the arm’s length outcome to the parties, and the case was settled for an amount understood to be in excess of £50 million.

**SPEED READ**

With the adoption of its Litigation and Settlement Strategy, HMRC is expected to pursue the transfer pricing enquiries it opens rigorously. More will be demanded of analyses in such cases, as is illustrated in the proposed revisions to the OECD’s Transfer Pricing Guidelines, and evidenced in the detailed, economics-based scrutiny of transfer pricing arrangements and comparables in the Dixons ruling and other cases around the world. Where risk-assessment highlights a potential exposure to challenge, an approach will be warranted that goes beyond basic documentation and penalty protection. This will increase costs for some – but not all – taxpayers, but also form the starting point for more strategic, value-adding and robust solutions.

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If the Litigation and Settlement Strategy is to achieve its goals... 

**Dixons** and other current cases will indeed represent a trend

There has also been a steady procession of cases elsewhere. In *Glassomithkline Inc.* (Canada, 2008) and *Société Van Camions et Bus* (France, 2009), comparability was also a key question determined by reference to economic factors. In *GE Capital Canada Inc* (Canada, 2009), of particular interest was note made in the ruling to the effect that proper application of the arm’s length principle required consideration of the guarantee fees GE Capital Corporation would charge were it, *ceteris paribus*, not related to its subsidiary. This illustrates very well what is arguably the correct application of the arm’s length principle, and something about which there is still a great deal of confusion. Specifically, when abstracting from the impact of the shareholder relationship, the commercial and financial relationship *as-is* remains the relevant context. These cases will influence the thinking of HMRC and other tax authorities about transfer pricing, as they will the minds of tribunals and courts also.

**Revised OECD Transfer Pricing Guidelines**

In September 2009, the OECD released a discussion draft on proposed revisions to its Transfer Pricing Guidelines (OECD Guidelines). The proposed revisions will change the way tax authorities (and tribunals or courts) expect practitioners and taxpayers to conduct transfer pricing analyses in important ways. We mention here two changes in particular.

First, the revised Chapter II of the OECD Guidelines will, if adopted (which seems likely), relax the current hierarchy of specified methods that lends profit-based methods (TNMM and profit split) their formal status as methods of last resort. In doing so, the OECD has acknowledged firstly that there has been an elephant in the room for some time – ie that TNMM has become the method of first default. The OECD has also recognised that modern multinational enterprises operate in an increasingly integrated manner with matrix structures and operating processes that typically span borders, and furthermore that ownership of and access to intangibles are becoming more important issues in transfer pricing. If this view is correct, and there are few who dispute it, then it seems reasonable to argue that the profit split method will be used more often than has been the case.

Second, Chapter III of the revised OECD Guidelines introduces as an example a ten-step, iterative process described as ‘good practice’ in comparability analysis. Such a process is seen in the proposals as playing a role from start to finish in every element of transfer pricing analyses. The steps are:

- **Step 1** A broad-based analysis of the taxpayer’s circumstances;
- **Step 2** Determination of years to be covered;
- **Step 3** Understanding the controlled transaction in particular on a functional analysis;
- **Step 4** Review of existing internal comparables, if any;
- **Step 5** Determination of available sources of information on external comparables;
- **Step 6** Selection of method and, if applicable, definition of profit level indicator;
- **Step 7** Identification of potential comparables, in accordance *inter alia* with significant comparability factors identified in Step 3;
- **Step 8** Determination and making of comparability adjustments where appropriate;
- **Step 9** Analysis and interpretation of (adjusted) comparables data, determination of arm’s length remuneration; and
- **Step 10** Implementation of support processes, and a review mechanism to ensure adjustment for material changes and processes.

This, or a similar, process clearly would raise the bar and appears to reflect a view amongst OECD Member States’ that too much transfer pricing analysis has been below par. This was made evident in the earlier discussion draft on comparability, which called for analyses to go beyond some vague categorization of one of the parties to the controlled transactions followed by the use of lightly examined comparable companies. This apparent frustration makes it seem likely that a process similar to that proposed (and there is ample reason for improvement of that version) will be incorporated into the new OECD Guidelines, a conclusion made more telling by the high threshold of comparability set in the Dixons case.

**PEs: Methodological spillover**

Another development that has attracted substantial interest was the release by the OECD of its report on the attribution of profits to permanent establishments (PEs). This report was released in its final form on 18 July 2008.

The report adopts the functionally separate entity approach as the ‘authorised OECD approach’ for attributing profits to PEs and puts forward the significant people functions (SPF) concept as a key analytical tool in identifying control over risks. In strict terms, the SPF concept relates only to the attribution of profit to PEs where there is no contractual confirmation of the relationship between the parties involved. The position of group entities working together in integrated operations, however, has much in common with the relationship between an entity and a PE, and the SPF concept seems likely to have a profound impact on how transfer pricing analyses are conducted. This point already seems accepted by many practitioners, although it should be noted that application of the concept will have its limitations (eg where intangible assets are acquired or developed over a long period of time).

**Implications for UK business**

Transfer pricing is changing important ways, and HMRC can be expected to pursue cases more rigorously where the stakes are high. As demonstrated by proposed revisions to the OECD...
Guidelines and recent rulings, more will be demanded of transfer pricing analyses in such cases. Accordingly, it would seem prudent for taxpayers and practitioners alike to think a little differently about transfer pricing.

First, risk assessment needs to play a decisive role in determining the approach taken in setting and defending transfer prices. Relevant factors here will typically include HMRC’s own risk assessment of the taxpayer, the nature of the controlled transaction, the overall relationship between the transacting parties, sums involved, and the quality of supporting data likely to exist.

Where the balance of risks and probabilities suggests vulnerability, an approach is warranted that assumes a high level of scrutiny and goes beyond the standard required for basic documentation and penalty protection. In this regard, the proposed revisions to the OECD Guidelines and decisions in recent cases provide a useful guide. Particular points to consider will include:

- engaging in detailed industry value chain and function and risk analysis, rather than presenting a statement of facts and tick-box function and risk analysis;
- paying greater attention in functional analysis to the performance of what might be called significant people functions;
- moving beyond ‘routine’ benchmarking and demanding a greater standard of rigour for comparables;
- applying quantitative techniques to the adjustment of comparables (e.g. using mathematical modelling techniques to price adjustment clauses in IP transfers);
- deriving economics based tests of market data (e.g. the application of models developed in financial economics to thin capitalisation, the use of real options to value incomplete R&D or exploration licences);
- using second methods to support primary results, especially profit split analysis.

Undoubtedly, this will increase costs for some – but not all – taxpayers. Equally well, transfer pricing enquiries not anticipated with appropriate preparation may unveil unexpected but significant exposures for a company, and the ultimate cost of having taken the cheap option is several orders of magnitude higher when things go wrong. Striking a balance therefore constitutes a wider business issue of risk management. Conducting a detailed analysis in situations that warrant it will lead to more robust solutions and is akin to a conducting reasonable due diligence before making an investment.

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