HM Revenue
& Customs

Introduction of secondary adjustments into the UK's domestic transfer pricing legislation

Consultation document
Publication date: 26 May 2016
Closing date for comments: 18 August 2016

Subject of this consultation:	This is a consultation on the potential introduction of a secondary adjustment rule into the UK's domestic transfer pricing legislation.
Scope of this consultation:	The consultation will be used to help inform the government's decision on whether to introduce secondary adjustments and the design of that rule.
Who should read this:	Whilst any rule would only be likely to affect large multinational enterprises, we would like to hear from all interested external stakeholders.
Duration:	26 May 2016 – 18 August 2016
Lead official:	Nick Shepherd, HM Revenue and Customs
How to respond or enquire about this consultation:	Responses or enquiries should be made: • By post to: Nick Shepherd, HMRC, CTIS Business International, 11th Floor East Spur, Euston Tower, 286 Euston Road, London NW1 3UH. • By e-mail:secondaryadjustments.consultation@hmrc.gsi.gov.uk Please note that the mailbox will not accept e-mails larger than 10Mb. Representative groups may wish to give a summary of the people and organisations they represent and, where relevant, how they consulted in reaching their views. You may wish to include contact details for follow-up (e.g. name, phone number, email address).
Additional ways to be involved:	Although this is a largely technical issue where much of the review will be based on written submissions, HMRC welcomes engagement with industry representatives who would be affected by the issues under discussion and would welcome discussion of this consultation where required. If you would like to arrange a meeting with HMRC, please use the email contact address given above.
After the consultation:	A response document will be published within 12 weeks of the consultation closing, and a decision will be made on whether the rule will be implemented.
Getting to this stage:	Secondary adjustments would be a new rule within the UK's transfer pricing legislation.
Previous engagement:	This is the first consultation on the topic.

Contents

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1. Introduction

Background

1.1 In the 'Business Tax Roadmap' in 2016, the government set out its commitment to make the UK's tax system more efficient and competitive. These commitments included the provision of low UK taxes, whilst making clear those taxes must be paid and that the UK system would not reward aggressive tax planning.

1.2 A recent strand of the government's work in addressing tax planning has been the leading role it has played in the OECD/G20 work on tackling Base Erosion and Profit Shifting (BEPS). This has included the early domestic implementation of action points arising from BEPS and the strengthening and clarification of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations that are imported and utilised within the UK's domestic transfer pricing rules.

1.3 The UK has not previously sought to introduce a secondary adjustment rule. However this government, in its commitment to ensure taxpayer compliance with the UK's transfer pricing rules, would like to consult on whether such a rule would help to achieve this objective by addressing the financial benefit arising from incorrect pricing which currently remains after the application of these rules. This would complement the government's work to date, both domestically and internationally, in tackling taxpayers entering into aggressive transfer pricing arrangements to avoid tax in the UK.

1.4 The UK's transfer pricing rules seek to ensure a correct allocation of taxable profit linked to activities undertaken in the UK from transactions between connected parties, typically two companies belonging to the same group. The rules require the terms of the transaction, and thereby the profits arising from it, to be calculated by reference to those which would have been agreed if the companies were independent. This is referred to as the 'arm's length principle' and it is applied whether a UK resident company is transacting with another UK company or one that is based overseas.

1.5 The arm's length principle has been adopted internationally for transfer pricing rules. It provides an agreed basis for the fair allocation of profit on cross border transactions between connected parties and also avoids double taxation. However, this also means that changes to that principle need the same international agreement and can take some time to agree.

1.6 The UK's transfer pricing rules calculate the taxable profits on the price that would have been charged at arm's length. This is achieved via an adjustment (the primary adjustment) to the price that is effective for tax purposes. As the primary adjustment is only effective for tax purposes, any cash benefit from non-arm's length pricing can accumulate in an overseas company, often located in a low tax country.

1.7 The above cash benefit can be reversed by a secondary adjustment rule, which applies a tax charge on the excess cash arising on non arm's length pricing. The rules are an internationally recognised approach and are already part of the transfer pricing rules applied in many leading economies including the United States, Canada, France and other EU Member States[1].

1.8 Whilst the approaches to secondary adjustments by individual countries vary, they represent an internationally recognised method to realign the economic benefit of the transaction with the arm's length position. It restores the financial situation of the relevant connected parties to that which would have existed if the transactions had been conducted on an arm's length basis.

Scope of consultation

1.9 The government is consulting on whether a secondary adjustment rule should be introduced into the UK's transfer pricing legislation and how that rule would be designed. It is seeking views from all stakeholders on its proposals.

1.10 The address secondaryadjustments.consultation@hmrc.gsi.gov.uk should be used for all responses via email.

1.11 The deadline for responses is 18 August 2016.

2. Secondary adjustments

2a) The OECD Transfer Pricing Guidelines

2.1 The UK's Transfer Pricing rules (Part 4, Taxation (International and Other Provisions) Act 2010) calculate the taxable profits on the price that would have been charged at arm's length. They are required to be construed in a manner that best ensures consistency with both:

- the arm's length principle in Article 9 of the OECD Model Tax Convention on Income and on Capital; and
- the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ('OECD Transfer Pricing Guidelines`).

2.2 Where the transfer pricing is not arm's length and a potential UK tax advantage has been obtained, the UK's rules require a 'primary adjustment' to be made to the original price. This adjustment is effective for tax purposes, but does not

[1] Secondary adjustments has also been the focus of an EU Joint Transfer Pricing Forum Paper, dated 18 January 2013.

address the additional cash benefit achieved from non-arm's length pricing of the underlying transaction. The advantage from this cash benefit can be addressed by the use of a secondary adjustment rule. The Commentary on paragraph 2 of Article 9 of the OECD Model Tax Convention notes that the Article does not deal with secondary adjustments, and thus it neither prevents nor requires tax administrations to make them.

2.3 The OECD's transfer pricing guidelines define secondary adjustments as *'an adjustment that arises from imposing tax on a secondary transaction'*.

2.4 *A s*econdary transaction is further defined as *'a constructive transaction that some countries will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends, constructive equity contributions, or constructive loans.'*

2.5 Some countries have introduced secondary adjustment rules into their domestic legislation in order to ensure the actual allocation of profits is consistent with the primary adjustment. By way of simple example:

> Company A is resident in the UK and has paid £10m for products supplied to it by connected overseas Company B. It is determined that a price of £8m would have been paid at arm's length for the same products.
>
> The UK's transfer pricing legislation adjusts this incorrect pricing to remove the tax advantage to company A and calculates its taxable profits on the basis it only paid £8m for the products i.e. it reduces the deduction to £8m thereby increasing the profits by £2m (the primary adjustment). However, this primary adjustment does not address the benefit obtained from the retention of that £2m by overseas company B. Secondary adjustments seek to remove the cash benefit obtained from that £2m.

2.6 The removal of the benefit of the £2m can be achieved by way of constructive dividend, equity contribution or loan. It follows that a secondary adjustment is linked to and follows both the presence and amount of a primary transfer pricing adjustment.

Question 1
The sections below set out a number of specific questions on the design of a secondary adjustment rule. However, the government would be grateful for any wider comments, beyond responses to these specific questions.

2b) Methods of secondary adjustments

2.7 Two of the methods discussed in the OECD transfer pricing guidelines are constructive dividends and equity contributions. Each of these would have inherent limitations in their effectiveness from a UK perspective due to principles within the UK's wider tax legislation.

2.8 A rule based on constructive dividends, would treat the excess profits transferred to the overseas company as a deemed dividend subject to withholding tax (WHT). There is no general requirement for UK companies to deduct WHT from the dividends they pay, meaning that the treatment would be in contrast to how real dividends are treated and administered by the current UK domestic rules.

2.9 Similarly, an equity contribution rule, where the excess profits are treated as a deemed equity contribution by the UK company, would have limited application until there was a capital disposal. Again, for the rule to be effective any capital disposal would need to move away from the tax exemptions currently in place for some corporate share disposals (e.g. the Substantial Shareholdings Exemption). This option would also need to address the added complications of group relationships between indirect parent-subsidiary or sister companies i.e. how would the deemed equity contribution be recognised by the wider group companies in the ownership structure and the countries in which they are resident.

2.10 The above methods do benefit from being one off adjustments that require minimal ongoing monitoring or administration. However, they appear to be more appropriate when taking into account certain features of the domestic tax regime of the territory in which they operate which may not be reflected in the UK's tax regime. They also seem more appropriate when the group relationship between the counterparties is that of direct parent and subsidiary.

2.11 The government's preference is for a rule to be designed on a third option, which treats the excess profits as a deemed loan from the potentially advantaged company. Such a deemed loan would have interest imputed upon it, which would then be treated as taxable income. The issues around this option are considered further below.

Question 2
What advantages and disadvantages do you see of the constructive loan option rule, when compared to the other options available, taking into account interactions with other parts of the UK's corporate tax regime?

2c) Constructive loans

2.12 The following text looks at a number of the design issues surrounding the use of a constructive loan rule. Where relevant, the government has set out its preference, which it feels achieves the policy aims for the rule to:

- encourage broader compliance with the UK's transfer pricing rules;
- provide business with certainty;
- not be complex to apply and administer; and
- act as a deterrent to aggressive transfer pricing structures.

On what primary adjustments cases should the rule be engaged?

2.13 A secondary adjustment rule would apply where a primary adjustment arises under Part 4 TIOPA 2010. The number of taxpayers for which any secondary adjustment rule would be engaged will depend in part on whether it is 'notice led' by an HMRC notice that targets specific structures or facts, similar to the Diverted Profits Tax) or an 'automatic' regime (where the rule would apply automatically by reference to set criteria).

Question 3
What are your views on the advantages and disadvantages of a either a 'notice led' or an 'automatic' rule?

2.14 The nature of the transactions, the structures in which they occur and the residence of the parties on which a primary adjustment applies varies significantly. The indicators that could trigger the application of a secondary adjustment rule are therefore equally diverse.

2.15 A rule triggered by structures considered to be aggressive tax planning would require the government to provide a definition or hallmarks on what it considered to be within the scope of the rule. This could create uncertainty for business on when the rule would be engaged.

2.16 Alternatively, a rule could focus on the absence of a double tax treaty and/or there being no non-discrimination article within a treaty. However, there are likely to be a limited amount of transactions which would meet these conditions, and behavioural changes to group structures would be expected in the longer term to further limit this. The government's view is that this option would likely make the rule ineffective.

2.17 The government's preferred option, as it considers it the most straightforward and effective, is for a secondary adjustment rule to be triggered for primary adjustments above a certain threshold i.e. all primary adjustments above £1m. This would be intended to apply whether or not those primary adjustments were taxpayer or HMRC initiated.

Question 4
What problems do you see in applying the rule by reference to a threshold and what alternatives are there?

Question 5
What level would you consider it appropriate to set a threshold at?

To what accounting periods should the rule apply?

2.18 The complexity of some transfer pricing investigations can mean it is a number of years before they are closed and any adjustments are agreed for the accounting periods under review. This timeframe will mean that the date of commencement of any rule will be significant in determining when deemed loans start to arise. The main options are:

- all accounting periods on which the enquiry window has not yet closed or are currently open to enquiry, such that the transfer pricing position has not yet become final.
- all accounting periods beginning or ending after the announcement, or effective date of the legislation.

Question 6
What views do you have on the options for the accounting periods to which the rule would be applied?

Between which parties should the loan be deemed?

2.19 The excess profits from non-arm's length pricing have been transferred between the parties on which the primary adjustment arises. It is the government's view that any loan should be deemed between the same two parties. The loan should be created as an account receivable, of the same amount as the primary adjustment, for each accounting period in which it arises.

Question 7
What problems do you see with the above proposal and what alternatives are there?

How should that loan be recognised for accounting purposes?

2.20 Financial accounts are prepared so as to give a true and fair view and in order to do that must be prepared in accordance with Generally Accepted Accounting Practice (GAAP). The starting point for profits chargeable to tax is the accounts prepared in accordance with GAAP. As noted above the UK's transfer pricing rules calculate the taxable profits on the price that would have been charged at arm's length. Where the pricing is not arm's length a 'primary adjustment' is made to the original price and this adjusted price is effective for tax purposes. If the adjustment is not required to be reflected through the accounts in order for them to show a true and fair view of profit (in accordance with GAAP), then the primary adjustment will just be made in the tax computation

2.21 Where a secondary adjustment arises it is unlikely that the accounts will be adjusted to reflect it unless the impact of the secondary adjustment is that the accounts do not show a true and fair view. Therefore if the secondary adjustment results in a deemed loan between the two parties, that deemed loan and any interest arising is likely to be reflected in the tax computation and not in the accounts.

Question 8
What issues, if any do you see arising on the interaction of secondary adjustments and accounting standards?

At what date should the loan be deemed to have arisen and what interest rate should be applied?

2.22 The primary adjustment will often represent the correction to the arm's length price of a significant number of transactions that have arisen throughout an accounting period. To deem the loan to have been created at the dates of the individual transactions would be complex and administratively burdensome to analyse and calculate. A simpler approach is preferred.

2.23 The government recognises that the date on which the loan is deemed to arise will have a significant impact on both the amount and timing of any imputed interest arising upon it. It is the government's view that any rule should deem the loan to arise at the end of the accounting period to which the primary adjustment relates, as this is the closest to realigning the economic benefits of non-arm's length transfer pricing arising in that accounting period.

Question 9
Do you agree with this preferred approach? If not, what alternative approaches would you propose?

2.24 Once the loan is recognised, it follows a rate of interest should be imputed upon it. The interest charge will apply until the excess profits represented by the loan are repatriated. The interest on the loan could be set by reference to what would be applied by an arm's length lender. However, the government is concerned this may lead to prolonged negotiations as part of the application of the rule. The government preference is for the rate to be set by reference to a predetermined market adjusted rate and will consider whether that should be set at well above market rate in order to support the rule's deterrent effect.

Question 10
What are your views on how and at what rate of interest should be set?

When should the secondary adjustment cease?

2.25 The deemed loan and associated imputed interest would apply until the date on which the excess profits are repatriated to the UK. This repatriation should require the physical recognition of the funds in the UK entity and be a transfer between the counterparties to the primary adjustment. The government's preference is for the repatriation, as it is the settlement of a deemed loan, be limited to being in the form of cash or cash in kind i.e. a net off against a pre-existing debt in the UK.

Question 11
What are your views on the merits of repatriation being required in the above form and what alternatives are there?

Taxation of repatriated balance

2.26 A rule that treats the excess profits as a deemed loan means the repatriation of the amount representing that loan should not be taxed at the point of receipt in the UK. This would be due to those profits already having been taxed by way of the primary adjustment.

Question 12
What are your views on the wider UK tax implications arising on the repatriation of the amounts representing the deemed loan?

Requirement for an anti-avoidance test

2.27 A secondary adjustment rule would act as a deterrent to non-arm's length pricing and aggressive tax driven structures. To address any attempts to sidestep or abuse it, the government's preference is for it to include an anti-avoidance rule.

Question 13
Do you see the need for an anti-avoidance rule? If so, what avoidance opportunities do you consider the rule would be open to and how would you suggest an anti-avoidance rule be designed to address these?

Interaction with the UK's wider tax legislation

2.28 The policy aims of the rule need to be considered when looking at how it would interact with current and any impending wider tax legislation. This includes its application to the UK's current UK:UK transfer pricing rules.

2.29 Consideration will need to be given on maintaining the deterrent effect of the repatriation requirement and the imputed interest arising on the loan i.e. ensuring it is not cancelled by a corresponding benefit elsewhere in the tax legislation which makes the rule partially or wholly ineffective. One option would be to ring-fence the deemed loan and the interest income arising on it, so that it is not effective for rules outside of Part 4 TIOPA 2010.

Question 14
What legislative interaction issues need to be considered in deeming a loan, or something to be treated in a manner consistent with a loan, and how would the difficulties they create be overcome?

2d) Mutual Agreement Procedures and Advance Pricing Agreements (APA)

2.30 A primary concern arising in the application of any secondary adjustment rule is the creation of non-relievable double taxation.

2.31 Article 9 of the OECD Model Tax Convention on Income and on Capital sets out the general application of the arm's length principle. Article 9(1) provides for upwards adjustments in the country from which profits have been diverted by non-arm's length pricing. Article 9(2) permits corresponding (downwards) adjustments in the country in which the other company or enterprise is located. The availability of a downward adjustment reduces the possibility of economic double taxation arising on the same profits, which is a key feature of international tax treaties.

2.32 However, Article 9(2) does not cover secondary adjustments and so does not require corresponding relief to be provided on them. This means the availability of relief from double taxation will either be gained by domestic legislation, the specific terms of the agreed tax treaty or alternatively through the relevant Mutual Agreement Procedure (MAP) article contained within that treaty.

2.33 Many double taxation treaties include a MAP article (one that is likely to be based along the lines of Article 25 of the OECD Model Tax Convention on Income and on Capital). This allows a taxpayer to present its case to the competent authority of the state of which it is resident that it is not being taxed in accordance with a particular treaty. This can lead to the competent authority either rejecting the application for relief or giving relief by agreement. The taxpayer's request can also lead to that competent authority endeavouring to resolve the case by negotiation with the competent authority of the other country that is party to the tax treaty.

2.34 Relief for the tax incurred in the UK on a secondary adjustment rule will therefore in part be dependent upon the presence of a tax treaty, the specific terms of that tax treaty and whether both competent authorities of the countries party to it are willing to enter into negotiations.

Question 15
What issues arise from the possibility of non-relievable double taxation and how may they be addressed?

Interaction with Advance Pricing Agreements (APA)

2.35 An APA is a written agreement between a business and the Commissioners of HMRC, which sets out the method for determining, in accordance with the law, the transfer price for connected party transactions. APAs are part of the internationally recognised best practices recommended by the OECD. They allow transfer pricing issues to be resolved in advance of a tax return being made and gives assurance to the business that the treatment of those transfer pricing issues will be acceptable to HMRC for the period covered by the agreement.

2.36 The government's preference is that a secondary adjustment rule would apply whether a primary adjustment arose within an APA or not. This would achieve policy consistency and also ensure no behavioural change arose by the rule encouraging taxpayers to request APAs primarily to mitigate exposure to a secondary adjustment. The government recognises that some current APAs will already include a condition that adjusts the pricing of a transaction in line with the aims of a secondary adjustment rule. Any rule would need to ensure its aims are applied consistently across all APAs.

Question 16
What issues do you see arising in the application of a secondary adjustment rule within the operation and agreement of APAs and how may these be addressed?

3. Assessment of Impacts

Introduction of secondary adjustments into the UK's domestic transfer pricing legislation

Summary of Impacts

Exchequer impact (£m)	The impact on the Exchequer will depend on the final design of the policy which will be finalised following this consultation. Any detailed costs would be subject to scrutiny by the Office for Budget Responsibility.
Economic impact	The rule is not expected to have any significant economic impacts. .
Impact on individuals and households	Transfer Pricing can apply to both companies and individuals. However, we expect the rule will primarily be a business tax measure that impacts large multinational enterprises. This means it should not directly affect individuals or households. It does not impact on family formation, stability or breakdown.
Equalities impacts	There are no impacts on any groups which share a protected characteristic.
Impact on businesses and Civil Society Organisations	The main impact of the rule would be to make the actual allocation of profits consistent with the primary adjustment made to correct non-arm's length pricing and deter aggressive tax planning. We expect its impacts will be mainly on large multinational enterprises with complex international operations. We will look to collect evidence on the scale of this through the consultation process, including assessing the impact any rule would have.
Impact on HMRC or other public sector delivery organisations	Any costs or other impacts on HMRC will depend on the final design of the policy. This will be determined following this consultation.
Other impacts	As highlighted above, we expect a rule would impact large multinational enterprises with complex international operations. Other impacts have been considered and none have been identified at this stage. We would welcome views on this initial assessment of impacts.

4. Summary of Consultation Questions

Question 1
The sections below set out a number of specific questions on the design of a secondary adjustment rule. However, the government would be grateful for any wider comments, beyond responses to these specific questions.

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5. The Consultation Process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

Stage 1 Setting out objectives and identifying options.

Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.

Stage 3 Drafting legislation to effect the proposed change.

Stage 4 Implementing and monitoring the change.

Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views on the detailed policy design and a framework for implementation of a specific proposal, rather than to seek views on alternative proposals.

How to respond

A summary of the questions in this consultation is included at chapter 4.

Responses should be sent by 18 August 2016, either by e-mail to secondaryadjustments.consultation@hmrc.gsi.gov.uk or by post to: Nick Shepherd, HMRC, CTIS Business International, 11th Floor East Spur, Euston Tower, 286 Euston Road, London NW1 3UH.

Or by fax to 03000 543795 marked for the attention of Nick Shepherd.

Telephone enquiries to Nick Shepherd 03000 585588 (from a text phone prefix this number with 18001)

Please do not send consultation responses to the Consultation Coordinator.

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from HMRC's GOV.UK pages. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentially can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

If you have any comments or complaints about the consultation process please contact:

John Pay, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.