Transfer Pricing Records Regulations 2023: mandatory requirements

Large Corporate

23 October 2023

As the Transfer Pricing Records Regulations 2023 bring in mandatory documentation requirements, we examine the requirements of Local Files and Master Files.

Key Points

What is the issue?

The Transfer Pricing Records Regulations 2023 have introduced mandatory transfer pricing documentation requirements.

What does it mean to me?

UK members of multinational groups which have at least €750 million revenues for the relevant period must now prepare transfer pricing documentation according to a prescribed format. Large groups below this threshold are usually recommended to follow the same format.

What can I take away?

Ensuring that the analysis is up to date, and that the facts on which it is based are accurately explained and considered, will be increasingly important in managing transfer pricing risks.

The UK has long been something of an anomaly in the world of transfer pricing documentation. It was an early adopter of the arm's length principle for related party transactions, with a tax authority that is experienced and sophisticated in applying this. However, the UK has hitherto treated transfer pricing documentation as a matter of general 'record-keeping' under its normal corporation tax self-assessment rules.

Now, though, the Transfer Pricing Records Regulations 2023 have introduced mandatory transfer pricing documentation requirements. UK members of multinational groups which meet the country-by-country reporting threshold of at least €750 million revenues for the relevant period must now prepare transfer pricing documentation according to a prescribed format.

The new rules apply for corporation tax accounting periods beginning on or after 1 April 2023, and for income tax purposes from the fiscal year 2024/25. For each period, in-scope entities must prepare a Master File and Local File which contain the information described in Annexes I and II to Chapter V of the 2022 OECD Transfer Pricing Guidelines.

The documentation need not be filed with the tax return but must be provided to HMRC within 30 days of request. In practice, the documentation should exist at the time the relevant self-assessment return is made and be considered by the person making the statutory declaration that the return is, to the best of their knowledge, correct and complete.

The Master File contains high-level information on the multinational group's global business operations and its transfer pricing policies. The Local File sets out the economic characteristics of the related party transactions of the UK entity, the amounts involved, and the transfer pricing analysis demonstrating that the pricing applied to each class of transactions is arm's length. The Master File and Local File requirements are widely used around the world and provide the detail to complement the group's country-by-country reporting information.

Groups below the €750 million threshold remain subject to the old 'record keeping' requirements. Unless an exemption (such as that for some SMEs) applies, transfer pricing documentation commensurate with the scale and complexity of the related party transactions is required. In practice, for groups toward the larger end of the scale, the Master File/Local File approach is often recommended. The updated HMRC International Manual

guidance at INTM450080 reinforces this as it states: ‘HMRC is of the view that an appropriate way to demonstrate that provisions between related parties adhere to the arm’s length principle is to prepare documentation in line with the OECD’s recommended approach even where the MNE group test is not met.’

Living in a material world

Only material categories of controlled transactions need to be included in the Local File. Materiality is assessed category-by-category and is to be considered from the perspective of the individual UK entity that is the subject of the Local File (i.e. not, for instance, the whole group or UK sub-group).

HMRC has listed certain categories of transactions that are always treated as material regardless of value due to their nature and complexity. These include transactions involving intangible assets, ‘leadership services’ or business restructurings, or those priced via a profit split methodology or involving a cost contribution arrangement. For other categories of transactions, a £1 million *de minimis* threshold applies; materiality above this level is a question of taxpayer judgement with reasoning required to support categories not considered material.

Related party transactions may be aggregated into a category when both:

- the economically relevant characteristics are materially the same; and
- the transfer pricing methodology and pricing are the same.

Although this will simplify the analysis, the Local File must still identify any different counterparties involved in the transactions and the amounts set out by counterparty jurisdiction.

As a further simplification, ‘low value-adding’ intra-group services (as defined in the OECD Transfer Pricing Guidelines, typically priced on costs plus a mark-up of 5%) may be included as a single category of transaction, including where they are provided by or to multiple counterparties.

Leave intended omits alone

Certain transactions may be excluded from the UK Local File regardless of materiality:

- The UK applies a very wide definition of related parties for transfer pricing relating to financial transactions, covering those who ‘act together’ with shareholders in relation to an advance of funds. Where ‘acting together’ is the only connection, the financial transaction may be excluded.
- Domestic (UK-UK) transactions may be excluded except where one or both of the parties have elected into the patent box or operates an oil and gas ring fence trade. Other UK domestic transactions do still need to be priced at arm’s length, even though not required to be included in the Local File (although HMRC is considering reintroducing a form of exemption for UK-UK transactions).
- Transactions covered by Advance Pricing Agreements (APAs) made with HMRC on or before 31 March 2023 do not need to be included. Later APAs must be documented but the information contained in the APAs application or annual reports can be leveraged to minimise the additional compliance burden.

If the result of the above is that the UK taxpayer would not be required to document any controlled transactions in the Local File, then it is not required to prepare Local File or Master File at all for the relevant period. (In practice, however, other countries will probably still require a Master File.) The reasoning underlying this conclusion should be documented.

The power of 'Gov'

A clear message from recent HMRC activity has been the need to close the 'information gap', ensuring that HMRC has access to the information it needs to conduct effective and targeted compliance activity. This is also explained as being a benefit to taxpayers by reducing unnecessary questions on matters that turn out to be low risk. The Regulations therefore also increase HMRC's powers to seek transfer pricing records, without launching a formal enquiry and including where they are held by other members of the group than the UK entity itself (e.g. a Master File held by the foreign ultimate parent entity).

The flip side is that if transfer pricing records are not provided within the 30 day deadline, there is a rebuttable presumption that any transfer pricing-related inaccuracies are careless (with a potential penalty of up to 30% of the lost tax or 10% of overstated losses). This can be rebutted by providing the records and showing that they were in place prior to submitting the self-assessment return, or by otherwise demonstrating reasonable care, which in the absence of documentation could be difficult.

The existing £3,000 penalty (previously rarely imposed) for failure to keep or preserve records is retained, and continues to apply to smaller groups. For groups subject to the mandatory Master File and Local File requirements, there is a new additional penalty of up to £300 and a further £60 per day where the 30 day time limit is breached.

Maintaining the specified transfer pricing records is within the Senior Accounting Officer responsibilities and HMRC points out that 'failure to keep the records may be an indication of not establishing and maintaining adequate accounting processes and arrangements'.

SATisfaction guaranteed

Also in the Regulations is a power for HMRC to introduce a requirement for businesses to prepare a Summary Audit Trail (SAT) explaining the steps taken in preparing the Local File.

The SAT has been under consultation and development for a couple of years and HMRC has confirmed the intention to publish a further consultation later in 2023. The intent behind the SAT is to encourage sufficient work to support transfer pricing policies and to enable HMRC to undertake high level quality assurance on the transfer pricing documentation and therefore allow better focus on higher risk areas during enquiries. Achieving a form of record that delivers these goals while not creating a cottage industry has been the challenge, hence the delay.

Does the delay to the introduction of the SAT mean that evidence is not yet important? Definitely not. HMRC can be expected to view assertions in a functional analysis with professional scepticism, seeking verifiable evidence and concrete examples underlying the claims made. It may challenge the reliability of the transfer pricing implications where particular emphasis is placed on characterisation of the role of entities that is not borne out by the facts on examination. This may include interviewing UK-based senior management to hear at first-hand their understanding of decision making processes and responsibilities.

Right here, right now

In a sense, these 'new' rules are not all that novel. The Master File/Local File concept has been recommended by the OECD since 2015 and is progressively being adopted by groups worldwide. UK groups too have often adopted the approach as a matter of good practice. The mandatory rules now bring the UK requirements for large multinationals into line with many other jurisdictions and should help to transfer pricing and tax teams to articulate the importance of revisiting existing UK transfer pricing documentation.

What is becoming more apparent is HMRC's clear drive for evidence-based transfer pricing documentation. Ensuring that the analysis is up to date, and that the facts on which it is based are accurately explained and considered, will be increasingly important in managing transfer pricing risks.

Prompt action is recommended: although the transfer pricing documentation does not have to be prepared until the tax return is submitted, the 'one-way street' approach of the UK transfer pricing legislation prevents tax return adjustments on cross-border transactions which reduce taxable profits or increase allowable losses. The emphasis is on the taxpayer to get the pricing right in the accounts. Where a review determines that UK profits should be lower at arm's length, leaving any change until after year end may be too late.

I can see clearly now...

Considering the following questions should help businesses prepare for the new rules:

- Are we within scope?
- What are our material transactions that will need to be included in the Local File?
- What transfer pricing documentation already exists for these transactions and are there any gaps to the OECD Master File/Local File content requirements?
- Are there intercompany agreements which describe the terms and conditions under which those transactions take place?
- If there is an agreement, when was the most recent review undertaken of whether the conduct of the parties is consistent with the agreement terms?
- When was the last time that a two-sided functional analysis was performed which examines the contributions made by each party in terms of functions performed (including control of economically significant risks), assets employed and risks assumed?
- When was the last time a review of third party agreements was performed to determine if any internal comparables exist?

- Have any third party comparables been reviewed and updated in accordance with the OECD Transfer Pricing Guidelines comparability standards? For comparable company benchmarking (transaction net margin method), this typically means at least every three years (with an annual roll-forward of financial data).
- Has any sanity check been performed that the distribution of taxable profits appears commensurate with the parties' respective contributions to value creation?

We expect to see HMRC conduct stricter enforcement of the new requirements and to make use of its powers to impose penalties for non-compliance.

Any groups subject to the rules, and the larger ones below the threshold, should review the evidence and analysis supporting their related party pricing as a matter of priority, and develop a timely plan for closing any gaps.

Make your transfer pricing records a platinum hit!

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