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## **Transfer Pricing: Transactions with connected Entities - An overview**

This article looks back to the UK transfer pricing legislation introduced by the 1998 Finance Act, examines the subsequent changes in 2004 and highlights important aspects for Japanese businesses operating in the UK.

Without specific UK transfer pricing legislation, a UK entity could divert profits to an overseas connected entity by manipulating the price paid for intra group sales or services. Therefore, UK entities e.g. companies are required to comply with the requirements of the UK transfer pricing legislation introduced by the Finance Act 1998. The UK legislation (Section 770A and Schedule 28AA ICTA 1988) applied from the commencement of UK Corporation Tax Self Assessment (CTSA) for companies, that is for all accounting periods ending on or after 1 July 1999. The then new legislation was framed in a way that explicitly identified it with Article 9 of the OECD Model Treaty and the OECD Transfer Pricing Guidelines.

The legislation, framed in accordance with the OECD Guidelines, adopts the arm's length standard, the internationally accepted standard for setting transfer prices. This standard states that related entities should set prices on transfers to be the equivalent to that which would be charged if they were independent, i.e. not connected parties dealing with one another on an arm's length basis. The UK's tax legislation therefore imposes arm's length transfer pricing on transactions with connected overseas entities. Similar transfer pricing regulations also operate in most countries to protect each jurisdiction's tax base.

Under the UK's CTSA legislation, UK entities must ensure that their Corporation Tax Return, Form CT600, reflects arm's length transfer pricing on transactions with non-resident connected entities. Where such transactions are not priced on an arm's length basis, an appropriate adjustment is required in arriving at the declared taxable profit.

From 1 April 2004, the UK's transfer pricing legislation also applies to transactions between commonly controlled UK entities. This has largely been attributable to EU regulations ensuring the UK transfer pricing legislation does not discriminate against other EU based entities. However, the 2004 changes include exemptions for small and medium sized companies/groups, based on specific EU criteria.



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UK CTSA returns are required to apply arms length prices on all transactions with connected persons. Prior to 1 April 2004 the transfer pricing regulations mainly applied to cross border group transactions. On 1 April 2004, the regulations were extended to cover transactions between UK based entities under common control.

The principal obligation under the UK CTSA transfer pricing legislation requires the corporation tax computation to be adjusted where:-

- a provision is made or imposed on a transaction or series of transactions between connected persons;
- this provision departs from the arm's length standard i.e. conducting business on terms and conditions that independent parties would adopt, expecting both businesses to make a profit; and
- a UK tax advantage is conferred on one of the parties i.e. where the provision or price charged results in a lower taxable profit or larger tax loss than would have resulted if an arm's length price had been used.

The legislation allows the overall price to be supported by reference to a composite range of transactions.

Connected persons are those under common control, or where one controls the other. Furthermore, the UK transfer pricing legislation applies to transactions with a 40 per cent joint venture partner.

With effect from 1 April 2004, interest deductions on connected party borrowing and loan guarantees were incorporated within the UK transfer pricing legislation.

Prior to 1 April 2004, transactions between connected UK entities were not subject to the arm's length transfer pricing regulations, unless one of the entities carried on their trade using an overseas branch.



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Since 1 April 2004, the UK transfer pricing regime is as follows:

- only large UK entities are subject to full transfer pricing on all connected party transactions, including those where the other party is a UK entity, and
- most small and medium sized entities no longer have to apply UK transfer pricing principles in dealings with connected overseas entities located in tax treaty countries.

Where the other party to the transaction is within the charge to UK corporation tax, the legislation provides for corresponding adjustments to be given where a transfer pricing adjustment is made.

Small and medium sized entities are exempt from the UK's arm's length transfer pricing regulations. This consequently provides a useful relief to small or medium sized groups whose UK entities were previously subject to transfer pricing adjustments on their transactions with non-UK resident group members.

Small and medium sized entities are defined under EU regulations and the specific criteria are tested on a consolidated i.e. group basis. Figure 1 sets out the criteria relevant to small and medium sized entities.

Figure 1: Small and Medium sized entity criteria

	Small	Medium
Employees	<50	<250
AND EITHER		
- Turnover	<€10m (~£7m)	<€50m (~£35m)
OR		
- Balance sheet total i.e. Gross Assets	<€10m (~£7m)	<€43m (~£30m)



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Large UK entities i.e. those that exceed the small and medium sized criteria set out in figure 1 must demonstrate that reasonable steps have been taken to apply the arm's length standard as a matter of compliance with UK tax law, and must have satisfactory documentation justifying their transfer pricing policy.

The UK guidelines issued by H M Revenue & Customs (HMRC) require large entities to maintain documentation supporting their inter-company pricing policies. HMRC guidance specifically outlines that the documentation should identify the following:-

- Relevant commercial or financial relations falling within the scope of the legislation.
- The nature and terms (including prices) of relevant transactions. Transactions which are clearly one family e.g. regular purchases made by a distributor throughout a return period of the same or similar products for resale may be aggregated.
- The method or methods by which the nature and terms of relevant transactions were carried out, including a study of comparables and any functional analysis undertaken.
- How that method has resulted in arm's length terms, or where it has not, what computational adjustments are required and how they have been calculated. This will include an analysis of market data or other information on third party comparables.
- The terms of relevant commercial arrangements with both third party and affiliated customers. These will include commercial agreements (e.g. service on distribution contracts, loan agreements) and any budgets, forecasts or other papers containing information relied on in arriving at arm's length terms, or in calculating any adjustment made in order to satisfy the requirements of the transfer pricing legislation.

In summary, for a large UK entity, proper care in setting and documenting transfer pricing policies will ensure that penalties can be avoided if HMRC were to challenge and succeed in taking a different view and impose a transfer pricing adjustment to its UK CTSA Corporation Tax Return.