United Kingdom

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2009 was an important year for UK transfer pricing developments

There have been important developments in the UK over the last year in terms of a new focus on enquiring into fewer, larger and higher risk transfer pricing cases, more guidance on the role of Advance Thin Capitalisation Agreements (ATCAs), the decision in the first significant UK transfer pricing case and the judgment in the Thin Cap Group Litigation Order (GLO). As we move into 2010, revised guidance is expected from HM Revenue & Customs (HMRC) on thin capitalisation and a resolution in the second major UK transfer pricing case.

I. Developments within HMRC

A. Transfer Pricing Group

A Business International Division (BID) was established within HMRC in January 2009 with a remit to address international tax issues including certain aspects of transfer pricing. The BID, headed by Judith Knott, has assumed governance of the Transfer Pricing Group formed in 2008. For most of 2009, thin capitalisation, financial services transfer pricing, the attribution of profits to permanent establishments, the anti-arbitrage rules and the Investment Management Exemption under Schedule 26 Finance Act 2003 and section 818 Income Tax Act 2007 were addressed by a separate specialist financial transfer pricing team. Towards the end of the year the head of this specialist team (Mark Carnduff) also became the head of the general transfer pricing team and they were merged.

B. Trends in transfer pricing enquiries

HMRC are concentrating on transfer pricing enquiries in relation to larger high-risk transfer pricing cases where they see a likelihood of capturing a reasonable amount of tax. To put this new focus in perspective, HMRC achieved a reduction of 35 percent in the number of open transfer pricing cases in 2008/ 2009, settling approximately 350 transfer pricing cases and opening only 109 new cases in that period. As part of this initiative, HMRC have, since July 2008, been entering into pre-return discussions as part of their new transfer pricing risk assessment procedure. HMRC have not said whether particular industries or transactions are to be regarded as high-risk but questions often arise in respect of valuable intangible assets and royalties and therefore the type of industries involved often include pharmaceuticals, technology, media and telecommunications, food and beverages or other branded consumer goods.

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II. ATCAs

A brief was issued by HMRC on January 12, 2009 giving more guidance on ATCAs. The briefing provided that ATCAs (created under HMRC Statement of Practice 04/07 in November 2007) should be submitted before filing the relevant tax return but after the relevant transaction has taken place. The brief further noted that ATCAs will not be available for general thin capitalisation forward agreements, interest imputation on outward loans or quasi-equity discussions or agreements on appropriate levels for guarantee fees, although the briefing notes that these issues as well as the level of return appropriate to a group finance or treasury company may be considered if raised during discussions about potential ATCAs.

III. Statutory developments

A. Senior accounting officer

The introduction by Finance Act 2009 of a requirement for Senior Accounting Officers of large companies (failure in respect of which attaches personal penalties) to take reasonable steps to ensure that the company and its subsidiaries establish and maintain appropriate tax accounting arrangements is likely to turn management's attention to transfer pricing risk management.

B. Worldwide debt cap

The 2009 Budget confirmed that the new UK worldwide debt cap rules will be introduced with effect for periods of account beginning on or after January 1, 2010. The rules are contained in Schedule 15 to the Fi-

nance Act 2009 and broadly limit the tax deductible amount in the UK of net financing expenses of a multi-national group by reference to the total gross external financing expenses of the group.

The UK transfer pricing rules operate independently of the debt cap rules so that, even where they are operating within established ATCAs, UK companies within a multi-national group may find deductions for finance costs restricted under the new rules. HMRC published new guidance on the worldwide debt cap rules in December 2009 with further guidance, including in respect of the interaction of the rules with other rules, to follow.

C. Related party loans – late interest

Finance Act 2009 relaxed an anti-abuse provision that previously prevented a debtor from claiming deductions for accrued interest owed to a connected party where that interest was paid "late" and not fully brought into account. Thus for accounting periods beginning on or after 1 April 2009, companies can claim interest deductions on an accrued basis on much late paid connected party debt. The old restriction continues, however, to apply to loans from tax haven companies.

IV. Case law

2009 has seen a significant transfer pricing decision in the tax tribunal and the handing down of a judgment in the High Court in respect of the long-standing Thin Cap Group Litigation. Further significant cases are preparing for trial.

A. The DSG case

Publication of the Special Commissioners' decision in *DSG Retail Limited v Revenue & Customs Commissioners* (2009 TC00001) on April 23, 2009 presents a landmark case for UK transfer pricing. *DSG* is the first UK case concerned with transfer pricing methodologies and the first case on the detailed transfer pricing statutory code enacted by Finance Act 1998 and incorporated into the Income and Corporation Tax Act 1988 as Schedule 28AA TA 1988.

The case, which overall represented a victory for HMRC, has now been settled by agreement and therefore will not be proceeding before the High Court.

DSG Retail, a UK company, was an electrical goods retailer which arranged for customers to purchase extended warranty agreements with an unrelated company (Cornhill initially, and subsequently another independent company, ASL) Cornhill/ASL in turn entered into an insurance or reinsurance (the model changed for indirect tax reasons) agreement with Dixons Insurance Services Limited (DISL), an Isle of Man company associated with DSG Retail, under which Cornhill/ASL's premium income was largely ceded to DISL. Cornhill was involved as DISL was not authorised by the FSA to underwrite insurance business in the UK. The Commissioners held that that these arrangements formed "a series of transactions" involving both DISL and DSG Retail, therefore falling within the UK transfer pricing regime.

DSG Retail was remunerated by Cornhill/ASL for customer introductions. HMRC challenged the arrangements on the basis that a benefit had been conferred upon DISL by DSG Retail and that it was appropriate also to impute a fee back from DISL to DSG Retail to reflect this benefit; although the customer contracted with an independent third party, the arrangement was only entered into on the basis that back-to-back arrangements with DISL would also be entered into (thus Cornhill/ASL acted, in effect, as conduits). Broadly, HMRC's position was that, as DISL was earning its profit from business generated by DSG Retail and the insurance/warranty was relatively low risk, similar arrangements on an arm's length basis could be expected to generate significantly higher revenue for DSG Retail.

DSG argued that it was inappropriate to regard the chain of contracts as either a "business facility" for the benefit of DISL (section 770 Income and Corporation Taxes Act (ICTA) 1988) or a "provision" from DSG Retail to DISL (Schedule 28AA ICTA 1988). If it were appropriate to impute an arm's length price, DSG justified the premiums paid to DISL by reference to several potential internal "Comparable Uncontrolled Prices" (CUPs). These CUPs were rejected by the Commissioners as, in turn, too old (one comparable dated from 1982), relating to different products (presenting higher or lower insurance risks), involving the sale of goods in a different situation (i.e. not in stores), and because they did not reflect, or could not be adjusted reliably to allow for, the relative bargaining power of DSG Retail in its relationship with DISL (the comparable related to an insurer with an established market position dealing with numerous customers and therefore considered to hold significant bargaining power). In the Commissioners' view, bargaining power rested with DSG Retail rather than DISL. The Commissioners concluded that no traditional transactional method could sufficiently reflect this position (being one where DISL's profit was effectively fixed by DSG Retail's rather than its own bargaining power), and that thus a transactional profit method had to be used.

DSG firmly establishes the concept of relative bargaining power within UK transfer pricing. Although the Commissioners declined to attempt to quantify the level of DISG's bargaining power, they used the concept to:

- recommend a split of residual profit taking the relative bargaining power of DSG Retail and DISL into account (residual because the Commissioners identified a minimum routine profit that should have accrued to DISL on the basis of a market return on capital employed)
- identify a "point of sales advantage" conferred by DSG Retail's network of stores
- conclude that a supplier which is the only supplier of a service (in this case DISL's supply of insurance/ reinsurance) does not necessarily have significant

bargaining power, even if the high cost of entering the market would be a barrier to entry for potential competitors
- illustrate that the appropriate transfer pricing result can change over time due to fluctuations in relative bargaining power, for example, during contract re-negotiations.

Given the difficulty in establishing sufficiently robust comparables and the increasing use of economic concepts in transfer pricing enquiries, *DSG* lends weight to the argument that there is a move towards recognising the profit split method as more than a method of last resort. This is confirmed at the international level by the draft revisions to Chapters I-III of the OECD's *Transfer Pricing Guidelines for Tax Administrations and Multinational Enterprises* (TPG) noted below, which propose an abandonment of the traditional hierarchy of methods.

1. Implications for transfer pricing planning and compliance

In addition to making it clear that HMRC will look at the transaction as a whole, *DSG* suggests that it is now appropriate, in the context of transfer pricing planning, to give weight not only to how functions, risks and assets are organised but also to how bargaining power is allocated, having regard, for example, to status, competitive position and the rates at which subsidiaries discount future profits.

> "A number of case management points have arisen following DSG Retail"

Turning to ongoing compliance, *DSG* suggests that it may be appropriate to revisit "benchmark" comparable uncontrolled transactions to examine whether they might be ruled inadmissible on the basis that the relative bargaining power of the parties involved is not comparable taking into account factors such as intangible assets and rate of time preference (as well as factors mentioned above). It may then be advisable, for internal risk minimisation, to corroborate any benchmarking exercise with a total, or residual, profit split and consider whether that profit split follows the relative bargaining power of the parties involved. It certainly seems highly probable that in future cases, HMRC may again seek to rule out potential CUPs on the basis of dissimilar bargaining power and to attempt to impose a residual profit split.

It is noteworthy that Lee Corrick, at that time Assistant Director at HMRC with responsibility for transfer pricing, asked the OECD restructurings working group to develop the concept of relative bargaining power as a key element in determining the transfer pricing method to be adopted and the appropriate arm's length price suggesting that the question of compensation to the restructured company should be addressed by answering the question: "given its relative bargaining power, could it have negotiated a better deal?".

2. Implications for case management

The case was heavily fact dependent, requiring a hearing of 15 days with extensive cross-examination of witnesses as to fact, together with the presentation of substantial expert evidence, all supported by thousands of pages of documentation. Even after conclusion of the three-week hearing it was necessary for both sides to agree to provide supplemental written submissions to the Special Commissioners to ensure that clarity was reached over the financial workings of the various contracts in question.

A number of points on case management have arisen following the DSG Retail case. In particular, the tax tribunal rules are likely to be aligned more closely with the rules of the commercial courts. For example, in appropriate cases, the litigation process will be more actively managed, e.g. with directions regarding witnesses and witness statements, and memoranda (ideally agreed by the parties) providing a short summary of the facts and questions. Such reforms will be welcome and indeed necessary, particularly given that, despite the intense importance of fact in *DSG*, some cases in the pipeline will dwarf that case in terms of complexity and evidence.

3. An increased level of litigation?

One of the cases currently under preparation for trial involves HMRC for the first time outsourcing the case to an external law firm. This reflected an acceptance by HMRC of the limitations of its own resources to fight major commercial litigation. However, it is evident that the costs involved for HMRC are a significant concern.

B. Thin Cap GLO judgment

On November 17, 2009, Henderson J handed down his judgment in the Thin Cap Group Litigation. Concluding that a conforming interpretation was not possible in this case, his judgment establishes that the UK's pre-2004 thin cap rules were incompatible with EC law on the basis that they did not provide for consideration of evidence of commercial justification and should therefore be disapplied where the relevant transaction was genuinely commercial. In light of that failing, Henderson J also considered it appropriate to reverse the burden of proof; it being for HMRC to show that the transactions lacked commercial justification by the bringing of positive evidence, not merely by showing that the arm's length test had not been met.

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The thin cap GLO claims, brought in the UK High Court, were stayed in December 2004 with a preliminary reference made to the European Court of Justice (ECJ) to consider, inter alia, whether the UK's rules were contrary to fundamental freedoms (namely Article 43 (freedom of establishment), Article 49 (freedom to provide services) and Article 56 (freedom of movement of capital) of the EC Treaty).

The ECJ's ruling on March 13, 2007 (*Case C-524/04* [2007] STC 906) clearly concluded that the UK's pre-2004 thin cap rules contravened Community law unless they could be interpreted as only applying to wholly artificial arrangements designed to obtain a tax advantage. In reaching this conclusion, the ECJ held that the pre-2004 rules primarily affected Article 43 (freedom of establishment) on the basis that they were targeted only at relationships within a group of companies; any restriction of Articles 49 or 56 being simply unavoidable consequences of the restriction of Article 43 and therefore not deserving of independent examination.

Prior to April 1, 2004, the thin capitalisation rules had been contained in section 209 ICTA 1988 and particularly at section 209(2)(da) and (in broad terms) treated certain interest payments as non-deductible distributions where:

- the borrower and the lender were in the same group;
- the lender was not within the charge to UK corporation tax; and
- the interest exceeded the amount which would have been payable under arm's length arrangements.

UK-UK debt was effectively treated more favourably than UK-EU debt as the rules only applied where the lender was not within the charge to UK corporation tax. These rules were repealed by Finance Act 2004 and subsumed within the general transfer pricing provisions in Schedule 28AA ICTA 1988, which were extended to include UK-UK transactions at the same time. Henderson J concluded that

> "[t]he UK thin cap provisions at all material times infringed Article 43 EC (freedom of establishment), because of their failure to provide a separate and independent defence of genuine commercial justification".

1. Remedies

Henderson J considered whether English law provided an adequate remedy for the thin cap claims. Any claims in relation to interest repayments which had actually been recharacterised and where it had actually led to the payment of a greater amount of corporation tax or advance corporation tax were agreed by the parties to be *San Giorgio* claims (i.e., claims for repayment as distinct from claims for damages). Henderson J concluded that English law provided an adequate remedy, either in the form of restitution as a result of mistake of law (the claimants' mistake being as to the lawfulness of the thin cap provisions) or restitution of tax unlawfully demanded under the principle in *Woolwich Equitable Building Society v IRC* [1992] STC 657. The claimant could choose which of these causes of action to plead in order to give effect to a *San Giorgio* claim.

It was agreed between the parties that the following were not *San Giorgio* claims: claims for costs and expenses of complying with the thin cap rules; claims for loss of return on the money paid; and claims for foreign tax liabilities incurred in the lender's jurisdiction. Further, Henderson J concluded that claims where the UK borrower had been funded with equity instead of debt, or a lower rate of interest had been applied, so that the amount of interest paid by the borrower which might potentially be deductible was lower; and claims which were made for tax reliefs, allowances or credits used up in the borrower in order to offset the additional corporation tax, were also not *San Giorgio* claims as they required the intervention of an independent decision and were not an "inevitable consequence" of the discriminatory rules.

Henderson J held that a claim for damages would need to fulfil the conditions set out in *Brasserie du Pecheur and Factortame* C-46/93 and C-48/93 (March 5, 1996), including the condition that the breach causing the damage was "sufficiently serious". In this respect, Henderson J concluded that the judgment in *Lankhorst-Hohorst* C-324/00 (December 12, 2002), in which the ECJ held that the German thin capitalisation provisions on which the UK's post-1995 provisions were modelled were unlawful, should have alerted the UK to the illegality of its own thin cap rules and that from that point the UK's breach of the EC Treaty was sufficiently serious to found a claim in damages.

It is considered highly likely that HMRC will appeal this judgment.

2. Limitation periods – possibility of further claims?

The possibility of further claims being made will depend on the type of claim as the UK time limits for claims for damages differs from that for mistake-based restitutionary claims, to which the limitation period in section 32(1)(c) Limitation Act 1980 applies. Section 32(1)(c) provides that the limitation period does not begin to run until the plaintiff has discovered (or could with reasonable diligence have discovered) the mistake. Henderson J held that the limitation period under section 32(1)(c) ran from the date of the *Lankhorst* decision (i.e. six years from 12 December 2002) and that prior to that date, he did not consider that any mistake made by the claimants about the lawfulness of the thin cap regime could have been discovered with reasonable diligence. This raises questions as to whether any further potential claimants making mistake-based restitutionary claims would effectively be time-barred.

As noted above, Henderson J held that damages claims could only be made from 12 January 2002 when the "sufficiently serious" breach took place. Such claims would then need to be made within six years of the payment of unlawful tax or the other relevant loss (for example the use of group relief). In any

event, given that the judgment relates to the pre-1 April 2004 rules, any claims not already out of time will need to be made as soon as possible.

3. Is there scope for the bringing of similar transfer pricing challenges?

Pre-1 April 2004 transfer pricing rules

Prior to the amendment of Schedule 28AA ICTA 1988 by Finance Act 2004, sub-paragraphs 5(2)-(6) provided an exemption for UK-UK transactions from the basic UK transfer pricing provisions in Schedule 28AA. As a reaction to European law concerns, Finance Act 2004 removed these provisions thereby extending transfer pricing generally to UK-UK transactions. It is perhaps worth noting, however, that under paragraph 6 of Schedule 28AA, where a transfer pricing adjustment is imposed on an advantaged party, the disadvantaged party is able to make a corresponding adjustment in the calculation of its UK taxable income. This, together with the ability to surrender losses within a group, has meant that in most cases UK-UK transfer pricing does not lead, at a group level, to an increased UK tax cost. Further, the introduction by Finance Act 2004 of paragraph 7A of Schedule 28AA, which enables balancing payments to be made to the advantaged person by the disadvantaged person where a corresponding adjustment has been made, has the effect of cancelling the impact of many UK-UK transfer pricing adjustments, so that it may be questionable whether the Finance Act 2004 amendments really levelled the playing field in this respect.

Given that *Lankhorst* considered thin cap, rather than general transfer pricing rules, it would seem less clear in the context of a potential challenge to the pre-2004 transfer pricing rules that any limitation period under section 32(1)(c) should run from 12 December 2002.

Revised thin cap guidance

HMRC hope to publish revised thin capitalisation guidance at the end of January 2010. It seems likely that the guidance will emphasise the importance of analysing the individual facts and circumstances of each case and of finding a pragmatic solution in that individual context rather than recognising and suggesting widely used “safe harbour” or “universal” methodologies or ratios that could be relied upon in certain situations as providing the arm’s length answer.

V. UK response to OECD developments

The OECD released its proposed revision of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* on 9 September 2009. Public comment was invited until 9 January 2010.

The main changes relate to the more equal status that has been given to Transactional Profit Methods (TPMs) (previously suggested as applicable on an exceptional basis); the acceptance of a wider range of profit level indicators; and the clarification that quality is more important than quantity when reviewing potential sets of comparables, together with more detailed guidance on comparability analysis.

The limitations of Traditional Transaction Methods (TTMs) have, including in the recent UK case of *DSG* discussed above, become more widely acknowledged. In the draft guidance, the OECD recognises the inherent difficulty in establishing the transactional comparability required by TTMs stating that: “the differences in the characteristics of property or services are less sensitive in the case of TPMs than in the case of TTMs”. Lee Corrick noted that the revised chapters I to III of the TPG reflect HMRC’s thinking following *DSG* and do not, in HMRC’s view, give a lower role to CUPs, or set the bar higher for accepting them. Those in HMRC who have been involved in the redraft emphasise that their objective has been to avoid prescription and that HMRC will continue to refer to the facts and circumstances of each case in interpreting the TPG.

VI. Conclusions

In summary, 2009 has been an important year for UK transfer pricing developments. HMRC have brought a new focus to enquiries, employing specialist transfer pricing economists and showing a willingness to litigate where necessary. The landmark *DSG* decision has made it clear in the UK that the relationship between the parties including their inherent bargaining power is key to determining the appropriate transfer pricing method: it is no longer safe merely to rely on benchmarking results; the concept of relative bargaining power will import new economic concepts and techniques into UK transfer pricing.

In the coming year it will be interesting to see the revised thin capitalisation guidance in the light of the GLO decision (and to follow the course of HMRC’s likely appeal), and the outcome of the second major UK transfer pricing case.

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