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Hard to Value Intangibles

1. Does your country have specific rules granting tax authorities the ability to either a) consider actual results as a relevant factor when examining the arm's length nature of ex ante pricing, or b) use actual results to adjust ex ante pricing? If so, what items or transactions are covered by those rules?
2. What is the general practice of the tax authority on this point when auditing taxpayers? Does the tax authority make ex post adjustments? If so, how are they generally applied in practice (and in particular, how is the adjustment made)? Is there a time period beyond which the rules can no longer be applied? Can taxpayers also apply the rules and make ex post adjustments considering actual results?
3. Are there exceptions to the legal or practical application of ex-post adjustments based on factors similar to those considered in the final OECD guidance on HTVI released on October 5, 2014? Specifically, are there exemptions related to the demonstration of the reasonableness of projections, exceptions for differences between projected and actual results within certain orders of magnitude, or time-based exemptions? Do any other exceptions apply?
4. What changes in domestic law and administrative practice do you expect, if any, associated with the finalization of HTVI guidance by the OECD?

United Kingdom

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Issue One

Does your country have specific rules granting tax authorities the ability to either a) consider actual results as a relevant factor when examining the arm's length nature of ex ante pricing, or b) use actual results to adjust ex ante pricing? If so, what items or transactions are covered by those rules?

The UK rules compare the taxable profit arising from the "actual provision" (i.e. transaction) between connected parties, with the taxable profit that would have arisen had the "provision" been made on arm's length terms (s. 147 Taxation (International and Other Provisions) Act 2010). The application of the arm's length principle for UK purposes, where a tax treaty applies, is conditioned by Article 9(1) of the OECD Model Tax Convention on Income and on Capital (the ***MTC***). For example, Article 9(1) of the UK-Australia double tax convention refers to conditions *"between the two* [connected] *enterprises in their commercial or financial relations which differ from those which might be expected to operate between independent enterprises dealing wholly independently with one another. . .".*

The rules allow HMRC to calculate the profits and losses arising from the HTVI *"as if the arm's length provision had been made or imposed instead of the actual provision"* [i.e. adjusting actual results on an arm's length basis] (s. 147(3) TIOPA 2010).

HMRC require taxpayers to retain records of transactions ("provisions") which accord to the "actual result", so that such results can be adjusted to equate to "arm's length" results under the transfer pricing rules (see HMRC's International Manual at 48030). Transfer pricing reports in the UK usually include the "actual results" of a transaction, and a comparison with the range of results that taxpayers put forward as comparables, which HMRC analyse on the basis of OECD guidance (see INTM484090). However, while this is the typical position, transfer pricing reports may not include the actual results at all; they may recommend a price *ex ante*, but the actual results frequently differ.

HMRC generally follow the OECD's practice with respect to pricing – including in the case of HTVIs (see INTM440140). S. 164 TIOPA requires that, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, Part 4 TIOPA (which sets out the UK's transfer pricing rules) is to be read in such a manner as best secures consistency with the OECD transfer pricing guidelines, or any successor document designated by the Treasury. The Special Commissioners in *DSG Retail v R&CC* [2009] UKFTT 31 (TC) confirmed that the forerunner to s. 164 TIOPA (paragraph 2 Schedule 28AA ICTA 1988) applied *"generally and independently of whether or not there is a relevant double tax treaty"*, such that there is no need for a treaty to be in force for the provision to take effect (at paragraph 70).

To date, the UK has not adopted the "commensurate with income standard" (***CWI***) with respect to HTVIs which the US provides for under § 482 of the US Internal Revenue Code. This provides that, with respect to intangibles, the income with respect to a transfer or licence shall be *"commensurate with the income attributable to the intangible"*[1]. In the OECD's Task Force Report of 1993 on § 482[2], the OECD noted "serious practical problems" (paragraph 2.5) with the use of hindsight as part of the CWI standard. The greater focus on the use of *ex post* results under the updated Guidelines – for which, see the discussion under 2) below – suggests that the OECD has moderated its historic concerns somewhat.

Issue Two

What is the general practice of the tax authority on this point when auditing taxpayers? Does the tax authority make ex post adjustments? If so, how are they generally applied in practice (and in particular, how is the adjustment made)? Is there a time period beyond which the rules can no longer be applied? Can taxpayers also apply the rules and make ex post adjustments considering actual results?

HMRC's general approach is to follow the OECD transfer pricing guidelines (the ***Guidelines***), and in particular the "natural hierarchy" of pricing methods (see INTM421010-30, and again s. 164 TIOPA). The current Guidelines (2010) state that the *"Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated en-*

terprises are at arm's length" (Chapter II, paragraph 2.3). These are the comparable uncontrolled price (***CUP***) method, the resale price and the cost plus methods. Although HMRC state in their guidance (INTM421030) that the CUP method is their preferred method (noting at INTM421020 the "critical" importance of comparability), following the Guidelines, the choice of method will depend on the available information and type of transaction. For example, in the absence of suitable uncontrolled comparables, a transactional method, such as a profit split method (see the discussion of *DSG* below) may be employed. HMRC's preference for using the CUP method suggests that *ex post* adjustments are likely to be used only where there are no suitable comparables.

The leading case on the application of the UK's modern transfer pricing rules is *DSG*, heard by the Special Commissioners. This case involved the sale of extended warranties to customers by a consumer goods group, the liabilities attaching to which were insured/reinsured by an insurance subsidiary within the group. The Commissioners found that the CUP method could not be used, and opted for a form of the profit split method. In relation to the question of *ex post* adjustments:

- The Commissioners held that the actual provision made between DSG (the retail company) and DISL (the insurer/reinsurer of customer warranties liabilities within the group) differed from the arm's length provision which would have been made as between independent parties. Accordingly, profits made by DISL ought to have been allocated to DSG based on a form of the profit split method (i.e. because there were no comparables). Importantly, the Commissioners held that the profit split method ought to be applied without using hindsight.
- HMRC's expert on transfer pricing relied on a hindsight method, employing a form of "*profit split approach that depends on the comparison of the actual profits with the level of profits implied by a normal rate of return on investors' capital*", in support of which he relied on paragraph 3.5 of the OECD guidelines (at paragraph 146 of the decision). This method required that HMRC's expert exclude retained profits in DISL "*that would not have arisen under arm's length pricing*", in response to which the Commissioners stated "*Since thisnecessarily uses hindsight we do not approve this method*" (at paragraph 149).
- The taxpayers' expert criticised HMRC's expert on the basis that his "*calculations* [we]*re ex post calculations of an expected return on equity rather than an ex ante assessment of the terms of an arm's length agreement, as required by the OECD guidelines*" (at paragraph 150).
- The Commissioners noted that they generally agreed with HMRC's expert (Mr Gaysford), but "*The only factor used by Mr Gaysford which was not in accordance with the* [OECD] *guidelines was that he used hindsight*", and thus that the form of profit split method was appropriate, in the absence of comparables, "*on the basis that it should be applied without using hindsight*" (at paragraphs 153-4).

Given that this is the leading case on transfer pricing, the hostility of the Commissioners to *ex post* or hindsight adjustments (notwithstanding that overall they found for HMRC) suggests that the interpretation of Part 4 TIOPA in line with the Guidelines (s. 164 TIOPA 2010) may not extend to *ex post* adjustments. Although the Commissioners did not consider whether *ex post* adjustments were acceptable under the CUP method, their flat rejection of the use of hindsight suggests that in the future, a court or tribunal will be reluctant to allow such adjustments.

However, the updated Guidelines with respect to HTVIs suggest that *ex post* results which differ from *ex ante* projections, where such differences are not due to unforeseeable developments, are likely to be an indicator of wayward *ex ante* projections (see paragraph 6.187 of the updated Guidelines). The updated Guidelines indicate that the increased stress on *ex post* results is intended to provide rebuttable "*presumptive evidence*" about the reliability of *ex ante* projections (paragraph 6.188 of the updated Guidelines). It is not clear how far this goes in the direction of the use of hindsight. It is likely to be acceptable for *ex post* results to serve as a 'red flag' to HMRC in respect of the reliability of *ex ante* pricing, but the Commissioners' hostility to the use of hindsight should be carefully respected by HMRC and indeed by taxpayers.

In terms of resolving disputes outside Tribunal and Court process, HMRC use "Advance Pricing Agreements" to reach binding agreements with businesses to resolve transfer pricing issues, including where determination of the arm's length provision has been disputed (see in particular s. 218(2) TIOPA and INTM422020), or is too complex for use of the Guidelines to be appropriate (INTM422040; see also 3)(ii) below).

The time period beyond which HMRC can no longer raise an enquiry into a taxpayer's self-assessment return in respect of corporation tax is 12 months after the filing date, which is generally 12 months after the end of the relevant accounting period (Schedule 18 paragraphs 14 and 24 Finance Act 1998). In terms of taxpayers making *ex post* adjustments to their self-assessed returns using actual results, this can only be done within 12 months of the filing date of the return (Schedule 18 paragraph 15 FA 1998). Taxpayers also have an opportunity to amend their returns (within 90 days) to comply with a 'transfer pricing notice' given by HMRC (s. 171 TIOPA). However, the reservations discussed above with respect to HMRC's potential use of hindsight adjustments will apply equally to taxpayers' amended returns.

Issue Three

Are there exceptions to the legal or practical application of ex-post adjustments based on factors similar to those considered in the final OECD guidance on HTVI released on October 5, 2014? Specifically, are there exemptions related to the demonstration of the reasonableness of projections, exceptions for differences between projected and actual results within certain orders of magnitude, or time-based exemptions? Do any other exceptions apply?

HMRC has of course not yet updated its guidance in its International Manual (INTM) to reflect the exemptions to the *ex post* review in paragraph 6.193 of the updated chapter VI of the Guidelines. Given HMRC's practice of closely following the Guidelines (see e.g. INTM421030), it is to be expected that HMRC's practice may follow the OECD exemptions to the application of the *ex post* outcomes, which, broadly, concern:

i. the reasonableness of *ex ante* projections (with supporting evidence for both the projections and that any significant difference with the *ex post* position is due either to unforeseeable events or "the playing out of probability of occurrence of foreseeable outcomes");

ii. the transfer of the HTVI being covered by a bilateral or multilateral pricing agreement;

iii. any significant difference between the *ex ante* and *ex post* positions does not increase or reduce the compensation for the HTVI by more than 20%; and

iv. a commercialisation period of at least 5 years[3] has passed since the HTVI first generated unrelated party revenues (and the significant difference condition in (iii) is satisfied).

HMRC's guidance states that the CUP method of calculating whether a "provision" was undertaken at arm's length is generally to be preferred ahead of other methods (INTM421030). However, the *DSG* case is an example of the difficulty of identifying comparable transactions, particularly in complex situations. A general note on these exemptions is that, particularly with respect to iii and iv, they appear arbitrary and may not necessarily comply with the arm's length principle. To the extent they are intended to act as safe harbours for taxpayers they are acceptable, but in the UK a taxpayer ought to be able to argue, on the facts of a particular case, that different thresholds ought to apply.

Issue Four

What changes in domestic law and administrative practice do you expect, if any, associated with the finalization of HTVI guidance by the OECD?

Domestic law on transfer pricing (Part 4 of TIOPA 2010) is to be read consistently with the OECD transfer pricing guidelines 2010 (and the MTC), and any replacement document approved and published by the OECD in their place (when such document is designated by the Treasury – see s. 164 TIOPA). Subject to OECD Council formal recommendation, the Guidelines have been substantially amended by BEPS actions 8-10, and a Treasury order designating the updated guidelines is expected in due course, after which HMRC will follow the revised principles. It is not clear how application of the updated Guidelines will operate in relation to provisions which pre-date the amendment of s. 164 TIOPA. HMRC may favour an 'ambulatory' approach which implies operating the updated Guidelines for all open cases.

HMRC's International Manual (which is not binding in law but indicative of HMRC's practice) notes that such construction of Part 4 TIOPA in line with the Guidelines is irrespective of the terms of any agreement between the two connected parties, but states that the Guidelines cannot override the terms of the legislation (INTM412010).

Therefore HMRC practice will be to follow the amended Guidelines, although this will not be permitted to the extent they conflict with domestic law (in Part 4 TIOPA read in light of any applicable tax treaty). It is an open question whether, at least in treaty cases, the arm's length principle could be brought to bear to displace the new *ex post* approach.

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NOTES

[1] https://www.law.cornell.edu/uscode/text/26/482

[2] http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=OCDE/GD(93)131&docLanguage=En

[3] There is a similar exemption under the US system in respect of the CWI standard – see US Treasury Regulation 1.482-4(f)(2)(ii)(E)