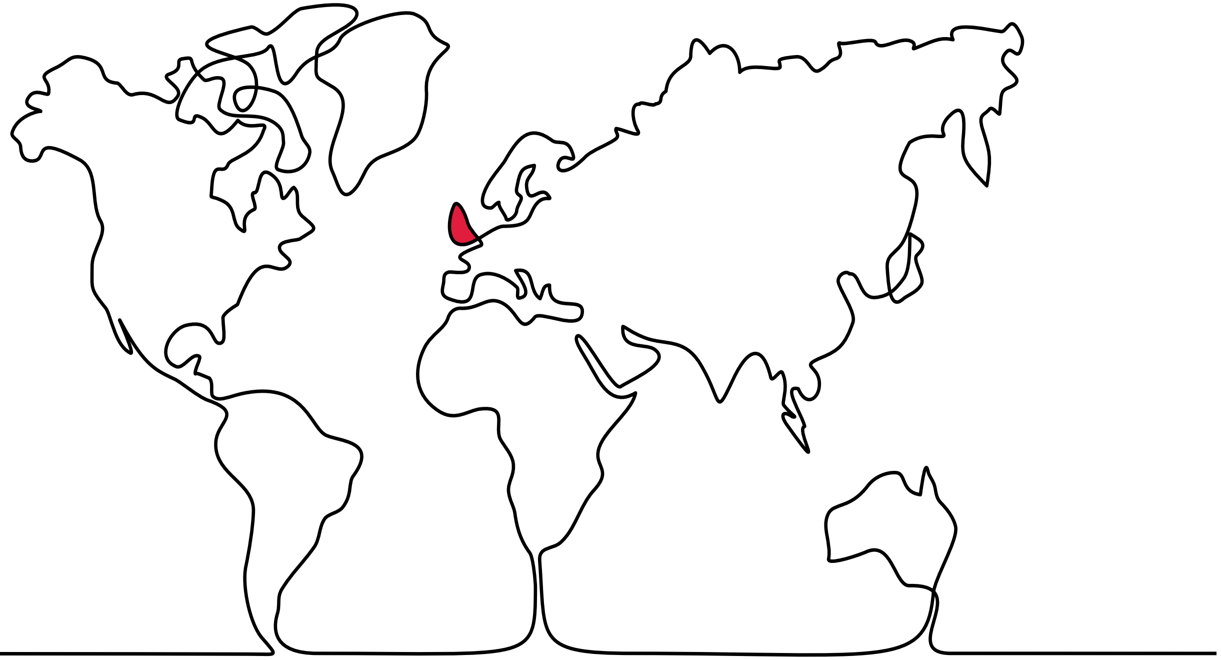
Oury Clark Quick Guides:

International Transfer Pricing



Corporation Tax: K18

Any company trading with connected parties, such as other group companies or other companies with common owners, has an obligation not to distort its taxable profits by entering into an "un-commercial" trading relationship.

This means that companies trading within a group need to give careful consideration to the value placed on inter-group transactions and the company needs to be able to justify that the value is reasonable.

This applies to groups of companies wholly within the UK, as well as international groups, although international transactions are likely to receive closer scrutiny.

Transfer pricing applies to physical movement of goods or stock between companies, as well as services and support provided by one company or its staff to another, and also to transfers of intellectual property.

As with interest payments (see below), payments in respect of intellectual property may be subject to withholding tax, depending upon the tax treaty position. Withholding taxes have to be deducted by the payer company, but can normally be offset against tax by the recipient.

The good news is that the requirements are fairly limited unless you are a "Large Company". The requirements when you are not large are merely to ensure that you have fair arms length basis for all transactions, but the level of reporting or evidence to support this basis is minimal so long as you are dealing with relevant tax treaty countries.

Large company requirements

For large companies, and any companies dealing with countries where the UK doesn't have a tax treaty with the relevant non- discrimination clause, there are formal valuation and documentation requirements specifying documents which would need to be produced in the event of a tax enquiry. Smaller companies may benefit from considering the requirements for larger entities as an example of best practice.

Large companies are those with over 250 employees and either turnover in excess of €50m or a balance sheet total in excess of €43m. Medium sized companies (over 50 employees and either over €10m turnover or balance sheet total above €10m) can also be directed by HMRC to apply the formal transfer pricing requirements.

How to value transactions

There are five acceptable valuation methods under transfer pricing principles. Preference is given on the whole to methods 1 to 3 as being the most objective.

The Five Methods:

- Comparable uncontrolled price - the price that would apply to a similar transaction with an unconnected party.
- Resale price - the transfer price is calculated by deducting the company's normal margin plus any relevant costs, from the final resale price.
- Cost plus - a mark up value is added to the cost (direct and indirect) associated with the supply.
- Profit split - the overall profit made by a group on a given transaction is analysed and allocated between the entities involved based either on their contribution to the transaction, or on the appropriate return for the functions under taken.
- Transaction net profit margin - similar to the above, the net profit for each party to the transaction is calculated based on cost, turnover or return on capital employed as appropriate.

Inter-group loans, thin capitalisation and interest charges

Historically HMRC have disallowed tax relief on interest payments which were considered to be excessive on the basis of the ratio of equity to debt in the financing structure of the company. Companies with high debt to equity were said to be thinly capitalised and interest relief would be restricted on inter-group interest payments.

This approach has now been largely replaced with one which focuses on the commercial borrowing power of the entity. If an entity, considered on its own without support from the parent company, would be likely to be able to raise the level of debt from banks or the capital markets then the interest should all be allowable for tax relief. If not, relief will be withdrawn in relation to the proportion of the loan which is considered excessive and "un-commercial".

It is important to bear in mind that interest payments made overseas can be subject to withholding taxes of 20%.

Even where a tax treaty allows for withholding tax relief to reduce or remove the charge, permission must be sort from HMRC by the company receiving the interest before the treaty rate of withholding tax can be applied.

Worldwide debt cap

Tax relief on interest payments is restricted for companies where the UK Company's borrowing exceeds their overall international borrowing. The restriction applies only to large companies (see above), and only where the UK net debt is above £3m and the UK net finance charge (exclude foreign currency fluctuation) is above £500,000.

Other considerations

- Companies will need to be aware of the potential VAT implications of their proposed transfer pricing structure. Where services or intellectual property are supplied by one entity to another a VAT charge will normally arise.
- Within the UK such inter-group VAT can normally be avoided by a group VAT registration.
- Companies likely to incur irrecoverable VAT on international transfer pricing transactions may wish to consider not applying an actual charge for a transaction, but instead making a transfer pricing only adjustment in their tax return. Currently this is not treated as a supply for VAT purposes and no VAT needs to be charged.
- Companies should also be aware that HMRC can only impose a tax adjustment which restricts relief and increases tax. They cannot impose an adjustment which has the effect of reducing UK tax. So from an international perspective, the impact of UK transfer pricing rules is one-sided, for example, HMRC cannot compel a UK company to pay more overseas interest, only less.
- In the event that the UK authorities do impose an adjustment to the UK tax return a corresponding adjustment should normally be available in the tax return of the other party to the transaction, although this will often need agreement from the local tax authorities.

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