UK transfer pricing rules – the SME exemption

Scope of UK transfer pricing rules

The UK transfer pricing rules apply where:

➢ a provision has been made or imposed between two persons by means of a transaction or series of transactions

References:

INTM412020
TIOPA 2010, s 147(1)(a)

➢ the participation condition is satisfied

References:

TIOPA 2010, s 147(1)(b)

➢ the actual provision differs from the arm’s length provision, and

References:

TIOPA 2010, s 147(1)(d)

➢ there is a potential UK tax advantage.

References:

TIOPA 2010, s 147(2)(b) and 4(b)

SME exemption

For the calculation of profits arising on or after 1 April 2004, TIOPA10/S166 provides an exemption from transfer pricing rules for the vast majority of transactions carried out by a business that is a small or medium sized enterprise.

What constitutes a small and medium sized enterprise for this purpose is a modification of the European recommendation (2003/361/EC). Details are at INTM412080.

Exceptions - transactions with parties in non-qualifying territories

The exemption does not apply where a business has transactions with or provisions which include a related business in a territory with which the UK does not have a double tax treaty with an appropriate non-discrimination article. TIOPA10/S167(3) keeps such transactions subject to transfer pricing rules.
An appropriate non-discrimination article is one that ensures the nationals of a contracting state may not be less favourably treated in the other contracting state than nationals of that latter state in the same circumstances (in particular with respect to residence). A list of the double taxation treaties that HMRC regards as containing an appropriate non-discrimination article as at 1st April 2011 (except where stated otherwise) is at INTM412090.

The Treasury has the power to make regulations adding to the list of territories that qualify even if the double taxation treaty in question does not contain an appropriate non-discrimination article, or to exclude territories even if the treaty in question does contain such an article.

Exceptions - Transfer pricing notice given to medium sized enterprise

HMRC may issue a transfer pricing notice to a medium sized enterprise to require that person to calculate their taxable profits applying transfer pricing to the provision specified in the notice. In any case where case teams think such a notice might be appropriate, they must make a referral to CSTD Business, Assets & International Transfer Pricing team.

Exceptions - Election to remain subject to transfer pricing rules

There may be occasions where a business wishes to apply transfer pricing rules even though it would qualify for exemption. A business can elect that the exemption will not apply. An irrevocable election can be made for a specified chargeable period and will cover all transactions or provisions made in that period.

Exceptions - Patent Box

Where a SME is party to a transaction that is relevant to a patent box claim HMRC may issue a notice to require that person to compute their profits in accordance with transfer pricing in respect of that provision. In any case where case teams think such a notice might be appropriate, they must make a referral to CSTD Business, Assets & International.

The definition of small and medium enterprises

The European Commission published a revised recommendation on 6 May 2003 concerning the definition of micro, small and medium sized enterprises (2003/361/EC).

The definition applies to any entity engaged in an economic activity, irrespective of its legal form and includes entities subject to income tax as well as corporation tax.

An entity qualifies as either small or medium if it meets the staff headcount ceiling for that class and one (or both) of the financial limits as set out in the following table (referred to as the qualification data in these notes). Where the entity is a member of a group, or has an associated entity, these limits apply to the whole group and not the specific entity.
<table>
<thead>
<tr>
<th></th>
<th>Maximum number of staff</th>
<th>And less than one of the following limits:</th>
<th>Balance sheet total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Enterprise</td>
<td>50</td>
<td>€10 million</td>
<td>€10 million</td>
</tr>
<tr>
<td>Medium Enterprise</td>
<td>250</td>
<td>€50 million</td>
<td>€43 million</td>
</tr>
</tbody>
</table>

Staff includes employees, persons seconded to work for a business, owner managers and partners. Where staff do not work full time during the year they should be counted as an appropriate fraction.

The measures of turnover and balance sheet total are net of VAT and otherwise have their ordinary meaning for accounting purposes. In particular, balance sheet total means total assets (for example, as defined by CA85/S247) and should not be taken as net of any liabilities. The recitals to the EU recommendation make it clear that the use of a balance sheet threshold is required to identify the economic position of an enterprise using a measure for its relative size or wealth.

Conversion to sterling should be made at the average exchange rate for the period of account whose profit is being computed, or the exchange rate on the date the account was drawn up if this produces a fairer result. As with any of the thresholds, businesses close to the limit should not rely on changes to the exchange rate but should plan in advance to meet the requirements (if any) which changing designation requires.

The Commission recommendation recognises that in two situations the staff and financial data of associated enterprises must be included with that of the enterprise seeking exemption. It refers to these as:

➢ linked enterprises

and

➢ partnership enterprises.

There is more detail about these situations at INTM412100.

**Modification**

There are modifications of the EU recommendation:
Rights of a liquidator or administrator (acting in that capacity) are left out of account in determining whether the enterprise, or any other enterprise meets the numerical tests.

Whether the person is an SME will be determined solely by reference to the period for which a return is being made.

The declaration as an autonomous enterprise in paragraph 5 of Article 3 is omitted.

The numerical tests are by reference to annualised figures for the chargeable period.

The genuine estimate for a newly established enterprise is omitted.

On 1 April 2019, the UK introduced new anti-profit fragmentation legislation intended to counter cross border structures which result in a tax mismatch. The rules are intended to apply where UK value is transferred or undervalued, resulting in that value being realised in a lower tax jurisdiction.

The rules place an obligation on taxpayers to prove that the arrangements are priced at arm’s length which means pricing the arrangements on the terms that would apply if there was no relationship between the UK person or company and the overseas person or company. SMEs are generally exempt from UK transfer pricing, but the new rules effectively extend the UK transfer pricing rules to SMEs.

Background

The new measures were first introduced in the Autumn Budget of 2017, followed by a consultation that ran from April to June 2018.

The draft legislation and a response document were published in July 2018. After a period of consultation, the legislation was introduced in Clause 16 and Schedule 4 of the Finance Bill 2018-19, including material changes to make it less burdensome with regards to measures such as self-notification and upfront tax payments.

The legislation introduced new anti-avoidance rules, effective from April 2019, in order to tackle ‘profit splitting’ arrangements intended to shelter taxable profits from UK tax.

The rules apply if:

➢ There is a transfer of value derived from a UK trade to an entity in a lower tax jurisdiction; and
➢ The transfer results in a tax mismatch – broadly the extra tax payable overseas is less than 80% of the reduction in UK tax; and
➢ A UK related individual (for example, a sole trader, shareholder, partner) has arranged for the profits to be diverted and can continue to ‘enjoy’ them; and
➢ The profit allocated to the entity in the low tax jurisdiction is excessive with regard to its activities.

Reasonable changes

The new rules have dropped the previous proposal for taxpayers to notify HMRC of schemes that result in profit fragmentation, as this could have resulted in taxpayers having to notify HMRC even if
no tax was due. Likewise, a proposal to require taxpayers to make an advance payment of any tax due has been dropped.

The legislation has introduced a quasi-motive test into Schedule 4 paragraph 2(2)(b) which states that arrangements are not profit fragmentation arrangements if it is not reasonable to conclude that the main purpose, or one of the main purposes, for which they are entered is to obtain a tax advantage. It remains to be seen how this will play out in practice, as it can be hard not to attribute the existence of a tax advantage as a motive.

Overall, these measures mean that the new rules are significantly less onerous from a compliance perspective than what was originally proposed.

**Still bad news for SMEs**

Arguably, the practical impact of the new rules is to extend the scope of UK transfer pricing rules to all UK businesses potentially caught by them. Essentially, a business that is conducting transactions with a related party in lower tax jurisdictions will have to show that those transactions are indeed arm’s length in order to avoid suffering a potential one-sided tax adjustment in instances where it is deemed the business can enjoy the benefits of the diverted profits.

One example is where a small UK business makes use of technologies held by a small subsidiary undertaking based in a lower tax jurisdiction (not uncommon) and pays royalties to that subsidiary undertaking. The royalty payment will be a deductible expense for tax purposes in the UK and will therefore need to be priced at arm’s length. This is to avoid the UK business being deemed to have transferred value in the form of excessive royalty payments that are then realised (via a generally tax-exempt dividend payment) in the small subsidiary undertaking resident in a lower tax jurisdiction.

Another example is where a small UK business pays for procurement services provided by a small Singapore based subsidiary that it recently set up to help it source products from the Asia region. The income of the Singapore subsidiary will typically be quite small. This will mean it benefits from the tax exemptions available for businesses in Singapore, where the first approximately £100,000 of income may be exempt from tax, thereby resulting in a tax mismatch. The procurement fees paid by the UK business to the Singapore entity will be tax deductible expenses in the UK. Under the new rules, the procurement payments will have to be priced at arm’s length in order to avoid the UK business being deemed to have transferred value in the form of excessive procurement payments that are then realised (via a generally tax-exempt dividend payment) in Singapore.

Both examples show SMEs that would have ordinarily been exempt from transfer pricing altogether, or considered very low risk for UK transfer pricing, which could previously have priced transactions without having to consider whether the pricing is arm’s length. Going forward they will now need to gather and maintain evidence that the arrangements are arm’s length.
The result of meeting the conditions

Should the conditions apply, then tax adjustments may need to be made to the tax computations of the UK businesses which:

- Relate to the relevant expense, income, profits or losses of the UK resident entity;
- Are based on the arm’s length principle; and
- Must be just and reasonable.

Commencement

For value transfers, the new rules came into effect on 1 April 2019 for corporation tax, and 6 April 2019 for income tax. This includes profits accruing on or after those dates on existing structures.

With the rules commencing directly following Q1 2019, UK businesses should, as best practice, self-assess their structures in order to determine whether these new rules apply.

Why work with Jupp Consulting?

Andrew Jupp, a Chartered Accountant and a former PhD research Andrew Jupp, has many years’ experience in successfully helping companies manage their transfer pricing strategy and compliance obligations. He has a thorough understanding of the systems in all the major trading jurisdictions and couples this with a pragmatic and commercial approach.

Contact us for an initial no-obligation discussion.

Practical and commercial strategic, tax and general business advice
chartered accountants | business advisors | non-exec directorships
www.juppconsulting.co.uk

Andrew Jupp PhD FCA
andrew@juppconsulting.co.uk

Bramley House | Crudwell | Malmesbury | Wiltshire | SN16 9EH
(O) + (44) 1666 577770     (M) + (44) 7775 433914

This information is believed to be correct at the time of publication and is based on information in the public domain. However, the publication is written in general terms for information purposes only based on our understanding of current legislation and practice, and in no way constitutes specific advice. You are strongly recommended to seek specific advice before taking any action in relation to the matters referred to in this publication. No responsibility can be taken for and errors contained in the publication or for any loss arising from action taken or refrained from on the basis of this publication or contents. No parts may be reproduced in whole or in part without our prior consent. ©Jupp Consulting 2020