

United Kingdom

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I. Introduction/Scene-setting

The UK transfer pricing (TP) rules¹ are, broadly speaking, designed to counter tax loss generated by non-arm's length pricing between related parties. They do this by implementing the arm's length principle as articulated in the OECD Model Tax Convention on Income and Capital; and they operate by substituting, for the purposes of calculating taxable profits, arm's length terms in place of the actual terms of transactions between connected parties.

The UK TP rules provide that they are to be construed in a manner consistent with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the TPG).² This includes Paragraphs 1.37 to 1.41 of the TPG, which recognise that, exceptionally, it may be appropriate to disregard the actual structure adopted by a taxpayer in entering into a controlled transaction. Further, the UK TP rules specifically apply to cases where a non-arm's length provision is made between any two persons, but no provision at all would have been made had they been acting independently.³

Very few TP cases have been litigated through the UK courts. The leading case is the landmark decision of the UK Special Commissioners (a specialist first-instance tax tribunal) in the *Dixons* case.⁴ Briefly put, the facts were that Dixons, a UK company, sold electrical goods to retail consumers, and also offered extended warranty protection for those goods. The liability to customers was insured/reinsured by an associated Isle of Man company (*DISL*), with a third party insurer standing in the middle. A substantial part of the insurance/reinsurance premium was left in *DISL*. The UK revenue authorities (HMRC) considered that these profits should be brought into charge in the UK, and invoked the UK TP rules to support their position. Their argument, in essence, was that a benefit had been conferred upon *DISL* by the UK retail operation which would not have occurred had the parties been operating on a wholly arm's length basis. This benefit took the form of the provision of a business opportunity involving an unrelated party.

Outside the TP arena, recharacterisation is a well known concept in UK tax law. There is a long line of cases, running from the 1980s to the present day, in which the UK courts have done down tax planning schemes by recharacterising them as some alternative transaction.⁵ The "traditional" recharacterisation approach involves disregarding steps inserted into a pre-ordained series of transactions, or disregarding/coalescing circular or self-cancelling steps, where those steps have "no commercial (business) purpose apart from the avoidance of a liability to tax", and then taxing the adjusted end result.⁶ More recently the recharacterisation doctrine has been recast as one of "purposive interpretation".⁷ But the earlier cases have not been overruled, and remain good law.

II. Issue One

In what ways has the "recharacterisation" concept discussed in Paragraphs 1.37 to 1.41 of the TPG been clarified by legislation, guidance and case law in the UK?

A. TP legislation, guidance and case law

As described above, the UK TP legislation must be construed consistently with Paragraphs 1.37 to 1.41 of the TPG. However, HMRC guidance indicates that "recharacterisation is expected to be very rare where the issue is the sale of goods or provision of services. Recharacterising the actual transactions is more likely to be appropriate in the financial arena."⁸ Furthermore, the guidance states that "disregarding the structure of a provision remains the exception rather than the rule", although it is recognised that "tax-driven fragmentation of businesses has considerably increased the number of situations where it may be "appropriate and legitimate" to proceed on the basis that the provision would not have been made had the parties been unconnected."⁹ Additional comments in the guidance indicate that there is a high hurdle to cross before it will be appropriate to recharacterise a transaction under TP principles: "this is a very difficult area and it would be necessary to ascertain all the facts and circumstances of a case, together with any evidence that arrangements would not have existed between third parties, before concluding that a provision should be set aside."¹⁰

UK case law has, to date, had very little to say about recharacterisation in the TP context. The concept was only very briefly (and then only obliquely) touched upon in the *Dixons* case. It was contended by HMRC that it was appropriate to impute an upfront profit commission payment from *DISL* back to the UK. The Special Commissioners disagreed. They considered that this would entail reducing the amount of cash retained by *DISL* to secure its obligations, and thus would undermine the commercially required robustness of the insurance structure, which would not be compatible with the UK TP rules. Although no specific mention is made of the principles set out in Paragraphs 1.37 to 1.41 of the TPG, it appears that the Special Commissioners considered HMRC's approach would require an impermissible degree of recharacterisation. This supports the suggestion in HMRC's guidance (noted above) that recharacterisation is seen as something of a weapon of last resort in the TP arsenal.

Considering the first example in Paragraph 1.37 of the TPG,¹¹ it is considered unlikely that this situation would be apt to be recharacterised under the UK TP code. One would expect the TP rules to apply to deny deductions for interest payments in excess of what would be achievable on an arm's length basis, rather than applying so as substantively to recharacterise the transaction as a subscription of capital. It is also worth noting, in this connection, the long-standing HMRC practice of not requiring the TP adjustment of

an outward interest-free loan, where that investment is in practice standing in the place of equity.¹²

B. Non-TP legislation, guidance and case law

There are many examples of the UK government responding to tax avoidance schemes with targeted anti-avoidance measures; and many of these measures seek to tax transactions in accordance with their economic substance, rather than their form. This is, of course, consistent with the approach advocated in the TPG. A recent example of this “recharacterisation by legislation” is the “disguised interest” rules,¹³ which aim to tax returns from arrangements that produce amounts economically equivalent to interest in the same way as interest, notwithstanding that the amounts in question may not, as a legal matter, represent interest.

The UK courts have traditionally shied away from adopting an explicit “substance over form” approach to their analysis of UK tax cases, although some decisions in the lower courts have come quite close to this on occasion.¹⁴ They have been similarly reluctant to impose tax otherwise than “by reference to what [the taxpayer] has actually done, and not by reference to some different transaction with the same or similar effect.”¹⁵

Regarding the second example in Paragraph 1.37 of the TPG (where form and substance are the same, but the transaction is “irrational”), the concepts of commercially rational transactions and structures which do not impede analysis by the tax authorities are not typically linked in the UK case law. There are cases which take the approach of disregarding steps in transactions which have “no business purpose” and whose inclusion can only be explained by reference to tax factors.¹⁶ This has echoes of the “commercially rational” test. Furthermore, the doctrine of “sham” (recognised in itself as a version of the “substance over form” principle) can be seen to have parallels with the concept of recharacterising structures which practically impede analysis by the tax authorities: under established UK case law, transactions may be disregarded where the documentation implementing them is revealed as a sham,¹⁷ or where the transactions actually undertaken are inappropriately characterised by the parties.¹⁸ It may also, in limited circumstances, be possible to lift or pierce the corporate veil if the use of a particular structure has been designed for the purpose of evasion.¹⁹

III. Issue Two

In what ways has the concept of recharacterising a transaction based on a comparison of the purported allocation of risk under the transaction with the economic substance of that transaction (as discussed in Paragraphs 1.25 to 1.27 of the TPG) been clarified by legislation, guidance and case law in the UK?

A. TP legislation, guidance and case law

UK TP legislation and guidance have little to say about the circumstances in which it is appropriate for a tax administration to recharacterise a transaction based on a purported allocation of risk which does not accord with the economic reality.

There is some discussion in the *Dixons* case of the relative ability of each of the parties to bear risk. Notwithstanding that the amount of risk borne by DISL was not necessarily commensurate with its reward from the arrangements, the court did not consider it appropriate to seek to recharacterise the transaction on the basis of an arm’s length risk allocation. It is, however, interesting to note the links here with the “relative bargaining power” concept developed by the Commissioners in the *Dixons* case, which was ulti-

mately used as the basis for calculating the recommended split of residual profits between DISL and Dixons.

B. Non-TP legislation, guidance and case law

Non-TP legislation, guidance and case law also has little to say in this connection. There are echoes in Paragraphs 1.25 to 1.27 of the TPG of some of the concepts that are familiar to UK tax lawyers from the *Ramsay* line of recharacterisation cases. Statements such as “it may be considered whether a purported allocation of risk is consistent with the economic substance of a transaction”²⁰ has similarities with the (modern) approach to purposive interpretation of taxing statutes, which requires one to analyse the facts “realistically”.²¹ If a purported allocation of risk were not realistically to reflect the true economic arrangements between the parties to a transaction, a court might feel able to recast the transaction and analyse the arrangements on the basis of a more realistic allocation of risk.²² Mention of the “purported” allocation of risk also carries faint echoes of the “sham” doctrine mentioned in Issue 1 above, although it is doubtful that a UK court could apply this doctrine to recharacterise either the example given in Issue 2, or the examples in Paragraphs 1.25 to 1.27 TPG. Case law makes it clear that the threshold is set quite high in this respect, and the courts seem generally reluctant to make a finding of sham in all but the most extreme cases.²³

IV. Issue Three

In what ways has the issue of determining the correct allocation of risk between parties to a transaction which has no market comparables (as discussed in the Business Restructurings Discussion Draft²⁴) been clarified by legislation, guidance and case law in the UK?

A. TP legislation, guidance and case law

Ascertaining the appropriate arm’s length allocation of risk and reward was a key issue in the *Dixons* case. In support of its TP position, Dixons tabled a number of transactions which it claimed were comparable with its approach (and to the extent that they were not perfectly comparable, it was said that adjustments could be made). HMRC’s case was that if an appropriate comparable uncontrolled price (CUP) could not be found, it was necessary to resort to other (OECD-endorsed) pricing methodologies, including transactional profit methods, and in particular the profit-split method. The Special Commissioner’s decision contains a detailed discussion of various comparable transactions advanced by Dixons, and indeed gives prominence to the OECD guidelines on comparable uncontrolled prices (CUPs). However, each of the various comparables analysed was regarded as a fundamentally unsuitable comparator, or as one for which appropriate adjustments could not be made, particularly as regards inequalities of bargaining power. It followed that the CUP method was unavailable. The Commissioners therefore agreed with HMRC that a profit-split method was appropriate, notwithstanding HMRC’s guidance that this approach is a “method of last resort” and that “the possibility of using the more traditional methods should have been exhausted before [transactional profit methodologies] are considered”.²⁵ The Commissioners considered that a suitable approach was one which tested the appropriate return on capital for DISL, with the residual profit accruing to Dixons in the UK (because the economic profits of the arrangement as a whole arose primarily due to Dixons’ point of sale advantage as retailer). A formulaic application of the capital asset pricing model was proposed as a reasonable approach to cal-

culating DISL's cost of equity, and the TP adjustment was made by way of supplemental profit commission payable by DISL.

B. Non-TP legislation, guidance and case law

The questions raised in Issue 3 are not ones which are specifically addressed in nonTP legislation or guidance in the UK. There are, however, some interesting links which might be made, as regards the approach to comparable transactions, with some antiavoidance case law, and in particular the *Tai Hing* case.²⁶ The statutory provision in point in that case allowed the tax authorities to assess the taxpayer (a) as if the transaction had not been entered into or carried out, or (b) in such other manner as was considered appropriate "to counteract the tax benefit which would otherwise be obtained". The court felt this clearly hypothesised not only that the actual transaction did not take place, but that some other transaction took place instead – the authorities could assess "on the hypothesis that there was a transaction which created income, but without the features which conferred the tax benefit." What, though, should the terms of this "alternative transaction" be? The court did not believe it was necessary to hypothesise "that the taxpayer had entered into an alternative transaction which attracted the highest rate of tax." Instead, the approach should be to adopt "the hypothesis which the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit." Australian authorities in a comparable context suggest that the comparator transaction must be a "reasonable" one.

V. Issue Four

In what ways has the concept of recharacterising transactions on the basis that an independent party would not enter into a transaction that was detrimental to it, rather than to its group, if it had the option realistically available to it not to do so (as discussed in the Business Restructurings Discussion Draft) been clarified by legislation, guidance and case law in the UK?

A. TP legislation, guidance and case law

UK TP legislation, guidance and case law shed little light on whether HMRC would feel able to recharacterise transactions on the basis that an independent party would not enter into a transaction that was detrimental to it, rather than to its group, if it had the option realistically available to it not to do so (as the Business Restructurings Discussion Draft suggests should be possible). The ability to recharacterise transactions is, as mentioned above, contemplated in the UK legislation – both specifically²⁷ (noting that the specific provision provides no assistance in determining *when* it would be appropriate to proceed on the basis that the provision would not have been made had the parties been unconnected)²⁸ and through incorporation of the TPG.²⁹ This incorporation does not, however, extend to the Business Restructurings Discussion Draft. The question to be asked in a UK context, therefore, is the fundamental one of whether the provision in question differs from the arm's length provision which would be made between independent entities: if it can in fact be established that an independent party would not take account of its group position in entering into a transaction, there is scope for the UK TP rules to apply.

Regarding the commerciality limb, it should be remembered that the TPG (and, through them, the UK TP rules) do not have a purpose of preventing multinational enterprises from benefitting from being multinational enterprises: "associated enterprises may engage in transactions that independent enterprises would not undertake . . . members of an MNE group face different commercial circumstances than would

independent enterprises."³⁰ The TPG permit the re-pricing of transactions to an arm's length level, but (other than in the exceptional circumstances described in paragraph 1.37) they do not support the approach of requiring entities to behave as if they were completely independent.

One point to note is that the Discussion Draft adds a gloss to the statement quoted in the question for Issue 4, which is that "in assessing the commerciality of a transaction that is part of a broader overall arrangement, it is important not to examine the transaction in isolation, but to look at the totality of the arrangements to determine whether the terms make commercial sense for the parties." A key argument for the taxpayer in this situation must surely be that it is appropriate to have regard to the wider group of which it forms part in assessing the commercial rationality of a given transaction.

B. Non-TP legislation, guidance and case law

See the response to Issue 1 above for some comments on the parallels to be drawn between the "commercially rational" test, and the "business purpose" test developed in nonTP case law.

A familiar approach in UK tax legislation (beyond TP) is to adjust transactions between connected/related parties, where the transactions are not entered into on arm's length terms. In the context of the charge to tax on capital gains, for instance, acquisitions and disposals between connected persons are deemed to be made for a consideration equal to the market value of the asset.³¹ This rule applies irrespective of the actual price paid; and is without regard to the wider benefits that may accrue to the groups of which the parties form part through the parties agreeing to transact on a nonarm's length basis. This approach, however, focuses on the pricing of the transaction. There is no concept, in this context, of completely ignoring the transaction actually entered into, and the legal relations created thereby. *Danny Beeton is Head of transfer pricing economics at Freshfields Bruckhaus Deringer in London and may be contacted by email at: danny.beeton@freshfields.com Murray Clayson is a Partner in Freshfields' tax practice group in London and may be contacted by email at: murray.clayson@freshfields.com Mark Boyle is a Senior Associate in the Tax practice of Freshfields' London office and may be contacted by email at: mark.boyle@freshfields.com.*

NOTES

¹ Found in Schedule 28AA, Income and Corporation Taxes Act 1988 (Schedule 28AA).

² Paragraph 2, Schedule 28AA.

³ Paragraph 1(3), Schedule 28AA.

⁴ *DSG Retail Ltd v. R&CC* [2009] UKFTT 31 (TC).

⁵ The key case from which the recharacterisation principles in use today derive is *WT Ramsay Ltd v. IRC* [1981] STC 174.

⁶ *Furniss v. Dawson* 55 TC 324.

⁷ *BMBF v. Mawson* [2005] STC 1. Under the approach adopted in this case, it is necessary to consider whether the facts, viewed realistically, meet the statutory provisions, construed purposively.

⁸ HMRC International Manual (*INTM*) 432030.

⁹ INTM464130.

¹⁰ INTM464130.

¹¹ The example given is an investment in an associated enterprise in the form of interest-bearing debt when, at arm's length, having regard to the economic circumstances of the borrowing company, the investment would more naturally be expected to be structured as a subscription of capital. Here, the economic substance differs from the form of the transaction.

¹² See e.g. Tax Bulletin 37, published on 4.9.98. This guidance has now been updated to the INTM.

¹³ Chapter 2A, Part 6, Corporation Tax Act 2009.

¹⁴ See e.g. *Spectrum Computer Supplies Ltd v. HMRC* [2006] STC (SCD) 668.

¹⁵ Per Henderson J in *Tower MCashback LLP1 v. R&CC* [2008] STC 3366.

¹⁶ See e.g. *Collector of Stamp Revenue v. Arrowtown Assets Ltd* [2003] HKCFA 46. As a decision of the Hong Kong courts, this case is only of persuasive, not binding, precedent value in the UK. Nonetheless, it was cited with approval by the House of Lords in *Mawson* (see fn 7 above).

¹⁷ See e.g. *Snook v. London and West Riding Investments Ltd* [1967] 1 All ER 518 and *Hitch v. Stone* [2001] STC 214.

¹⁸ See e.g. *Welsh Development Agency v. Export Finance Co Ltd* [1992] BCC 270, CA (a non-tax case).

¹⁹ See e.g. *Re H and others* [1996] 2 All ER 391.

²⁰ Paragraph 1.26, TPG.

²¹ See fn 7, above.

²² In *Arrowtown* (see fn 16 above), the court refused to accept that arrangements which purported to involve an issuance of shares actually did so, on the basis that these “shares”, viewed realistically, gave no real entitlement to a “share” in the “capital” of the company.

²³ See e.g. the approach of the Special Commissioner in *Tower MCashback* (see fn 15 above).

²⁴ The OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings, September 2008.

²⁵ INTM463060.

²⁶ *CIR v. Tai Hing Cotton Mill (Development) Ltd* [2007] FACV No 2. See also *IRC v. Hong Kong International Terminals Ltd* [2007] FACV Nos 9 and 17. As decisions of the Hong Kong Court of Appeal, these judgments are again only of persuasive value in the UK. However, an influential former member of the House of Lords handed down the unanimous judgment in each case, and they are thought to be of relevance to the development of UK law.

²⁷ Paragraph 1(3), Schedule 28AA.

²⁸ INTM464130.

²⁹ Strictly, a requirement to interpret the “basic rule” in paragraph 1, Schedule 28AA consistently with the TPG.

³⁰ Paragraph 1.10, TPG.

³¹ Sections 17 and 18 Taxation of Chargeable Gains Act 1992.