

Navigating the stormy waters of year-end closing



What are the key transfer pricing actions?

Despite the challenges this poses, a majority of UK businesses have chosen to adopt 31 December as their year-end. The year-end close period is typically a whirlwind of activity and transfer pricing is just one of a long list of areas that need to be dealt with. With this in mind we have put together a checklist of key transfer pricing year-end actions to help you navigate through the storm that is year-end closing. Here are the key questions from this checklist that you need to look at.

Am I ready to submit my corporate tax return for the prior year?

UK businesses are required to self-assess their compliance with the arm's length principle when filing their corporation tax return each year. When digitally approving the return for submission, the responsible person is confirming that:

We have provided a quote below from a recent enquiry which gives a more specific idea of what HMRC would be looking for.

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All transactions (involving goods, services, financing or intellectual property) with related parties have been identified and are reflected on an arm's length basis in the statutory accounts. Alternatively, where this is not the case and the actual basis used could result in a potential UK tax advantage, appropriate transfer pricing adjustments have been made in the tax return and computation to reflect an arm's length basis for such transactions;

02

Where the UK business is a branch (permanent establishment) of an overseas entity or has overseas branches (permanent establishments) itself, the attribution of profits to the permanent establishment(s) has been undertaken by applying the principles of the relevant double tax treaty.

It might sound a rather broad-fitting description of a taxpayer's obligation to self-assess correctly so let us try and shed a bit more light on the required actions.

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when [the responsible person] signed the declaration and submitted the tax return for the period ended 31 December 2016 what measures were undertaken to ensure the related party transactions for [UK Company] were in line with the arm's length principle?

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We've listed several measures which we recommend you look at to gain comfort that the pricing of your related party transactions meets the arm's length standard prior to approving the tax return filing:

1. Do you have reliable support for the pricing of your related party transactions? Are your benchmarking studies and TP documentation up-to-date and relevant?
2. Have you made sure that the expected profit outturns correspond to both what the policy recommends and the interquartile ranges of the benchmarking studies you have? Should you apply any transfer pricing adjustments?
3. Have you assessed the impact of any exceptional costs appearing in the financial statements? Should you recharge these costs and to which recipient? Should a mark up be applied to the costs, and if so, at what rate and how would this rate be supported?
4. Do you have legal agreements in place that cover the related party transactions and have they been signed on time?

We recently saw an example where, if a taxpayer had gone through this checklist before year end, they would have saved themselves a penalty for carelessness from HMRC. In this specific example, the UK company of the taxpayer turned out to be a loss maker while it had been forecast to make a profit.

In the revenue inspectors' own words: 'A prudent person, on reviewing the accounts prior to submission would have questioned why a loss was being made....'.

And questioning the position would have meant not just checking whether documentation requirements were met, but also whether the profit outcomes of the group make sense from a broader transfer pricing and commercial perspective.

In another similar enquiry, the tax inspector said: 'Although the [connected party] charge was underpinned by an OECD transfer pricing report, we [HMRC] believe that [the client's] financial accountants and controllers should have considered the recharge in the context of its impact on [the client's] results prior to signing the return... and considered the imposition of the charge moving [the client] from returning a small profit to being in a loss position.'

Both of the enquiries quoted above resulted in hefty penalties for the taxpayer which may have been avoided if a sense check had been run before submitting the respective tax returns.

Therefore, our advice for approaching year end is to take a step back and question the big picture of the financial results you are about to put in the tax return. If going through this doesn't take you to a place where you are comfortable with the numbers you are submitting, you may want to revisit and adjust the results and the underlying policy.

While it sounds a strategic exercise, changing your TP policy is not necessarily one that should be left for better days. A policy overhaul can sometimes be best done around year end when all stakeholders of the business feel the need to report correct results and implement a robust process going forward. You may even consider approaching HMRC (either formally or informally) to agree in advance the cornerstones of the new policy.

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Looking ahead

The finance profession has always been about forward looking solutions as well. Once you have sufficient comfort with your current year end closing, it is worth spending some time to think about what challenges next year might pose so there are no negative surprises:

- Do you expect changes in your business model? Any restructurings, closures or new transactions?
- When you look at monthly or quarterly results, does it seem like year end results would be in line with levels set by policy?
- Does any company in the group continuously generate losses or abnormal profits?
- Does any company use group IP without paying a charge?
- Will any entities require additional financing or refinancing next year?
- Does the TP documentation you have still offer reliable defence for your transactions' pricing?

If you have any doubts regarding any of the questions and recommended actions we list both for current year end closing and planning ahead for the next financial year, have a look at our checklist below.

Documentation and housekeeping

- Contemporaneous TP documentation
- Contemporaneous benchmarking studies (generally should have been performed within the last 3 years and refreshed to include the latest financial data for the comparable companies)
- Signed legal agreements
- Accounting records clearly showing correct application of TP policy

Transactions

- Costs (including exceptional ones). Recharge or no recharge? Mark-up or no mark-up?
- Royalties – Is anyone using "free" IP? Are royalties pushing a company into a loss?
- Interest - have you benchmarked the rate? Have you considered broader implications - CIR, thin capitalisation?
- Services - is anyone getting them for free? Is there evidence of recipients' benefit?

Profit outcomes

- Do I see a loss where I expected a profit? Are results compliant with policy?
- Are the companies that contribute most getting the most profit as well?
- Would year end adjustment be necessary? Think early, VAT and customs duty may be impacted as well

