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# INTERNATIONAL TAXATION AND THE GREAT TRANSFER PRICING DEBATE: THE POSITION ADOPTED ON THE OTHER SIDE OF THE ATLANTIC

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## I. INTRODUCTION

Over the course of the twentieth century, the number and size of corporations and other business entities operating in and through more than one country has grown beyond all recognition. Just as it was once possible to claim that the sun never set on the British Empire,<sup>1</sup> now the presidents and chairmen of a large number of corporations—American, European, Japanese and others—can quite truthfully claim that the sun never sets on their multinational group. Such widespread operations, of necessity, take place in a number of countries, many of which have radically different tax systems and rates of taxation.<sup>2</sup> It would be a fairly simple matter for the financial controllers of multinational groups to organize the affairs of the various business entities which make up those groups, be they corporations, branches, partnerships or joint ventures, so as to channel profits out of a high tax jurisdiction into a low tax jurisdiction or from a consistently profitable entity into one with accumulated losses.

An obvious, although by no means the only, method of achieving an effective movement of profits around a multinational group would be to ensure that prices charged between members of the group for intra-group transactions are maintained at either an artificially low or an artificially

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1. See J. Wilson [Christopher North], *Noctes Ambrosianae*, No. 20 (Apr. 1829) ("His Majesty's dominions, on which the sun never sets").

2. See P. POSTLEWAITE, INTERNATIONAL CORPORATE TAXATION § 401 (1980).

high level. In the absence of effective legislation or regulations to counter this practice, the intra-group price paid would be deductible for tax purposes by the paying entity and taxable in the hands of the receiving entity.<sup>3</sup> If the former pays tax at a high rate, and the latter pays tax in a low tax rate jurisdiction (not necessarily a traditional tax haven), or if the former is consistently profitable whilst the latter has accumulated losses, such a transaction could give rise to a significant tax saving for the group as a whole and, conversely, a significant loss of revenue for the authorities in the high tax jurisdiction. To prevent this practice, commonly referred to as transfer pricing, sophisticated legislation and policies have developed fairly rapidly over the last fifty years, particularly in the traditionally high taxing jurisdictions of the world.<sup>4</sup>

Legislation to deal with transfer pricing was first introduced in the United Kingdom in 1952,<sup>5</sup> and the basic rules have remained largely unaltered since that date.<sup>6</sup> As in many other countries, however, the policy of the United Kingdom's tax agency, Inland Revenue, on transfer pricing has developed rapidly,<sup>7</sup> and in recent years there has been a marked increase in the number of taxpayers targeted for investigation.<sup>8</sup> In the 1986 tax year, the Inland Revenue's central office completed ten transfer price investigations which together resulted in adjustments to profits amounting to almost £49 million.<sup>9</sup> By 1987, this had risen to twenty-four cases giving rise to adjustments of over £59 million<sup>10</sup> and an immediate tax yield of £14.8 million.<sup>11</sup> In the three months ending March 31, 1990, the

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3. In the United Kingdom, the payment would be deductible as a trading expense by a United Kingdom paying entity under general computation principles and taxable in the hands of a United Kingdom resident as trading income within Case I of Schedule D of the Income and Corporation Taxes Act, 1988, ch. 1, § 18. Schedule D is one of the six schedular bases for the assessment of income tax in the United Kingdom. Case I of Schedule D provides the basis for the assessment of income arising from a trade.

4. See, e.g., I.R.C. §§ 482, 925 (1988); Income and Corporation Taxes Act, 1988, ch. 1, § 770. By contrast, traditional tax havens such as the Isle of Man, Jersey, British Virgin Islands and Panama have no legislation aimed at transfer pricing currently in force.

5. See Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, ch. 10, § 469.

6. The legislation is now consolidated in the Income and Corporation Taxes Act, 1988, ch. 1, § 770.

7. See *The Transfer Pricing of Multinational Enterprises: Notes by the U.K. Inland Revenue*, 5 SIMON'S TAX INTELLIGENCE 42 (1981) [hereinafter *Transfer Pricing*].

8. REPORT OF THE COMMISSIONERS OF HER MAJESTY'S INLAND REVENUE ¶ 220 (Nov. 6, 1990).

9. This approximates \$72.6 million, converted as of the exchange rate on December 31, 1986.

10. This approximates \$111.2 million, converted as of the exchange rate on December 31, 1987.

11. This approximates \$27.9 million, converted as of the exchange rate on December 31, 1987.

Technical Division (International) of the Inland Revenue's head office, which handles transfer pricing and controlled foreign companies legislation, concluded investigations which yielded additional tax of £43 million,<sup>12</sup> a significant proportion of which was derived from transfer pricing investigations.<sup>13</sup>

The Inland Revenue's determination to stamp out what it views as an abuse of the transfer pricing rules is based on the significant amount of revenue which it estimated to be lost by the United Kingdom.<sup>14</sup> Its ability to deal more effectively with the perceived abuse results not from any change in the rules, which have remained largely unaltered since 1952, but rather in the ever-increasing sophistication of Inland Revenue investigative techniques and from the ever-increasing cooperation between revenue authorities around the world.<sup>15</sup>

## II. LEGISLATION IN THE UNITED KINGDOM

Legislation governing transfer pricing in the United Kingdom is contained in sections 770 through 774 of the Income and Corporation Taxes Act of 1988,<sup>16</sup> with the principal charging provisions contained in section 770.<sup>17</sup>

### A. *The Charge to Tax*

#### 1. Basic provisions

Section 770 provides that the Inland Revenue may substitute, for tax purposes, a notional price equal to the price which the goods or services would have fetched in an open market transaction for the active price paid if both of the following are satisfied: (1) property, including goods, services and other business facilities, is sold under circumstances where the buyer controls the seller, or vice versa, or where both are

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12. This approximates \$70.8 million, converted as of the exchange rate on March 31, 1990.

13. Specialist teams within the head office undertake certain aspects of technical review work and are part of the Technical Division (International), which handles major cases involving transfer pricing and the controlled foreign companies legislation. See TOLLEY'S TAX PLANNING 1220 (1991).

14. "The principle objective [of adjusting transfer prices] is to ensure that the U.K. taxpayer is paying the proper U.K. tax on its profits under the law." *Transfer Pricing*, *supra* note 7, at 44.

15. *Id.* at 43.

16. Income and Corporation Taxes Act, 1988, ch. 1, §§ 770-774 (formerly incorporated in Income and Corporation Taxes Act, 1970, ch. 4, § 485 and Income Taxes Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, ch. 10, § 469).

17. *Id.* § 770.

under common control, and the property is sold at a price which is either:

- (i) less than the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's-length (the arm's-length price), or
- (ii) greater than the arm's-length price;

and (2) the buyer resides and carries on a trade in the United Kingdom, and the price paid by the buyer for the property is taken into account as a deduction in computing the profits or losses of that trade for United Kingdom tax purposes, or (where the actual price paid is greater than the arm's-length price) the seller resides and carries on a trade in the United Kingdom, and the price paid for the property is not to be taken into account as a trading receipt in the United Kingdom in the hands of the seller.<sup>18</sup>

For example, *X Ltd.*, a United Kingdom resident, is a wholly owned subsidiary of *Y Ltd.*, and *X Ltd.* sells an item to *Y Ltd.* for \$5,000, which *Y Ltd.* immediately sells to a third party for \$10,000. If *Y Ltd.* is resident outside the United Kingdom, Inland Revenue may treat *X Ltd.* as if it had disposed of the property for \$10,000 and charge United Kingdom corporation tax for this transaction, notwithstanding that *X Ltd.* will only have received \$5,000. Section 770 would not apply, however, if *Y Ltd.* were a United Kingdom resident company whose profit on the transaction (\$5,000) would be brought into charge to United Kingdom corporation tax, because in that circumstance no tax advantage would arise.

## 2. Common control

Section 770 only applies to transactions between parties one of which controls the other or both of which are under common control.<sup>19</sup> There are a number of different definitions of "control" for various purposes contained in United Kingdom tax legislation.<sup>20</sup> For transfer pricing purposes, a person—an individual, a company or a partnership—has control of a *company* if that person has the power either to secure that the affairs of the company in question are conducted in accordance with

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18. *Id.* § 770(1), (2).

19. *Id.* § 770(1)(a).

20. *See, e.g.*, Capital Allowances Act, 1990, ch. 1, § 161(2) (when a person, by means of holding shares, voting power, or power conferred by articles of association, conducts affairs of body corporate according to his wishes; when a person has right to share more than one-half partnership assets or income); Income and Corporation Taxes Act, 1988, ch. 1, § 416(2) (when a person controls a company's affairs and possesses the greater part of the company's share capital or assets).

that person's wishes by virtue of holding shares or possessing voting power, or by virtue of any powers conferred by the articles of association of the company or any other document.<sup>21</sup> A person has control of a *partnership* if that person has the right to more than half of that partnership's income or assets.<sup>22</sup> In determining whether any person has control of a company or a partnership, it should always be borne in mind that that person will have attributed to him or her all of the rights and powers of his nominees<sup>23</sup> and of persons who are connected with him, which would include his or her spouse, brothers, sisters, ancestors, lineal descendants, partners and the spouses and nominees of such connected persons.<sup>24</sup>

For example, *A* will control *A Ltd.*, a United Kingdom resident, if the ordinary shares in *A Ltd.* are held as follows:

<i>Shareholder</i>	<i>No. of Shares</i>
<i>A</i>	10,000 (10%)
<i>A's</i> nominees <sup>25</sup>	10,000 (10%)
<i>A's</i> wife	10,000 (10%)
<i>A's</i> brother	21,000 (21%)
<i>B</i> (unconnected with <i>A</i> )	49,000 (49%)

*A* will also control *C Ltd.*, a company resident outside the United Kingdom, where the shares in *C Ltd.* are held as follows:

<i>Shareholder</i>	<i>No. of Shares</i>
<i>A</i>	1,000 (1%)
<i>A's</i> brother-in-law	20,000 (20%)
<i>A's</i> brother	10,000 (10%)
<i>D Ltd.</i> <sup>26</sup>	20,000 (20%)
<i>B</i> (unconnected with <i>A</i> )	49,000 (49%)

Under these circumstances, section 770 could also be applied to any transaction between *A Ltd.* and *C Ltd.*

Interestingly, it has been held in the case of *Inland Revenue Commissioner v. Lithgows, Ltd.*<sup>27</sup> that co-trustees who hold shares in their capacity as co-trustees do not individually control the company in which they hold shares because, by virtue of the fiduciary duties they owe to the

21. Income and Corporation Taxes Act, 1988, ch. 1, § 840.

22. *Id.*

23. Nominees include other persons who exercise or possess rights or powers on behalf of the shareholder. *Id.* § 773(3)(b).

24. *Id.*

25. Held as a nominee for *A*.

26. A company in which *A* owns 51% of the issued share capital.

27. 39 T.C. 270 (1960).

beneficiaries of the trust, and to each other, they may not direct that the affairs of the company are carried on in accordance with their own wishes; rather, they are bound collectively to ensure that the affairs of the company are carried on in accordance with the best interests of the beneficiaries.<sup>28</sup> However, whilst on the subject of trusts, it should be noted that a trustee in his capacity as such will be connected with any individual who in relation to the settlement is a settlor, and with any other person who is connected with such settlor.<sup>29</sup>

### 3. Types of transactions affected

Clearly, section 770 applies to sales of goods and services between connected persons.<sup>30</sup> It is extended, with necessary adaptations, to "letting and hiring of property, grants and transfers of rights, interests or licenses and the giving of business facilities of whatever kind,"<sup>31</sup> to loan interest, patent royalties, management fees and payment for services.<sup>32</sup> In addition, section 770 applies to contributions by a subsidiary towards costs incurred by its parent company.<sup>33</sup>

#### *B. Determination of Arm's-Length Price*

Assuming that a transaction falls within section 770<sup>34</sup> and that it occurred between connected parties, one of whom is a non-resident such that a United Kingdom tax advantage may be obtained as a result of the transaction, the next crucial question is whether that transaction has been concluded at an arm's-length price.<sup>35</sup> This, unfortunately, is where the science of transfer pricing regulations becomes more of an art with uncertain boundaries.

United Kingdom legislation does not contain any detailed rules about transfer prices in particular circumstances and the Inland Revenue

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28. *Id.* at 274. The authors are aware of instances, however, where Revenue Agents have argued that the legislation can apply where the resident company is controlled by a non-resident company underlying a trust. This situation was not considered in *Lithgows*. See *id.* at 270-79.

29. Income and Corporation Taxes Act, 1988, ch. 1, § 839(3).

30. *Id.* § 770(1)(a) (transactions subject to this section include those where "property is sold and . . . the buyer is a body of persons over whom the seller has control or both the buyer and the seller are bodies of persons over whom the same person or persons has or have control").

31. *Id.* § 773(4).

32. *Transfer Pricing*, *supra* note 7, at 42-43.

33. *Id.* at 43.

34. It is suggested that there are very few transactions which would fall outside the potential scope of the section.

35. Income and Corporation Taxes Act, 1988, ch. 1, § 770(1)(b).

is not prepared to give an advance ruling on transfer prices or to discuss hypothetical situations.<sup>36</sup> The Inland Revenue has identified three methods of ascertaining an arm's-length price, namely the comparable transactions method, the resale prices method and the costs plus method.<sup>37</sup>

### 1. The comparable transactions method

The most obvious and, in theory, the easiest method of determining an arm's-length price in any transaction is to compare the prices paid on a particular transaction with prices which are generally paid on the open market for similar types of transactions between unconnected persons. The principal difficulty with the operation of this method is that the likelihood of finding another transaction where all of the surrounding circumstances, apart from the connection between the parties, coincide with the circumstances surrounding the relevant transaction is remote. The Organization for Economic Co-operation and Development (OECD)<sup>38</sup> recognized the difficulties surrounding this method and identified a number of factors which may affect comparability of transactions, such as the nature of the goods, packaging and brand name.<sup>39</sup>

A review of these factors shows clearly how difficult in practice the comparable transactions method is to operate effectively, particularly as the Inland Revenue is likely to be prevented by confidentiality rules from disclosing information concerning the pricing arrangements of other companies who are competing with the company whose pricing arrangements are under investigation.<sup>40</sup> Accordingly, although in theory examination of comparable transactions is the easiest and fairest method of evaluating any transaction under investigation, in practice it will usually be very difficult to operate effectively. Therefore, the Inland Revenue invariably falls back on the other methods of determining an arm's-length price, at least in the first instance.

### 2. The resale prices method

Appropriate generally to marketing activities, this method involves taking the retail price obtained by the purchasing company on an eventual sale into the open market and deducting an appropriate mark up to

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36. See Letter from Inland Revenue to the Institute of Chartered Accountants in England and Wales (Apr. 25, 1986).

37. *Transfer Pricing*, *supra* note 7, at 44.

38. The OECD was established under the Convention for European Economic Co-operation, Dec. 14, 1960, 888 U.N.T.S. 143.

39. OECD COMM. ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 13, 35-38 (1979).

40. See, e.g., Taxes Management Act, 1970, ch. 9, § 6.



cover that company's costs and a reasonable profit margin to give a resulting arm's-length price for section 770 purposes.<sup>41</sup> The critical issue in arriving at an arm's-length price using this method is the appropriate level of profit margin for the purchasing company. Factors which frequently are taken into account include: (1) the exclusiveness of the purchaser's marketing rights;<sup>42</sup> (2) the level of risk assumed by the company which will sell the goods into the open market;<sup>43</sup> and (3) the amount of work, if any, performed by the purchasing company on or in respect of the goods in question.<sup>44</sup> Determining the level of profit invariably involves comparison with similar transactions undertaken by other companies. This brings the Inland Revenue back to the practical difficulty of obtaining the necessary information to make this comparison.

### 3. The costs plus method

This method involves the opposite approach to that adopted for the resale prices method and consists of taking the cost incurred by the selling company in providing the goods or services in question and adding an appropriate mark up to represent that company's profit margin.<sup>45</sup> Factors similar to those discussed in relation to the resale prices method as to the appropriate mark up level to be adopted must be examined when using the costs plus method, and similar difficulties in determining the mark up are likely to arise.

The OECD has acknowledged the difficulties of operating this method in isolation<sup>46</sup> and, in particular, has identified a number of disadvantages of the method. For example, this method: (1) overemphasizes historical cost, (2) ignores user demand, (3) fails to reflect competitive conditions adequately, (4) assumes a guaranteed profit in all circumstances, and (5) ignores abnormal factors such as increased costs due to poor management.<sup>47</sup> Notwithstanding these stated difficulties, the method is used particularly in circumstances where the resale prices method is inappropriate<sup>48</sup>—for example, on a sale of semi-finished products between connected parties, perhaps involving further processing by the purchaser—or as a method of checking figures obtained under one of

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41. *Transfer Pricing*, *supra* note 7, at 44.

42. OECD COMM. ON FISCAL AFFAIRS, *supra* note 39, at 40.

43. *Id.* at 39.

44. *Id.*

45. *Transfer Pricing*, *supra* note 7, at 44.

46. OECD COMM. ON FISCAL AFFAIRS, *supra* note 39, at 40.

47. *Id.*

48. *Id.* at 41.

the other methods.<sup>49</sup>

There are no figures published by the Inland Revenue on the frequency of use of any particular method or combination of methods<sup>50</sup> of calculating arm's-length prices. However, regardless of the method adopted, the Inland Revenue has stated that it will be guided by the principles set out by the OECD<sup>51</sup> in arriving at an arm's-length price.<sup>52</sup> On this basis the following principles are applied in practice:

- (1) The Revenue authorities should not form their own commercial judgment on any transactions and should rely on real and not hypothetical cases in reaching their evaluation.
- (2) Reasonable and consistently applied pricing arrangements should not, as a general rule, be challenged, even where on occasions such arrangements give rise, for whatever reason, to an unusually high or low price.
- (3) Subsidies, grants and price controls, other than those imposed between connected parties, should be taken into account.
- (4) All benefits, and not just pure profit or loss, accruing to either party must be given appropriate consideration. For example, under certain circumstances it should be possible to justify uneconomic pricing policies where such policies are part of a long-term coordinated strategy within the multinational group involved.

In this way it is hoped that commercial realities can be observed whilst, at the same time, the aims of the transfer pricing rules, namely "to ensure that the U.K. taxpayer is paying the proper U.K. tax on its profits under the law"<sup>53</sup> can be achieved.

### III. DOUBLE TAXATION

#### A. Generally

One knock on effect of a substitution by the Inland Revenue under section 770 of a notional price for the actual price paid for goods or services is the possibility that economic double taxation may arise where no corresponding adjustment is made by the Revenue authorities in the jurisdiction of residence of the other party to the transaction. For example, assume *A PLC*, a United Kingdom resident, sells goods to *B Inc.*, a

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49. *Id.* at 40.

50. Methods may be utilized separately, in conjunction or as cross-checks. *See id.* at 33-34.

51. *See* OECD COMM. ON FISCAL AFFAIRS, *supra* note 39.

52. *Transfer Pricing*, *supra* note 7, at 44.

53. *Id.*

wholly owned subsidiary of *A PLC* and a resident of *Z country*, at a price of \$10,000, and *B Inc.* immediately resells the goods to a third party for \$100,000. Under section 770, the Inland Revenue will have the right to deem *A PLC* to have sold the goods for \$100,000 for United Kingdom tax purposes.<sup>54</sup> The revenue authorities in *Z country*, however, would, in the absence of any double tax agreement between the United Kingdom and *Z country*,<sup>55</sup> be free to impose a tax charge on *B Inc.* on the basis that it has made a profit of \$90,000 on the transaction.

To avoid this double taxation, it is usual for double tax agreements entered by the United Kingdom with other nations to include an article, usually headed "Associated Enterprises," covering this problem and generally based on the provisions of article 9 of the OECD Model Convention.<sup>56</sup> The model article provides that, where one contracting state has charged tax on the basis of an arm's-length price, the other state is required to adjust the amount of tax which it charges on the same profits.<sup>57</sup> Provided that the two states are in agreement on the amount of the arm's-length price,<sup>58</sup> double taxation may be eliminated.

There are circumstances, however, where double taxation cannot be eliminated in this way, either because the (1) revenue authorities cannot agree on an arm's-length price, and the relevant treaty contains no dispute mechanism or authority for the revenue authorities to consult on the case,<sup>59</sup> or (2) because the treaty does not contain the "Associated Enterprises" article, or (3) because no treaty exists between the United Kingdom and the country in question. In each of these cases the taxpaying multinational corporation will have to rely either on the mutual agreement procedure generally incorporated into United Kingdom tax treaties for resolving double taxation or, where no treaty exists, on United Kingdom domestic law offering unilateral relief in certain circumstances.<sup>60</sup> In either event, the group in question would be well ad-

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54. See Income and Corporation Taxes Act, 1988, ch. 1, § 770(1).

55. See, e.g., Convention for the Avoidance of Double Taxation, Dec. 31, 1975, United States-United Kingdom, 31 U.S.T. 5668, T.I.A.S. No. 9682.

56. OECD MODEL CONVENTION ON THE TAXATION OF INCOME AND CAPITAL art. 9 (1977), reprinted in Brit. Int'l Tax Agreements (CCH) ¶ 6-575, at 7724.

57. *Id.* art. 9(2), reprinted in Brit. Int'l Tax Agreements (CCH) ¶ 6-580, at 7724.

58. Treaties generally enable the revenue authorities of the two nations to consult each other on this. See, e.g., Convention for the Avoidance of Double Taxation, Dec. 11, 1979, United Kingdom-Netherlands, 1980 Gr. Brit. T.S. No. 77. The Convention between the United Kingdom and the United States goes further by providing a mechanism for the resolution of disputes between the respective revenue authorities. See Convention for the Avoidance of Double Taxation, *supra* note 56, art. 9(3), 31 U.S.T. at 5677.

59. See, e.g., Convention for the Avoidance of Double Taxation, May 22, 1968, United Kingdom-France, art. 8, 725 U.N.T.S. 3, 8.

60. See Income and Corporation Taxes Act, 1988, ch. 1, § 790.

vised to contact the Tax Policy Division (International) of the Inland Revenue in an effort to resolve the difficulty.

### *B. The European Community Connection*

For the time being, transactions between associated enterprises resident within two or more European Community member states, one of which includes the United Kingdom, are treated in the same way as any other international transaction, and the considerations relating to effective double taxation apply. On July 23, 1990, however, the European Community Council formally adopted a draft directive and convention regarding the elimination of double taxation relating to adjustment of transfers of profits between associated enterprises.<sup>61</sup> This convention, which adopts the terms of a draft directive,<sup>62</sup> provides for the creation of a co-operation and arbitration procedure for situations where member states cannot reach mutual agreement, as between themselves, regarding an equitable elimination of double taxation arising as a result of an adjustment of profits (for example, under section 770) between companies resident in two or more member states.<sup>63</sup> Broadly, the draft directive envisages that, if the relevant revenue authorities within the concerned member states fail to reach an agreement eliminating the double taxation, they would be required to present the case to an arbitration commission who would make a final decision on the matter.<sup>64</sup>

For the time being this remains a European Community Council convention and draft directive only. It is not a part of United Kingdom law and, until it becomes a full directive, it cannot have direct effect in the United Kingdom. Until then, transactions between the United Kingdom and other European Community member states are treated in the same way as all other international transactions, with reliance being placed on the relevant double tax treaty provisions discussed above.

## IV. CONDUCT OF TRANSFER PRICING ENQUIRIES

### *A. Procedure*

Transfer pricing enquiries in the United Kingdom are the responsibility of the Board of the Inland Revenue, which maintains a network of local offices throughout the United Kingdom. With the exception of enquiries relating to oil companies, which are dealt with by the centralized

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61. 33 O.J. EUR. COMM. (No. L 225) 10 (1990).

62. 20 O.J. EUR. COMM. (No. L 336) 15 (1977).

63. *Id.* at 17-19.

64. *Id.*

oil taxation office in London, most enquiries are handled, at least in the first instance, by local inspectors, and only enquiries involving substantial amounts of money or points of principle are dealt with at the Inland Revenue central head office in London.<sup>65</sup> In any event, wherever the enquiry is handled, the objectives of the enquiring office will be the same, namely to "ensure that the U.K. taxpayer is paying the proper U.K. tax on its profits under the law."<sup>66</sup>

Most enquiries arise out of routine examinations of a company's accounts carried out by local inspectors in preparation for the usual assessment of tax liability on the profits of that company for a given chargeable period. Increasingly, however, Inland Revenue agents are targeting particular businesses, for example the pharmaceutical industry, for the attention of the Inland Revenue's specialist transfer pricing team.<sup>67</sup>

Once a review is underway, the Inland Revenue can be expected to raise protective tax assessments on the tax paying company so as to prevent the tax claim becoming time-barred.<sup>68</sup> Once the Inland Revenue raises an assessment, interest and penalties on the tax so assessed will begin to accumulate and, given the length of time which enquiries invariably take<sup>69</sup> and the fact that the Inland Revenue will usually insist on interest and penalties being paid in respect of tax so assessed,<sup>70</sup> a taxpayer should, on receipt of such an assessment, give consideration as to how best to deal with what could amount to a significant interest and penalty charge. In particular, serious consideration should be given to the making of an investment in Certificates of Tax Deposit.<sup>71</sup>

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65. *Transfer Pricing*, *supra* note 7, at 43.

66. *Id.* at 44.

67. 2 *TOLLEY'S TAX PLANNING* 1220 (1991). The Inland Revenue established its specialist team, composed of eight to ten people, to engage exclusively in transfer pricing work. *Id.*

68. An assessment would be time-barred after six years in the absence of fraud or negligence, Taxes Management Act, 1970, ch. 9, § 34, or after twenty years where there has been fraudulent or negligent conduct, *id.* § 36.

69. In the authors' experience, the time taken for enquiries can be anything from a matter of a few weeks to a number of years, depending upon the complexity of the issues involved and the willingness of both sides to the negotiations to compromise.

70. Interest on late paid tax generally accrues pursuant to Taxes Management Act, 1970, ch. 9, § 86. In concluding negotiated settlements, the Inland Revenue has the power to effectively waive charges by simply issuing a revised tax assessment for the tax involved. In the authors' experience, however, interest and penalties are rarely waived in the case of transfer pricing enquiries.

71. Certificates of Tax Deposit are cash deposit certificates issued by the Inland Revenue which carry a favorable rate of tax-free interest, tied to the rate of interest on unpaid tax, if utilized to meet a tax liability. See Prospectus for Certificates of Tax Deposits, *reprinted in SIMON'S TAXES*, Dec. 6, 1990, A3.1328, at 1098.

### B. Information Requirements

Where, for whatever reason, Inland Revenue agents decide that it is appropriate to examine the pricing policies of a taxpayer, it is likely that the Revenue will need to embark on a fact-finding exercise to elicit information in addition to that which has led them to determine that an enquiry is appropriate. What additional information will be required depends upon individual circumstances. The Inland Revenue does not have a standard list of questions but the following matters are likely to be of interest to the Revenue in connection with the taxpayer itself:

- (1) ownership and/or control of the taxpayer;
- (2) the nature of its trade;
- (3) the organization of the group of which the taxpayer is a member;
- (4) the functions of particular companies within the group; and
- (5) how far the profitability of particular companies within the group has come up to expectations.<sup>72</sup>

In addition, it is likely, depending on which arm's-length pricing method is adopted, that the Revenue will at some stage need to enquire into some or all of the following matters:

- (1) the open market prices of goods or services comparable to those supplied by or to the taxpayer;
- (2) production costs;
- (3) research and development costs; and
- (4) the price at which the multinational group of which the taxpayer is a part ultimately sells the goods into the open market.<sup>73</sup>

### C. Sources of Information

Generally, transfer pricing enquiries in the United Kingdom are resolved through discussions and negotiations between the inspector and the taxpayer, during the course of which the taxpayer is usually able to supply the necessary information which the inspector will require. In the unlikely event that an inspector is unable to persuade a taxpayer to provide information which the inspector considers relevant, the Inland Revenue has fairly wide-ranging statutory powers to request information from a taxpayer.<sup>74</sup> In addition, section 772 of the Income and Corpora-

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72. *Transfer Pricing*, *supra* note 7, at 43.

73. See *supra* notes 35-54 and accompanying text.

74. See, e.g., Taxes Management Act, 1970, ch. 9, § 20. That section provides, in pertinent part:

tion Taxes Act<sup>75</sup> empowers the Inland Revenue in the case of enquiries into transactions with section 770 to: (1) require the taxpayer to produce information relating to its transfer prices and also which is or may be relevant to the transfer prices of other entities, regardless of whether such entities are associated with the taxpayer;<sup>76</sup> (2) require the production of books and accounts or other relevant documents or records of the taxpayer and, in certain circumstances, the taxpayer's subsidiaries;<sup>77</sup> and (3) in certain circumstances, to enter premises used in connection with a trade carried on by a taxpayer which is believed to be a party to a transaction within section 770 to inspect books, accounts or any other documents or records whatsoever relating to that trade.<sup>78</sup>

#### D. Confidentiality of Information

Information acquired by the Inland Revenue during the course of a transfer pricing enquiry is subject to very strict confidentiality rules.<sup>79</sup> However, it should be noted that disclosure of such information is permitted in the case of disclosure by the Inland Revenue to Her Majesty's Customs and Excise and, probably more important, in the case of disclosure to the revenue authorities of other countries under double tax agreements or under directives concerning mutual assistance between the revenue authorities of the member states of the European Community.<sup>80</sup>

#### E. Section 770 Notices

Most transfer pricing enquiries are resolved as a result of negotiations between the Inland Revenue and the taxpayer without the tax inspector ever having to resort to formal notification proceedings under section 770.<sup>81</sup> Where agreement on the substitution of an arm's-length

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- (2) Subject to this section, the Board may by notice in writing require [a person—  
 (a) to deliver to him such documents as are in his possession or power and as . . . contain information relevant to—  
     (i) any tax liability to which that person is or may be subject, or  
     (ii) the amount of any such liability, or  
 (b) to furnish to him such particulars as the inspector may reasonably require as being relevant to, or to the amount of, any such liability.]

*Id.* § 20(2).

75. Income and Corporation Taxes Act, 1988, ch. 1, § 772.

76. *Id.* § 772(1).

77. *Id.* § 772(3).

78. *Id.* § 772(6).

79. See Taxes Management Act, 1970, ch. 9, § 6.

80. See Council Directive, 20 O.J. EUR. COMM. (No. L 336) 15 (1977).

81. See Income and Corporation Taxes Act, 1988, ch. 1, § 770(2)(d); see also *id.* § 772(6) (authorizing investigation procedures for the Board to determine whether § 770 direction need be given).

price in any transaction cannot be reached, the Inland Revenue is required to serve a direction on the taxpayer under section 770 before the provisions of the section can apply to the transaction and a corresponding assessment raised.<sup>82</sup>

Once a direction has been made, the direction itself cannot be appealed. Instead, the taxpayer must appeal to the Special Commissioners<sup>83</sup> against the assessment raised by the Inland Revenue as a result of the direction and, in determining the appeal, the onus lies on the taxpayer to show that no direction under section 770 should have been given or that the arm's-length price substituted by the Inland Revenue is inappropriate.<sup>84</sup>

## V. TRANSFER PRICING PLANNING

The incidence of transfer price enquiries in the United Kingdom, although still not of a great number, is on the increase. The same is true in many other developed countries where complex transfer pricing regulations are becoming commonplace.<sup>85</sup> With this in mind, every multinational group should examine on a regular basis its intra-group pricing policies to ensure that they clearly are established and able to stand up to detailed investigation. The policies should, wherever possible, be documented and should be applied consistently with any exceptions to the stated policies being clearly justifiable. Where possible, any major transactions between connected entities which may be vulnerable to a section 770 investigation should be documented individually, and any unusual items or considerations involved in the transaction highlighted with the thought process behind them made clear.

As to the actual policies to be adopted, these will obviously depend on the individual circumstances of the group in question. United Kingdom legislation incorporated in section 770 deals with general charging provisions and, therefore, is of little use in helping develop appropriate policies. Even the guidelines issued by the Inland Revenue<sup>86</sup> do little more than set out the Inland Revenue's thinking on certain transfer pricing issues in very general terms—the notes are of very little practical assistance.

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82. *Id.* § 770(2)(d)(3).

83. *Id.* § 772(8).

84. Taxes Management Act, 1970, ch. 9, § 50(6).

85. See, e.g., I.R.C. §§ 482, 925 (1988); "Verwaltungsgrundsätze Zu Verrechnungspreisen" (Feb. 1983) (Ger.).

86. See *Transfer Pricing*, *supra* note 7.



The OECD has produced a number of reports on transfer pricing<sup>87</sup> which examine the area in some detail and which throughout give practical information which may provide guidance when seeking to establish and maintain a transfer price policy. Clearly, the Inland Revenue is not bound by the thoughts of the OECD. However, representatives from the Inland Revenue were involved in the preparation of these reports, and it is likely that the Reports will influence the views not only of the Inland Revenue, but also of revenue authorities around the world. For this reason, if for no other, the reports provide at the very least, an invaluable bench mark against which multinational groups can start to evaluate their own pricing policies. This is so not only within the United Kingdom which, whilst it has its own peculiarities in terms of transfer pricing legislation and policy rules, is seeking to achieve through that legislation objectives similar to those which many other countries throughout the world are seeking to achieve with their own transfer pricing rules, but throughout the world.

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87. See, e.g., OECD COMM. ON FISCAL AFFAIRS, ISSUES IN INTERNATIONAL TAXATION (1987); OECD COMM. ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES—THREE TAXATION ISSUES (1984); OECD COMM. ON FISCAL AFFAIRS, *supra* note 39.