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Published in Japanese  
*Eikoku News Digest*  
April 2010

## TRANSFER PRICING

- *Can you explain transfer pricing in layman's terms?*

Sure! Different countries have different rates of corporation tax. If a business manufactures goods in one country and sells them in another, it might do this by transferring the goods from its manufacturing subsidiary to its sales subsidiary. Since both subsidiaries are controlled by the same business, it can set the price for the transfer at whatever level it wishes. The business could, therefore, use pricing to move the profits around.

- *Oh, so it's only relevant to companies selling goods.*

No. The same principle applies to all services, including management services, liaising with customers, marketing and even financing. The net is cast very wide, so do ask your accountant if you are at all uncertain.

- *Great! So we can use transfer pricing to move profits to low tax countries, right?*

Wrong, I'm afraid! Most countries, including the UK and Japan, have tax rules to prevent this. In the UK, the directors must have evidence available that shows why they consider that the transfer prices meet the arm's length standard.

- *What's the "arm's length standard"?*

A transaction is "arm's length" if the conditions in the transaction are comparable to the conditions that would be imposed if the transaction were between independent entities.

- *That doesn't sound so complicated. I'm sure I can throw together a couple of pages.*

I recommend caution. The documentation requirements are onerous. The UK rules refer to a comprehensive set of guidelines produced by the Organization for Economic Cooperation and Development (OECD). Those guidelines set out in great detail the matters that need to be considered and how to prove that your

intercompany transactions meet the arms length standard. Also, in the event of an inspection, even if HMRC agrees with your transfer prices, it could still fine you simply for having inadequate documentation.

- *I see, so I should get an expert to prepare a transfer pricing report, then. That could be pricey. Can we use the one produced in Japan for the whole group?*

Well, even though the transfer pricing rules in OECD countries are based on the same set of guidelines, they do vary. The Japanese report would certainly be very useful, but it may not be sufficient on its own to meet the UK requirements.

- *We're only a small operation on a tight budget. Is there any good news?!*

If the group that you are part of qualifies as small or medium then you will be exempt from the more onerous requirements. As a guide, currently if the group has more than 250 employees then the full rules apply. If it has less than 250 employees then the company is exempt if the group also has turnover of less than €50m or total assets of less than €43m. There are specific rules regarding, for example, counting temporary and part-time employees, and including entities that are not wholly-owned within the group, so again, if you are borderline then it is well worth checking with your tax adviser.

- *Do we have to do this every year?*

As a rule, best practice would be to do a full report whenever there is a major change in operations or in the business environment and in any case every few years. In intervening years a more general review would usually suffice. This does depend on the business sector you are in, though.