



Transfer pricing: UK documentation proposals and disputes

The UK government is consulting on proposals for mandatory transfer pricing documentation in the form of the OECD recommended master file and local file for large MNEs, plus supporting evidence log, and an international dealings schedule for all businesses subject to UK transfer pricing rules. The latter two of these, in particular, have the potential to impose a significant additional compliance burden. The consultation suggests the proposals should lead to fewer and more focused transfer pricing enquiries which can be resolved more quickly because the facts are better understood at the outset. However, in practice those objectives may be difficult to achieve.

On 23 March 2021, the government published a consultation on proposals to update and strengthen the transfer pricing documentation requirements for UK businesses.

The consultation suggests that the proposals would enable HMRC to:

- conduct better risk assessment;
- direct transfer pricing enquiries more appropriately; and
- reduce the time taken to establish the facts when enquiries are opened.

HMRC's desire for more and better quality information seems fairly clearly to support a continued focus on revenue-raising from transfer pricing and diverted profits tax audits. In an area notorious for long-running, fact-heavy disputes their objectives are laudable ones which could also bring benefits for business if achieved.

However, some of the proposed documentation and reporting requirements go beyond OECD minimum standards and seem likely to involve a significant additional compliance burden for affected groups. Taxpayers might justifiably question the extent to which that burden will in practice be counter-balanced by significantly fewer or shorter transfer pricing enquiries.

Existing transfer pricing documentation requirements

The OECD's final report on BEPS Action 13 (transfer pricing documentation and country by country reporting) recommended a three-tiered standardised approach to transfer pricing documentation for MNEs:

1. **A master file** of high-level information regarding global business operations and transfer pricing policies, which would be available to all relevant tax administrations.
2. **A local file** containing detailed transactional transfer pricing documentation specific to each country, including material related party transactions, the amounts involved in those transactions and the company's transfer pricing analysis of them.
3. **A country-by-country report (CBCR)** to be filed annually by large MNEs providing specific information for each tax jurisdiction in which they do business, including revenue, profit before income tax, employee numbers and details of the entities within the group doing business in that jurisdiction together with an indication of the business carried on.

While the UK was an early adopter of CBCR, via the Taxes (Base Erosion and Profit Shifting) (Country by Country

Reporting) Regulations, SI 2016/327, it has not to date implemented the other OECD recommendations.

Instead, as a proxy for a specific requirement for companies to maintain appropriate documentation to support their transfer pricing, the UK has continued to rely upon the broad requirement for UK tax resident businesses to keep and retain sufficient records to demonstrate that their tax returns are complete and accurate (contained in FA 1998 Sch 18 para 2(1)).

As a consequence of this, the UK rules do not currently prescribe what transfer pricing documentation must be prepared or in what format, although HMRC's published guidance gives a sense of what may be considered appropriate (see, for example, HMRC's *International Manual* at INTM483030).

What is proposed?

In short, the consultation proposes the introduction of specific and standardised transfer pricing documentation requirements for UK businesses. There are broadly three elements to the proposals.

Master file and local file

The consultation leads with a proposal for MNEs in CBCR groups to be mandatorily required to provide HMRC with a copy of the master file upon request, and to keep (and similarly produce on request) a local file. This would largely align the UK position with the BEPS Action 13 recommendations and other tax authorities that have already implemented those, including around half of those in Europe.

It is expected that MNEs would use the master file and local file to support preparation of their tax returns and, on that basis, they would be required to provide copies to HMRC within 30 days of a request. Any failure to do so would be taken into account by HMRC when considering whether reasonable care had been taken in preparation of the tax return and so could potentially lead to penalties.

The aim is to deter taxpayers tempted to commission the necessary documentation only upon receipt of a request. That is similar to the approach in the US, where a failure to provide appropriate transfer pricing documentation to the IRS within 30 days of a request can in certain circumstances lead to penalties of up to 40% based on the net transfer pricing adjustment.

Evidence log

It is also proposed that the local file be supported by some form of evidence log setting out key facts (as opposed to technical analysis or opinion).

The consultation hints that this might be similar to the evidence log required for reports prepared under the auspices of the profit diversion compliance facility (*PDCF*) and refers to the example of that given in

HMRC's published *PDCF* guidance. If a similar approach were to be followed, various forms of evidence supporting the technical transfer pricing analysis might be required, such as:

- notes of staff interviews;
- copies of agreements with third parties (presumably relied upon as evidence of comparable uncontrolled prices); and
- reviews of internal emails.

International dealings schedule (IDS)

In addition, there is a proposal for all UK businesses to which transfer pricing legislation applies (i.e. not just the largest MNEs) to prepare and file an annual IDS reporting high level details about cross border, intra-group transactions. This concept is based on similar reporting requirements in other jurisdictions, such as Australia, with links to examples included in Appendix B of the consultation document.

Potential types of information to be required by the IDS include:

- the nature and amount of transactions;
- the identity and location of the counterparty;
- the compensation for the transaction;
- the transfer pricing methodologies applied; and
- the level and type of supporting documentation.

Materiality limits are mooted as an option to exclude some transactions, for example by reference to the size or nature of the transaction, in order to reduce the potential administrative burden. However, no further detail has yet been given on the level at which those might be set.

The case for change

This is framed in terms of benefits for both HMRC and business. For HMRC, better quality standardised data should improve the use of data analytics for risk assessment and in turn enable more efficient use of limited resources.

For taxpayers, benefits are envisaged in the form of increased visibility of, and access to, the relevant data when preparing tax returns. (This also has the potential to benefit HMRC if, as hoped, it prompts businesses with higher risk transfer pricing positions to change their behaviour.)

For both, it is contemplated that transfer pricing enquiries will be more focused and the time taken to establish the facts will be reduced, leading to faster resolution of those enquiries.

However, the consultation document acknowledges that these should be weighed against the potential impact of the proposals on business – and therein lies the rub.

Compliance implications

Master file and local file

The assumption is that groups affected by the master file and local file proposal are likely already to be preparing master files and/or maintaining transfer pricing documentation that would align with local file requirements, so that aspect should not impose a significant additional compliance burden.

That may well be right for some groups, but the consultation document itself recognises that one of the issues with the current UK position is a lack of consistency between businesses in terms of the transfer pricing documentation that is maintained. Moreover, the master and local file requirements do vary between those jurisdictions where they are already in place (for example, as to the level of materiality applied), so what must be included for one jurisdiction may not be required for another.

Overall, however, this aspect of the proposals seems unlikely to be particularly controversial, as it essentially represents the UK catching up with other jurisdictions that have already implemented the BEPS recommendations.

Evidence log and IDS

The evidence log and IDS proposals are likely to raise more concerns, as both could potentially involve quite a significant additional compliance burden for affected groups.

While the consultation document notes that feedback from some business and tax advisers indicates that the evidence log approach used in the PDCF is beneficial, that is in the context of what would otherwise be a full transfer pricing audit. It would not be appropriate or proportionate to demand an equivalent level of evidence to be maintained by taxpayers as part of an ongoing compliance process where no material risks have been identified.

As for the IDS, the consultation document anticipates that the information sought would be drawn from existing business records and compliance systems. But how onerous the obligation to complete an IDS might be in practice is likely to turn on the format selected (in particular, whether it is limited to numerical information or requires more subjective narrative responses), whether information needs to be provided at group or UK-entity level, the materiality threshold adopted and, for large MNEs, how it interacts with the local file requirement.

Implications for transfer pricing enquiries

Fewer?

HMRC has for some time been using data analytics to enhance its risk assessment processes and the IDS is described as ‘potentially transformative’ in this respect.

In theory, the additional data that would be generated by a local file and IDS *should* translate into transfer pricing enquiries being focused on the intra-group arrangements that are perceived to be highest risk, in terms of shifting profits outside the UK tax net, with fewer enquiries being opened overall. That may prove to be the case for smaller businesses. However, HMRC’s resource constraints mean this approach is largely adopted already, with taxpayers otherwise ‘nudged’ towards self-disclosure under the PDCF – a trend that seems likely to continue.

In practice therefore large taxpayers may not see much, if any, reduction in the number of transfer pricing enquiries opened. Indeed, it is perhaps inevitable that increased visibility over intra-group arrangements may prompt transfer pricing enquiries to be opened that previously would not have been. Complex groups could find themselves effectively subject to a constant transfer pricing audit.

Shorter?

A key objective of the proposals seems to be a reduction in the time taken to establish the facts in ‘compliance interventions’ and thus the time taken to resolve enquiries.

But a *detailed* understanding of the facts and the overall business context is critical to any kind of transfer pricing or diverted profits enquiry. Thorough testing of the facts will almost always be required, as a pre-requisite to analysing the technical position, for any proposed resolution to be approved by HMRC’s internal stakeholders. So while easy access to high level information may replace an initial round or two of correspondence with the taxpayer once an enquiry has been opened, it seems unlikely to result in any significant reduction in the time taken for the enquiry to be resolved, especially for the largest and most complex MNE groups.

Experience shows that what can make a difference to the efficient resolution of transfer pricing investigations (whether HMRC-led enquiries or conducted internally, under the PDCF) is taxpayers and their advisers adopting an approach of critically analysing the existing transfer pricing, as HMRC will. While self-critique is never comfortable, it should mean the key issues can be identified, discussed and resolved more quickly.

What next?

Comments and suggestions are sought on a number of different aspects of the proposals, as well as more generally, with the consultation closing on 1 June 2021. Given the fairly fundamental changes that are proposed, HMRC should expect plenty of feedback from both business and advisers keen to influence the design of the new regime.

Where might things end up? It's unlikely that HMRC will abandon the proposals, but it is keen to receive feedback on how far to go and on areas where additional guidance may be needed.

Our recommendation would be that:

- the master file and local file proposals should closely follow the OECD's guidance;
- further consultation is needed on the format of the IDS, and ideally there would be some level of international consensus on an appropriate approach, to ensure consistency between jurisdictions; and
- an evidence log should be reserved for transfer pricing enquiries.

One thing that does seem a sure bet is that HMRC's continued focus on the transfer pricing of MNEs will not ease up any time soon – in fact, quite the opposite.

The consultation document is available [here](#). The consultation closes on 1 June 2021.

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