UK transfer pricing section 147: the arm's length principle

Large Corporate

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This article considers the operation of TIOPA 2010 s 147 in UK transfer pricing enquiries and questions the validity of the common use of the interquartile range and transfer pricing adjustments made ‘within the range’.

Key Points

What is the issue?

Section 147 of TIOPA 2010 essentially requires that a taxpayer’s profits and losses are calculated for tax purposes based on the arm’s length principle and requires substituting the ‘arm’s length provision’ for the actual provision if certain criteria are met.

What does it mean for me?

As HMRC must ensure that the basic pre-condition has been satisfied in order to make a transfer pricing determination, this means that HMRC must be satisfied that the taxpayer’s self-assessment differs from an arm’s length provision.

What can I take away?

As controversies arise and as transfer pricing enquires continue to get more complicated, there is a clear need to go back to basics and ensure that transfer pricing discussions are grounded in the underlying legislation.

Transfer pricing enquiries and disputes in the United Kingdom often involve extensive information requests, protracted correspondence on the OECD transfer pricing guidelines and debates concerning the economics of transactions and 'technical transfer pricing positions'.

The link back to the legal powers of HMRC to assess under the Taxation (International and Other Provisions) Act (TIOPA) 2010 s 147 is, however, often inadvertently given limited, or no, consideration.

This article considers the operation of TIOPA 2010 s 147 and in this context explores practices seen in UK transfer pricing enquiries, such as the use of the interquartile range and transfer pricing adjustments made 'within the range'.

We also consider the burden of proof in transfer pricing disputes and how this is affected by the specific requirements of s 147.

The basic transfer pricing rule

Section 147 of TIOPA 2010 essentially requires that a taxpayer's profits and losses are calculated for tax purposes based on the arm's length principle and requires substituting the 'arm's length provision' for the actual provision if certain criteria are met. The criteria are:

- the 'basic pre-condition' is satisfied (TIOPA 2010 s 147(2)(a)); and
- the actual provision confers on the taxpayer a potential advantage in relation to UK taxation (TIOPA 2010 s 147(2)(b) and (4)(b)).

Section 164 of TIOPA 2010 requires that s 147 is to be read consistently with the OECD transfer pricing guidelines. As the UK operates a self-assessment tax system, taxpayers must at the outset ensure compliance with s 147, which is the operative section relied upon by HMRC when seeking to make a 'transfer pricing determination'.

The basic pre-condition

Sections 147(2)(a) and 147(4)(a) state that for the arm's length provision to replace the actual provision under s 147(3) or s 147(5) the 'basic pre-condition' must be met, which is defined through four criteria:

- There is an actual provision made or imposed between two affected persons by means of a transaction or series of transactions (s 147(1)(a)).
- The 'participation condition' is met (s 147(1)(b)).
- The actual provision is not related to oil transactions, which have their own rules (s 147(1)(c)).
- There is a difference between the actual provision and the arm's length provision (i.e. that which would have been made as between independent enterprises) (s 147(1)(d).

Transfer pricing determination

HMRC may make an amendment to a taxpayer's tax assessment to give effect to conclusions contained in a closure notice under the Finance Act 1998 Sch 18 s 34.

Where this amendment is made under the UK's transfer pricing legislation, it must be accompanied by a 'transfer pricing determination' which has received the Commissioners' sanction under TIOPA 2010 s 208, without which a closure notice would not be valid.

Section 208(2) defines a 'transfer pricing determination' as being 'a determination of an amount to be brought into account for tax purposes in respect of any assumption made under section 147(3) or (5)', thus meaning that HMRC must show the basic pre-condition is satisfied.

For the basic precondition to be satisfied, the taxpayer's self-assessment must differ from the arm's length provision.

This is an important and often overlooked consideration, that may appear to be of limited consequence at first glance. However, in practice, where the arm's length provision is almost always determined by reference to a 'range', it is very significant in that it appears to restrict HMRC from making 'adjustments within the range', as discussed below.

The arm's length range

In transfer pricing practice, there is typically not a single arm's length price, but rather a range of arm's length results. This is recognised in the OECD Transfer Pricing Guidelines. Chapter III para 3.55 provides that 'because transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures, all of which are relatively equally reliable' (see bit.ly/3ekVEUs). HMRC acknowledges this in its guidance in its International Manual INTM485120, which notes that: 'Usually a transfer pricing model will produce a range of possible results.'

The arm's length range concept is important, as stated in OECD Transfer Pricing Guidelines Chapter III para 3.60:

> 'If the relevant condition of the controlled transaction (e.g. price or margin) is within the arm's length range, no adjustment should be made.'

HMRC confirms this in INTM485120:

> 'If the results of the tested party fall within an acceptable range of arm's length prices, then no adjustment should be made. If the results of the tested party fall outside an acceptable range, teams will need to agree how to revise the tax computation so that the arm's length price replaces the actual transfer price.'

Notwithstanding the importance of the arm's length range concept, the 'arm's length range' is not defined in TIOPA 2010, nor is there any prescriptive requirement as to how the arm's length range is to be constructed. There is nothing in the UK legislation concerning the use of statistical measures, such as the interquartile range. This is in contrast to the United States, for example, where their regulations contain specific rules concerning the use of the interquartile range.

Despite the lack of any requirement to apply the interquartile range, it is our experience that practitioners in the UK, including HMRC, routinely apply the interquartile range. In our view, this practice does not accord with the legislation and the OECD Transfer Pricing Guidelines. This view is confirmed by HMRC in INTM485120:

> 'There is nothing in either TIOPA 2010 Part 4 or the OECD Transfer Pricing Guidelines that say that an interquartile range must be used, although paragraph 3.57 of the Guidelines states that the use of an interquartile range may enhance the reliability of a range in which non-quantifiable comparability defects

remain as a result of the limitations in available information on the comparables used.

'A potential problem with using the interquartile range is the discarding of more accurate comparables which fall within the full range but outside the inter-quartile range. This problem arises when some of the companies in the reported list are less reliable comparables than others. It is therefore important to carry out as robust a comparability analysis as is reasonably possible in arriving at the arm's length range from which the inter-quartile range is derived.

'If case teams are satisfied that the comparables are all highly reliable, then there is no need to restrict themselves to using an interquartile range. The task is to find the accurate comparables.'

This position has also been recognised by international courts, where OECD principles have been applied to determine the arm's length range. Importantly, the courts look to the full range of results rather than the interquartile range, as is shown in the following examples:

- In *Sweden v Absolut Company AB* (Supreme Administrative Court, Case no 1913-18) in June 2019, the Swedish Supreme Administrative Court ruled on transfer pricing benchmarking analyses and found that the full range of results in the benchmark study could be applied, rather than the interquartile range, to support an arm's length result.
- In *Chile v Avery Dennison Chile S.A.* (Case no RUT 96.721.090-0) in March 2021, the Chilean Tax Court found that the remuneration of the distribution and marketing activities performed by the taxpayer had been determined to be at arm's length by application of a 'full range' analysis. The tribunal commented that the application of the interquartile range was not mandatory.
- On 13 July 2021, in *Blackstone/GSO Debt Funds Europe S.à.r.l.* (Case No. 43264), the Administrative Tribunal of Luxembourg noted that the use of the interquartile range is not mandatory under the OECD Transfer Pricing Guidelines para 3.62 and decided that the effective yield on the profit participating loan, being within the full range of benchmark interest rates, should be accepted by the tax administration.

In our view, when applying section 147, the default position when it comes to the construction of the arm's length range should be the 'full range'. Limiting the range by way of statistical measures, such as the interquartile range, should be the exception, rather than the rule.

Adjustments within the arm's length range

Despite the commentary from the OECD Transfer Pricing Guidelines and HMRC's International Tax Manual guidance, we have experienced situations in the UK whereby transfer pricing adjustments have been proposed, and even made, within an arm's length range. We would argue that such adjustments are contrary to s 147, since the basic pre-condition requires that the actual provision differs from the arm's length provision.

For example, a taxpayer has demonstrated that its purchase of goods from a related party is arm's length by applying the transactional net margin method and demonstrating that the operating margin of 2% is within the arm's length range of operating margins achieved by comparable distributors of (for example) 1% to 5%. In this case, a transfer pricing determination should only be made if HMRC believes, for example, that one or more of the comparable distributors are in fact not comparable so as to change the arm's length range (e.g. from 2.5% to 5%) and render the 2% outside of that revised range. If this is not the case, it would seem that the basic pre-condition is not satisfied and thus a transfer pricing determination cannot be made.

Consistent with the OECD Transfer Pricing Guidelines and indeed HMRC's guidance in INTM, it seems to us that s 147 does not allow for transfer pricing adjustments that are 'within the range'. This highlights the importance of the definition and construction of the range as discussed above.

Burden of proof

Another interesting issue that arises from an analysis of the basic pre?condition in s 147 is how the burden of proof operates.

Under the UK's self-assessment regime, taxpayers are required to show that on the balance of probabilities the original provision was arm's length. However, in order for HMRC to challenge this, it must inter alia determine that the taxpayer's provision was *not* arm's length (i.e. that the pre-condition was satisfied) and issue a sanction notice to that effect.

In our experience, HMRC rarely clearly sets out its analysis and position with respect to the application of s 147 and, in particular, with respect to the basic pre-condition. However, we consider that HMRC ought to be willing to share its thinking, as in order to assess a taxpayer, HMRC must have concluded that the taxpayer's approach is not arm's length in accordance with s 147 and must have reached that decision on a principled basis.

Conclusion

These issues have not been explored fully before the tax tribunals. We consider that the manner in which some transfer pricing enquiries have progressed in some instances means that the basic precondition point is one that is ripe for challenge before the tribunals and the courts, particularly where HMRC is proposing adjustments within the arm's length range, and/or is narrowing the range by application of the interquartile range without a supportable basis.

Notwithstanding the large body of transfer pricing practice and theory internationally, the importance and legal significance of the OECD Transfer Pricing Guidelines in the UK still needs to be critically explored. In our view, as controversies arise and as transfer pricing enquires continue to get more complicated, there is a clear need to go back to basics and ensure that transfer pricing discussions are grounded in the underlying legislation.

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