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United Kingdom transfer pricing: Diverted Profits Tax means double trouble

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Thursday, January 4th, 2024

Back in 2015, my first ever blog asked Does the UK Diverted Profits Tax help or hurt BEPS? Whatever the answer, the level of complexity and the challenges it brought to UK cross-border taxation cannot be underestimated.

The recent decision of the UK Upper Tribunal in in *Refinitiv Ltd and others v HM Revenue & Customs* [2023] UKUT 00257 (TCC) highlights the complexity of having, in effect, two transfer pricing regimes potentially applicable to the same transaction.

Basic transfer pricing rule

The basic UK transfer pricing rule in s 147 of the Taxation (International and Other Provisions) Act 2010 ("TIOPA") is broadly patterned on article 9(1) of the OECD Model Treaty. Its awkward language was summarised by the Tribunal in *Refinitiv* as:

'comparing "the actual provision", that is the provision "made or imposed as between any two persons…by means of a transaction or series of transactions" (s147(1)(a)), with "the arm's length provision" that "would have been made as between independent enterprises" (s147(1)(d)). Where the "actual provision confers a potential advantage in relation to United Kingdom taxation" (s.147(2)), "the profits and losses of the potentially advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision" (s147(3)).' (at paragraph [12]).

Interpretation of this provision for the tax years in question, was required to be consistent with the BEPS Actions 8-10 2015 Final Reports that introduced provisions later included in the 2017 OECD Transfer Pricing Guidelines.

Diverted Profits Tax

The Diverted Profits Tax (DPT), introduced in 2015, applies to a "relevant alternative provision", defined in Finance Act s 82(5) as:

'the alternative provision which it is just and reasonable to assume would have been made or imposed as between the relevant company and one or more companies connected with that company, instead of the material provision, had tax (including any non-UK tax) on income not been a relevant consideration for any person at any time.'

Unlike the basic transfer pricing rule, the OECD Transfer Pricing Guidelines have no statutory force for DPT. The only guidance on the meaning of “relevant alternative provision” in in the normal rules of statutory interpretation. The Tribunal clearly accepted as axiomatic that the purpose of the DPT was “to address the situation where multi-national groups deploy arrangements to divert profits away from the UK to lower tax jurisdictions.”

The DPT, however, applies in more limited circumstances than the basic transfer pricing rule. These include the requirement that an amount that is deductible in calculating UK taxable profit, is taxed in the hands of a non-resident who ultimately receives the deductible amount at a rate of less than 80% of the UK corporation tax rate. DPT, a separate tax is then imposed at a higher rate than corporation taxon that amount (25% v 20% in the years concerning *Refinitiv*) .

IP holding company

In *Refinitiv*, intellectual property was centrally held within the Thomson Reuters group by a Swiss resident company. UK resident group companies provided services to the Swiss company. The services were described as: “Software and New Product”; “Content Development and Acquisition”; “News and Editorial Services”; “Data Hosting Services”; “Marketing Central and Support Services”; “Advisory”; and “Synergy and Integration”.

The intellectual property generated profits for the Swiss company and was eventually sold in 2018 for a significant gain.

HMRC issued DPT charging notices, including for 2018. The tax was said to be the arms’ length compensation for the services that the UK companies should have received for their services that enhanced the IP held by the Swiss company.

Transfer pricing

Only one transfer pricing issue was before the Tribunal: the choice of transfer pricing method. The dispute did not however concern the merits of the choice. The taxpayer argued, in judicial review proceedings, that HMRC should have used the methods that were agreed in an advance pricing arrangement (APA) that had previously been agreed with HMRC in respect of the same services and that applied from 2008 to 2014. The taxpayers had attempted to secure a further APA, but HMRC had declined to agree.

The APA provided for the services to be priced by applying the Transactional Net Margin Method. A cost-based profit level indicator was required to be used. The Tribunal confusingly referred to this as a cost-plus method. The “Synergy and Integration” services were to be priced on the basis of cost-allocation.

In contrast, HMRC sought to apply DPT using a profit split method. It was clear that HMRC relied on the 2017 OECD Transfer Pricing Guidelines for their DPT analysis even though they do not form part of the DPT legislation. They argued that the UK company would have additional income in the form of arm’s-length compensation paid to it by the legal owner of the IP for the performance of DEMPE functions (development, enhancement, maintenance, protection and exploitation” of intangibles) on the basis that the vast majority of those functions were carried out in the UK [and the US]. In their view, the UK company performed value-adding functions (including development and risk control functions) relating to the IP.

The Tribunal accepted that the scope of the "relevant alternative provision" is "conceptually broader" than arm's length pricing transfer pricing under the regime. In *Refinitiv* it was agreed that both regimes "entail precisely the same exercise of positing an arm's length transaction between the parties." The formulation of the arm's length pricing by the Tribunal, however, adopted the wider language of the DPT: "that the hypothetical transaction posited as the one that would have taken place had tax not been a relevant consideration, to simply be the same transaction but one which was priced at arm's length." That is plainly not the test for transfer pricing.

Judicial review

Judicial review is an administrative law remedy that addresses the lawfulness of the actions of a public authority for breach of legitimate expectation, an abuse of statutory power or acting irrationally. This case concerned whether there was unfairness amounting to an abuse of power where HMRC "have been guilty of conduct equivalent to breach of contract or breach of representations on their part."

The taxpayer argued that this unfairness was because the profit split method used in the DPT charge was inconsistent with the APA. This was because the APA and DPT cover the same subject matter but do so inconsistently, undermining the written agreement and the statutory regime. HMRC accepted that if the DPT charge was inconsistent with the APA then it would be unlawful. The Tribunal ultimately upheld HMRC's argument that the DPT charges concerned years subsequent to the APA.

Curious concessions

Both sides made curious concessions. HMRC argued that for DPT purposes, The arm's length amount must be calculated according to the basic transfer pricing rule (which incorporates the OECD Transfer Pricing Guidelines). If that is the case, what is the point of two regimes? The taxpayer accepted that generally, HMRC would be able to change the transfer pricing method from one year to another. This is highly doubtful.

Concluding observations

The case raises more questions than it answers. While an APA is generally only applicable within its terms, an APA which is supported by proper analysis and reasoning, but which is not renewed, raises questions about departing from that analysis (rather than the agreement itself) for later periods to which it does not apply in the absence of changed circumstances. To do so would undermine the proposition that the pricing of a transaction is determined by the parties when the transaction is concluded. Hindsight is not allowed.

Refinitiv does not consider which "relevant alternative provisions" might be beyond the scope of the basic transfer pricing regime. This remains a black box.

If HMRC wanted to apply the 2017 OECD Guidelines (from 2015 in the form of the BEPS Actions 8-10 Final Report) to this case, a more straightforward transfer pricing assessment would have the same effect. Use of the DPT simply allowed a higher-than-normal rate of tax to be imposed as well as the draconian administrative provisions that apply to the DPT.

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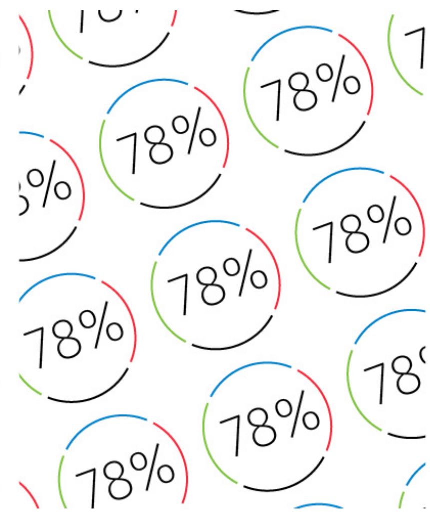

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