

Advance pricing agreements: a UK perspective

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The UK's APA programme may offer assistance and practical reassurance, even if not pursued to a binding agreement

HM Revenue & Customs (HMRC) have operated an Advance Pricing Agreement (APA) programme in the UK for complex transfer pricing issues since 1999. An APA is a written agreement between a taxpayer and a tax authority which specifies the method for determining the treatment of one or more transfer pricing issues. APAs are normally prospective but can in some cases apply to past periods. APAs are intended to provide a taxpayer with certainty about how a tax authority will regard the matters covered by the agreement for its duration. Several of the UK's major trading partners also have APA programmes: for example, the USA, Canada, Germany, France, Australia and Japan.

Advance Thin Capitalisation Agreements (ATCAs), a sub-set of APAs, derive from the same UK legislation but are subject to separate guidance (contained in Statement of Practice (SP) 4/07). ATCAs are not discussed in this article.

This article provides a brief overview of the UK's APA rules, as supplemented by HMRC guidance. The rules have recently been rewritten as part of the UK's Tax Law Rewrite Project, and HMRC are in the process of revising their guidance. We consider some of the common concerns raised by taxpayers about the APA process in the UK, along with some of the potential benefits of seeking APAs. The article includes comments from an in-house tax professional at one of our major multinational group clients on practical experiences negotiating APAs (see Box 1).

I. Uni/bi/multilateral APAs

At its simplest, an APA can record a unilateral agreement between taxpayer and tax authority. However, a unilateral APA will not eliminate the risk of double taxation in cross-border transactions because it does not tie in the tax authority at the other end. Bilateral

APAs can be negotiated between tax authorities where the countries have a Double Tax Treaty containing a Mutual Agreement Procedure (MAP) article. Where a number of countries are involved, it may be possible to agree multilateral APAs (strictly, a series of bilateral APAs).

In some cases a unilateral agreement will be more attractive; for example, where the material issues relate to the UK and trying to address the non-UK issues would cause delay. It might also be necessary; for example, where there is no bilateral process between the UK and the other jurisdiction(s) involved. It can also be the case that taxpayers may find themselves somewhat on the sidelines of a MAP negotiation, with less influence compared to direct dealings with a single tax authority.

II. Common situations

APAs are most likely to be considered in cases where traditional transfer pricing methods are (for whatever reason) inappropriate or hard to apply. They may also help where groups have experienced major changes either in the way they conduct their business or in the business climate in which they operate. Cost sharing arrangements may also be good candidates for APAs, where there is sufficient uncertainty over the application of the arm's length standard.

III. Legislative background

APAs are somewhat unusual in UK tax law in providing a statutorily-backed basis for entering into binding private agreements with taxpayers on the treatment of particular transactions by reference to a thorough analysis of the facts. In other clearance processes, the outcome typically relies on an assumption

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Box 1: an in-house perspective

(These comments were contributed by an in-house tax professional at a major international group client. We would like to record our thanks to him for providing his practical insights.)

As a global organisation we view APAs as one of the tools available to us to manage tax risk. Certainty is the main benefit derived from APAs. However (and this is a point that is often overlooked), due to the time that it generally takes to agree APAs, there is significant uncertainty in accounting for the taxation of the inter-company transactions whilst the APAs are being negotiated. This uncertainty should not be more than that surrounding the same transactions had an APA not been requested, but due to the additional information that is available, e.g. certain lines of enquiry by the tax authorities, and additional scrutiny from the auditors, the tax accounting process tends to become more onerous.

What we use APAs for

Broadly, we tend to use APAs for:

- Obtaining certainty around inter-company transactions that are complex and are of such a magnitude that any adjustment to the inter-company prices for tax purposes will have a significant impact on profits.
- Eliminating potential double taxation. Although this should also be possible under the mutual agreement procedures in the relevant double tax treaties.
- Mitigating potential penalties on unpaid taxes. This is often not achieved under the mutual agreement procedures.
- Managing tax exposures in open years that will in all likelihood lead to significant tax adjustments and penalties through the use of the roll-back option in certain jurisdictions.
- Obtaining a measure of control over the actions of some tax authorities. In some jurisdictions the tax authorities may act unreasonably with respect to transfer pricing and the application of the OECD Transfer Pricing Guidelines. In order to achieve a reasonable result, an APA is a proactive alternative to appealing the position in the courts. By requesting an APA the authorities are often forced to take a more reasonable approach due to the commitment by both authorities to reach a negotiated position.

Practically, unilateral APAs have not been of significant use to our organisation as they do not provide the certainty provided by a bilateral APA.

Because bilateral APAs are negotiated by the tax authorities and therefore the outcome is unpredictable, APAs are of limited or no use when trying to manage the effective tax rate. The exception is that the taxpayer may be able to avoid penalties.

UK experiences

Our experiences with the APA programme in the UK have been positive – certainly more so than in other jurisdictions. On paper the APA rules and guidelines may appear to be unclear and could lead to the taxpayer feeling uncertain whether it meets the requirements. In practice, we have found the process to be co-operative, transparent and clear.

HMRC have always been willing to openly discuss any APA requests at an early stage before any significant amount of time and resource has been committed to putting together the APA application. After the initial meeting HMRC have also been prompt and clear in communicating whether they believe the “complexity” threshold has been met.

In our view HMRC’s approach to the APA process has always been pragmatic and flexible.

Experiences in other jurisdictions

Unfortunately, this approach is not always mirrored in other jurisdictions. This can lead to increased uncertainty and the need to commit time and money to the APA application prior to having certainty that it will be accepted into the APA programme.

Another negative aspect is the time that it takes governments to agree an APA position. This could lead to a lot of uncertainty within the business, not only when it comes to tax accounting, as I mentioned above, but also other practical issues such as what a company’s capital structure will look like after any adjustments under the APA and how to deal with tax claims and elections in the interim.

Part of the reason for time delay is certainly down to a lack of resources within HMRC. However, more often than not it is down to other territories not being able to negotiate a position.

Other considerations

Costs can also be prohibitive. Compiling the APA application requires a high level of application, time and expertise, and therefore it is expensive to put together. In a large multinational organisation such as ours, the cost benefit analysis is generally fairly straightforward, but I can imagine that it may be more difficult to decide whether an APA application is worth the time, money and effort/distraction in smaller organisations. A point that is worthwhile making, however, is that we have certainly found that, apart from assistance with the initial approach and application, we have been able to manage the remainder of the APA process in-house in the UK. This has reduced costs considerably. Again this is not necessarily true in some other jurisdictions where the APA processes can be very rigid and the taxpayer needs the advice of external advisers who deal with the APA processes on a day to day basis.

In summary, we believe that APAs are a useful tool in managing taxes. However, the taxpayer should be very clear in what he/she wants to achieve when requesting an APA.

that the facts as presented by the taxpayer are accurate, without any further investigation by HMRC.

The APA rules, previously in sections 85 to 87 Finance Act 1999, have been rewritten to Part 5 Taxation (International and Other Provisions) Act (TIOPA) 2010. The substance of the rules appears to be unchanged. In general the new layout and headings make the rules easier to follow but, in now familiar rewrite style, they have been “simplified” without being shortened.

The following may be covered by an APA:

- the attribution of income to a UK permanent establishment (PE);
- the attribution of income to a PE, wherever located;
- the extent to which income is treated as arising outside the UK; and
- the treatment of provisions made between “associated” persons (section 218 TIOPA 2010).

The rules do not specifically provide for a determination that a PE exists, although some of these issues will be agreed on the basis that one does exist. In other cases where a taxpayer is concerned that HMRC might argue that a foreign associate has a UK PE within the scope of the issues covered by the APA, HMRC may agree that no income will be attributed to the potential PE.

An APA binds HMRC and the taxpayer as regards the matters covered by the APA, which will be exclusively determined for UK tax purposes according to an agreed methodology as long as the agreement is in place (section 220 TIOPA 2010). APAs are typically for three to five years but can be renewed provided the

issues and methodology are substantially unchanged. They may be modified if circumstances change without invalidating the “critical assumptions” on which the APA is based. In the case of unilateral APAs, they may also be modified by HMRC to give effect to the terms of any MAP agreement with another country concerning the same issues.

APAs are primarily intended to have prospective effect, but can also “roll back” an agreed treatment for earlier periods (section 224 TIOPA 2010). This can be useful for resolving open enquiries (see further below).

Taxpayers are required to provide information to HMRC “from time to time” (section 228 TIOPA 2010) for the purposes of demonstrating that they have complied with the APAs terms and that the assumptions on which the methodology have been agreed remain appropriate. In practice HMRC ask for annual reports.

Although intended to be binding, HMRC can revoke an APA if they determine that:

- a taxpayer has not complied with a “significant provision” of the agreement (section 221(3) TIOPA 2010);
- a “key condition” of the agreement has not been met or is no longer met (section 221(4) TIOPA 2010); or
- a taxpayer fraudulently or negligently provided HMRC with information which was false or misleading (section 226(4) TIOPA 2010).

In the first two cases, the APA will cease to have effect from the relevant time (section 221(1) TIOPA 2010). In the third case, the APA will be treated as if it had never been made (section 226(6) TIOPA 2010).

IV. HMRC guidance

The UK's APA rules are fairly skeletal; the process is substantially fleshed out in HMRC's published guidance. SP 3/99, which explains how HMRC apply the rules, was last updated in August 2005. HMRC are preparing guidance to replace SP 3/99 and reflect more recent experience. No dramatic changes are expected, although there have been indications from HMRC that the new guidance may be less prescriptive about the format of the application and more positive about unilateral APAs.

At the joint IFA/HMRC meeting on June 25, 2010, Melissa Tatton, Deputy Director of HMRC Business International and head of HMRC's Transfer Pricing Board, stressed the high priority attached by HMRC to improvements to the UK's APA programme and the likely increased utility of unilateral, bilateral and multilateral APAs. We understand that the APA entry requirements are also under review, including the "complexity" threshold.

SP 3/99 contemplates a four stage application process: expression of interest, formal submission, evaluation and agreement. The process is intended to be cooperative and to promote open discussion.

Common taxpayer complaints include that the process is too onerous, too focused on bilateral APAs and too vague about what sorts of issues will meet HMRC's complexity threshold (carrying the risk that one invests in the early stages of the process only to be rejected later).

Less prescriptive guidance (e.g. on the requirements of the annual report) and a stronger statement of case-by-case flexibility might encourage more taxpayers to brave the process.

Similarly, a more positive reception for unilateral APAs in appropriate cases would give recognition to the difficulties sometimes encountered in engaging other tax authorities on MAP requests, and reflect that bilateral APAs are not possible where there are gaps in the UK's treaty network (which, for example, seems often to be the case in the oil industry) or where the treaty partner has no APA process. However, it is understood that most UK APAs are still bilateral and that most applicants request bilateral agreements (although to date that may say more about HMRC's preference for bilateral agreements than taxpayer interest in unilateral agreements).

More guidance on the complexity threshold would also be helpful. HMRC seem to regard a transfer pricing issue as "complex" when it is not clear how the arm's length standard should be applied, or where there is an absence of reliable market comparables. This is quite a broad indication, and HMRC may intend it to cover less than it does. As a gateway to the APA programme, the complexity threshold seems designed to discourage taxpayers from seeking to clear transfer pricing positions more generally, and reflects that HMRC have limited resources to consider applications (it is understood that around 50-60 cases are currently in the UK's APA programme, and that around 20 will be added annually with a similar number closed out). This can leave a taxpayer in some doubt as to whether to commit time – and money – to the process.

However, in practice HMRC have seemed open to early, informal discussions. This can go some way to helping taxpayers gauge whether their issues are sufficiently complex from HMRC's point of view to justify putting more effort and resources into the application process. Those early discussions can be anonymous, fronted by the taxpayer's advisers. HMRC say that "complex" does not necessarily mean "large", although smaller businesses may be less likely to need the APA process, e.g. they may be exempt from the UK's transfer pricing rules to begin with.

V. APA benefits

If a taxpayer can "get with the programme", the benefit may go beyond future certainty. HMRC are also prepared to address pre-existing issues in APA applications. In suitable cases, an APA might help a taxpayer resolve open issues with HMRC against the background of a process that should (at least in theory) draw less heat than a formal enquiry. This could become a more attractive secondary objective as HMRC continue to toughen up on transfer pricing disputes.

HMRC also seem willing to discuss transfer pricing issues under the APA rubric even where taxpayers do not – and perhaps, from the outset, do not intend to – make formal applications. A taxpayer might walk away with an impression of HMRC's views on an issue, which may provide some – albeit, non-binding – comfort without pursuing the process to its end. There is something in it for HMRC, too: the thinking seems to be that this encourages compliant behaviour and provides insight into innovative transfer pricing methods and, potentially, unfamiliar industries or circumstances. On both sides, a move to a more "real time" discussion of issues should be welcomed. Issues can be worked through more dynamically before positions harden and, as mentioned, for the taxpayer there is at least the prospect of an early assurance that arrangements are on track.

Information provided to HMRC during the process should be kept confidential in the same way as other taxpayer information (in a bilateral process it may be shared with treaty partners under the exchange of information article in the relevant Double Tax Treaty). Nonetheless, taxpayers may worry that information volunteered to HMRC as part of an APA application could lead to extra scrutiny in unexpected ways. That will be part of the assessment in deciding whether to seek an APA, or how far to take the process.

HMRC will also hear initial expressions of interest on a no-names basis, e.g. through a taxpayer's adviser. For some taxpayers, this could be a relatively risk-free way to dip one's toes before jumping in.

VI. Critical assumptions

Getting the assumptions right is critical to avoiding post-agreement headaches. If the assumptions fail, HMRC could revoke the APA. The recent economic downturn underlines the importance of building in enough tolerance in the parameters to withstand some change. Assumptions that depend on the reliability of predictions about future profit are particularly vulnerable. The assumptions on which an APA is

based should be agreed with great care (and, ideally, limited); they are likely to be second in importance only to the methodology used to resolve the issue (or issues) raised in the application.

VII. Conclusion

APAs are a feature of transfer pricing systems in the UK and elsewhere. Taxpayer experiences of using APA programmes often vary depending on the tax authority involved. In the UK, HMRC have shown a willingness to be flexible and more or less formal depending on the issues and the taxpayer's expectations. For tax-

payers dealing with complex transfer pricing issues, the UK's APA programme may offer assistance and practical reassurance, even if not pursued to a binding agreement. It is more likely to be a positive experience if taxpayers are clear about their objectives early in the process.

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