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Phil Roper

Thomas D. Bettge

Alistair Pepper

Phil Roper is a partner in KPMG UK's global transfer pricing services practice, and Thomas D. Bettge is a senior manager and Alistair Pepper is a managing director in the economic valuation services group of the Washington National Tax practice of KPMG LLP.

In this article, the authors examine the United Kingdom's "one-way street" transfer pricing rule and weigh the benefit of maintaining this approach versus providing greater flexibility for taxpayers to make self-initiated downward adjustments.

Introduction

U.K. transfer pricing operates via domestic legislation (part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA)). While generally aligned with the international approach endorsed by the OECD, some of the U.K. rules have been criticized for being too rigid and complex. This can create unnecessary compliance burdens at best and, at worst, increase the risk of double taxation. One particular challenge is the so-called one-way street (OWS) rule, which requires an arm's-length tax return adjustment that increases taxable profits (or reduces allowable losses), but generally does not permit a tax return adjustment in the other direction for cross-border transactions unless this has been pre-authorized by HM Revenue & Customs through an advance pricing agreement or after the conclusion of a mutual agreement procedure.

This article suggests that the United Kingdom, and other jurisdictions with similar rules, should reevaluate whether a strict OWS approach is still necessary for cross-border transactions in light of major developments in the international tax landscape.

'Tell Me Why'

The OWS is found in section 147(2) TIOPA 2010. The rule restricts the circumstances in which U.K. tax reporting can be based on adjusted arm's-length prices in lieu of the prices reflected in the financial accounts based on the actual provision. An adjustment is only permissible when "the actual provision confers a potential advantage in relation to United Kingdom taxation" on one or both of the "affected persons" (i.e., the counterparties to the transaction).

A potential advantage for the purposes of U.K. tax exists if, because of the actual provision, the income or profits of a person (for corporation tax or income tax purposes) for a chargeable period are less than, or its losses are greater than, they would have been had the arm's-length provision been made between the affected persons. In the absence of a potential U.K. tax advantage, there is no scope to apply the U.K. transfer pricing rules: They cannot be used to correct a potential U.K. tax "disadvantage" that arises when a U.K. resident company has overcharged or underpaid a non-U.K. resident-connected company for goods or services.

Proponents of the OWS argue that the United Kingdom's legislation mirrors the approach to primary adjustments under article 9(1) of the OECD model tax convention, which states that when:

> Conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, *may* be included in the profits of that enterprise and taxed accordingly. [Emphasis added.]

However, actual double taxation agreements operate to restrict, rather than create, domestic taxing rights. Although there are dissenting views, the only legal basis for making a primary transfer pricing adjustment is the domestic law of a particular jurisdiction and the effect of article 9(1) is to restrict adjustments to those that conform with the arm's-length principle. The use of the word "may" in article 9 makes it clear that contracting states are under no obligation to make transfer pricing adjustments, but if they do, the adjustments should not result in taxation of profits exceeding the arm's-length amount.

It is therefore a matter for each jurisdiction to determine the precise scope of any transfer pricing rules, though those rules will then be limited by applicable double tax agreements. For example, neither the OECD model tax convention nor individual tax treaties define which enterprises are "associated" — i.e., what level of direct or indirect participation is necessary for association. Instead, this is typically left to domestic rules.

The rationale behind the OWS is that if taxpayers were allowed to make downward transfer pricing adjustments (outside of a MAP) this would give rise to the risk of double nontaxation (as was the case historically under informal capital rulings in the Netherlands and excess profits rulings in Belgium that operated on the basis of downward transfer pricing adjustments). However, the lack of flexibility to make downward adjustments under domestic legislation can cause double taxation, for example, when there is no double tax agreement and the risk of double nontaxation can be addressed in other ways (e.g., by allowing a downward adjustment when accompanied by a certification that the adjusted price has been or will be reported in the counterparty jurisdiction).

The requirement for corresponding adjustments to go through a MAP creates an additional burden on taxpayers and on competent authorities' resources, limiting the speed with which MAPs and APAs can be resolved or agreed upon. In practice, taxpayers frequently opt not to pursue MAP unless the adjustments are very significant, because of the additional costs involved in pursuing relief and perceptions that the outcome is uncertain and resolution is unlikely to be swift.

Notwithstanding the OWS rule, taxpayers sometimes file returns including downward adjustments, which will generally lead to an HMRC inquiry. This is something HMRC called out in "Guidelines for Compliance: Common Risks in Transfer Pricing Approaches," released in September. It is unsurprising that mistakes happen because it isn't an intuitive rule. When people think about arm's-length pricing they naturally think about a bilateral transaction and a price that is acceptable to both parties — and the challenges of operational transfer pricing frequently necessitate adjustments after the books for a year are closed.

'You Can't Always Get What You Want'

It is worth reflecting on why taxpayers may struggle to "get things right" the first time in the accounts. Tax administrations and policymakers tend to underestimate (when they do not simply disregard) the real challenges of translating a transfer pricing policy into a workable framework for a business. As often as not, transfer pricing today is a matter of returns and margins rather than set prices — meaning that, rather than setting a price once for a related-party transaction, a company often must forecast its profitability for the relevant segment and then use intercompany prices and adjustments to achieve the intended arm's-length result.

Furthermore, when the transactional net margin method is used to test the profit outcomes of entities, HMRC and many other tax administrations expect the amounts used to calculate the relevant net profit indicator to be measured under local generally accepted accounting principles, irrespective of the makeup of the set of comparable companies (which are often regional rather than purely local companies). Many groups will undertake transfer pricing reviews as part of the year-end close using the GAAP used by the group for consolidated financial reporting purposes, with any initial true-up adjustments based on variances between actuals and budgeted or forecast income and expenses being based on those numbers. Local GAAP financial statements tend to be produced later, and timelines differ by country, so making a subsequent two-sided true-up adjustment (which falls into the same accounting period for both parties) is often impractical.

For entities that buy and sell tangible goods, the challenges in managing to keep annual margins measured under local GAAP within the interquartile range of results of comparable independent companies can also be exacerbated by inventory held at year-end because retrospective transfer pricing changes to the cost of goods will partly affect the balance sheet carrying value of unsold inventory rather than the profit and loss account. It would help if all tax administrations accepted techniques such as multiple-year averages and the use of the full range rather than the interquartile range, but that is not always the situation.

So if taxpayers want to avoid unwanted tax audit discussions about margins for transactional net margin method entities outside the relevant interquartile ranges, they need the ability to make tax return adjustments going in both directions. This point will become even more important after the implementation of amount B, as explained below.

Another issue we see in practice is where the taxpayer makes an adjustment through the accounts in the next accounting period. HMRC is clear that this does not negate the requirement to report upward transfer pricing adjustments in the tax return for the earlier period. Furthermore, if the accounting treatment in the subsequent period treats the transfer pricing adjustment as a prior-year adjustment through retained earnings for both parties, rather than affecting the income statement, there will still be unresolved double taxation.

'Why'd You Have to Go and Make Things So Complicated?'

There are other problems that arise from making the transfer pricing rules dependent on a potential U.K. tax advantage test. For example, HMRC is known to take the view that the "wholly and exclusively" trading expense deductibility rule should be applied in priority to the transfer pricing rules. When those rules fully disallow a related-party expense, the transfer pricing rules would not be engaged because there would then be no potential tax advantage. The alternative view is that transfer pricing should apply first to rewrite the accounts to reflect arm's-length transfer pricing; only after this has been done should other tax rules that restrict deductions be applied. The latter approach minimizes the risk of unrelieved double taxation and is the intuitive approach that most taxpayers and advisers tend to take. It is also the position of the IRS in dealing with cases in which U.S. deductibility and transfer pricing rules overlap.[1]

The OWS is also particularly sensitive to the identified provision, or "delineation of the transaction," as HMRC acknowledged in the 2023 public consultation on reform of the transfer pricing legislation:

> Because the potential tax advantage rule at [section] 155 [of TIOPA 2010] operates at the level of the provision, the scope of provision can have a material impact on which transactions between entities can be offset against one another when establishing the extent to which the profits derived from the actual and arm's length provisions differ. How restrictive an

[1] *See* GCM 38676; 1996 FSA LEXIS 354. This policy does not apply to cases involving excessive employee compensation.

interpretation one takes of "provision" can alter the amount of tax payable.[2]

Another difficulty arises from the fact that taxpayers must apply the rules, including the tax advantage test, on the basis of each chargeable period, which can leave taxpayers facing a situation in which no transfer pricing adjustments can be made to correct excess returns in years 1 and 2 (because no potential U.K. tax advantage arises in those periods), and then a transfer pricing adjustment is strictly required in year 3 even if there is a cumulative excess return across years 1 to 3.

'Go Your Own Way'

There is inconsistency between the rigidity of the OWS for transfer pricing and the more flexible permanent establishment profit attribution rules.

For non-U.K. resident companies that operate in the United Kingdom through a branch rather than a U.K. resident subsidiary, there is no equivalent to the OWS under the profit attribution rules. Those rules require the profits attributable to a PE to be calculated as if the PE were a distinct and separate enterprise that (1) engaged in the same or similar activities under the same or similar conditions, and (2) dealt wholly independently with the non-U.K. resident company.

The authors understand that HMRC interprets the separate enterprise principle as requiring the determination of the profits under the fiction that the PE is independent from the rest of the enterprise of which it is a part, as well as from any other person. When a transaction between the nonresident company (with the U.K. PE) and an associated group company directly affects the attribution of U.K. PE profits, we understand HMRC's view to be that, for the purpose of computing the profits attributable to the PE, the conditions of the transaction should be consistent with those of a comparable transaction between independent enterprises.

Under that approach, if a U.K. PE of a non-U.K. resident company (Company A) acquired goods from another non-U.K. resident company within the same multinational enterprise group (Company B), and the contractual supply price was below what would have been agreed between independent enterprises, then the profits of the U.K. PE of Company A should be calculated based on the higher arm's-length supply price. This is analogous to a downward transfer pricing adjustment.

The policy justification for the difference in treatment of U.K. subsidiaries and branches is unclear. Perhaps in a branch scenario the risk of double nontaxation was perceived as lower, or it was thought that the risk should be addressed at the level of the state of residence of the company that is party to the actual transaction. Either way it would seem sensible to revisit whether this difference is still justifiable.

'Born in the U.S.A.'

The United States was the first country to implement transfer pricing rules based on the arm's-length principle. Under the U.S. transfer pricing regulations, taxpayers are permitted to use their timely, original U.S. returns to adjust the transfer prices on their books if necessary to achieve an arm's-length result. Until the 1990s U.S. transfer pricing was an OWS, but with the introduction of the transfer pricing penalty regime, a limited right to make taxpayer-initiated transfer pricing adjustments was introduced, allowing taxpayers to adjust their transfer pricing downward on original, timely filed returns if necessary to achieve an arm's-length result. After the return is filed, however, taxpayers are still forbidden from filing amended returns to decrease U.S. taxable income. Because U.S. corporate taxpayers typically file their returns more than nine months after their fiscal year-end, this rule provides considerable breathing room to reflect the correct transfer pricing on the U.S. return.

For example, if a U.S. distribution entity's books for 2023 showed an operating margin of 6 percent and the transfer pricing analysis performed indicated that the arm's-length range (in the United States this would typically be the interquartile range) was between 2 percent and 5 percent, then the taxpayer would be entitled to make a tax return adjustment that reduces the

[2] HMRC, "Reform of UK Law in Relation to Transfer Pricing, Permanent Establishment and Diverted Profits Tax" (last updated Jan. 16, 2024).

margin to a position within the arm's-length range. Note, however, that U.S. taxpayer-initiated adjustments come with their own compliance challenges.

Allowing for downward adjustments on the tax return is a sensible approach because it eases operational transfer pricing pressures and helps taxpayers avoid penalties. Most jurisdictions, including the United Kingdom, have corporate income tax regimes that are self-assessment-based and put the onus on the taxpayer to accurately calculate their own tax liability. You might expect those rules to encourage taxpayers to get their transfer pricing right at the tax return filing stage. However, U.K. rules aim to ensure taxpayers don't get their transfer pricing wrong to the detriment of the U.K. exchequer, rather than actually getting to a substantively correct outcome for both parties to a cross-border related-party transaction.

The behavioral impact of an OWS could be to drive companies — to the extent this is within their power — to set operational transfer prices high, so that distributors' margins are low and are topped up as necessary because it is harder to reduce them. This may mean a distributor in an OWS jurisdiction on average will have lower margins within the interquartile range than one where there is a fuller freedom to adjust downward as well as upward. Whether the counterparty jurisdiction permits adjustments is another relevant consideration. Customs duties and compliance with applicable customs rules are further complicating factors: Higher import prices on dutiable goods potentially give rise to higher duty costs depending on how subsequent transfer pricing adjustments are treated for customs valuation purposes.

'If It's Good Enough for EU, It's Good Enough for Me'

The European Commission's draft transfer pricing directive put forward commendable proposals to make the interaction between what it refers to as primary adjustments (i.e., upward adjustments by the tax authority) and corresponding adjustments (i.e., downward adjustments in the counterparty jurisdiction)[3] more efficient and establish a common approach to compensating adjustments (i.e., taxpayer-initiated adjustments) within the EU.

The explanatory text to the directive noted that compensating adjustments are a cause of double taxation because they tend not to be recognized in all jurisdictions on the grounds that the tax return should reflect the actual transactions. To address this issue, the draft says member states must ensure that a compensating adjustment in the form of a year-end adjustment initiated by the taxpayer is accepted if certain conditions are met:

1. before recording the relevant transaction, or series of transactions, the taxpayer made reasonable efforts to achieve an arm's-length outcome;
2. the taxpayer makes the adjustment symmetrically in the accounts in all member states involved;
3. the taxpayer applies the same approach consistently over time;
4. the taxpayer makes the adjustment before filing the tax return; and
5. the taxpayer can explain why its forecast did not match the result achieved.

It is unclear whether condition (2) would require the accounts adjustment to be made symmetrically in the accounting period to which the adjustment relates, or whether a prior-period adjustment in the year 2 accounts made prior to filing the tax return for year 1 would allow compensating adjustments for year 1 to be made in the tax returns for year 1. This is an important question because it is often difficult to make symmetrical adjustments in the accounts for year 1.

In addition, there were two key proposals on corresponding adjustments:

- The introduction of a new "fast-track procedure" through which member states can perform the corresponding adjustment

[3]The corresponding adjustment does not exactly accord with the similar concept of a correlative allocation under the U.S. transfer pricing regulations. Correlative allocations are also downward adjustments, but are only made for U.S. tax purposes and thus do not result in the elimination of double taxation where the counterparty is subject to tax on its income outside the United States.

within 180 days, which would replace the (lengthier and more resource-intensive) MAP in those cases where there is no doubt that the primary adjustment was made for well-founded reasons.

- In the absence of a primary adjustment, member states may perform a downward adjustment, but only where:
  1. the downward adjustment is consistent with the arm's-length principle both in principle and as regards the amount;
  2. an amount equal to the downward adjustment is included in the profit of the associated enterprise in the other jurisdiction and taxed in both the member state and the other jurisdiction and thus subject to double taxation;
  3. the member state requested to perform the downward adjustment has communicated to the other tax administration the intention to perform a downward adjustment with the factual and legal circumstances necessary to indicate arm's-length pricing.

It does not appear likely that these measures will be implemented in the short term because they formed part of a more ambitious package that failed to achieve the necessary unanimous approval of EU member states. Nevertheless, there is at least a welcome recognition on the part of European Commission officials[4] that there is a problem that needs to be addressed.

'Listening to the Wind of Change'

The United Kingdom's OWS approach can be traced back to the original U.K. arm's-length-based legislation enacted by Finance Act 1998. There have been major changes in international tax rules over the last 15 years that, in the authors' view, have significantly reduced the benefit of maintaining an OWS approach versus providing greater flexibility for taxpayers to make self-initiated downward adjustments.

The number of countries that have implemented transfer pricing rules based on the OECD arm's-length principle has increased from 35 in 2000 to more than 115 today. This significantly reduces the risk of asymmetrical transfer pricing positions being taken on the same transaction.

The OECD's original base erosion and profit-shifting project fundamentally altered the international tax landscape, prompting significant changes in countries' approaches to tax competition. Informal capital and excess profits rulings were among the harmful tax practices countered by BEPS action 5. More than 54,000 information exchanges on tax rulings have been carried out in more than 130 jurisdictions under the BEPS action 5 standard and the 2022 peer review results show that 100 jurisdictions are fully in line with the BEPS action 5 minimum standard.[5]

More than 140 jurisdictions are committed to enacting the pillar 2 global minimum tax framework, which aims to ensure that the profits of large multinational enterprises are subject to a minimum level of taxation regardless of where they operate. The OECD estimates that 90 percent of MNE groups in-scope of the pillar 2 rules will be subject to them beginning in 2025.[6] Widespread implementation of pillar 2 will significantly reduce the risk of profits escaping taxation, which is the primary concern underlying the OWS.

The pillar 2 model global anti-base-erosion (GLOBE) rules require that constituent entities must compute their GLOBE income or loss on the basis of arm's-length prices for transactions with other constituent entities.[7] Rather than give up taxing rights to other countries, many jurisdictions are adopting GLOBE-compatible domestic minimum top-up taxes. For these taxes to be considered a qualifying domestic minimum top-up tax (QDMTT), they must provide for outcomes consistent with the GLOBE rules, which generally require that any variations do not

[4]Furthermore, the compensating adjustment provision in the EU transfer pricing directive was inspired by a January 2014 report on compensating adjustments approved by the EU Joint Transfer Pricing Forum at a time when the United Kingdom was an EU member state.

[5]OECD, "Harmful Tax Practices — 2022 Peer Review Reports on the Exchange of Information on Tax Rulings: Inclusive Framework on BEPS: Action 5" (2023).

[6]OECD, "OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors" (Oct. 2024).

[7]*See* OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)," art. 3.2.3 (2021).

produce a lower liability than under the GLOBE rules (this will be determined by peer review). Because income and tax computations generally need to mirror the GLOBE rules to ensure functional equivalence,[8] this effectively means that the same arm's-length pricing requirements will apply to QDMTTs.

Another important initiative by the inclusive framework on BEPS is the amount B framework to simplify and streamline the application of the arm's-length principle to baseline marketing and distribution activities. There are two specific aspects of amount B that are relevant when evaluating the need for an OWS approach.

Amount B introduces a simplified matrix-based return on sales for eligible distributors of tangible goods, which is intended to enhance tax certainty by reducing compliance burdens for taxpayers and supporting tax administrations with efficient resource allocation.

The OECD has specified that amount B can only be applied to accounting periods beginning on or after January 1, 2025, but whether and when to implement it are matters for individual jurisdictions to decide.

Under the amount B framework there is a very narrow tolerance (±0.5 percent) on the return on sales indicated by the matrix. Where the operating expense cross-check mechanism applies to notch up or down from the standard matrix return, this 0.5 percent tolerance disappears. This is significant because taxpayers are used to setting and testing baseline distributor returns against an arm's-length range of outcomes rather than needing to deliver a specific margin on the nose. This issue will be exacerbated if tax administrations expect amount B returns to be tested against a local GAAP measure of profits. For amount B to deliver on its aims of simplifying and streamlining transfer pricing, taxpayers in-scope for amount B will need the flexibility to adjust transfer prices for the purchase of tangible goods up and down in their tax returns.

As a result of consensus-building negotiations over the first half of 2024, agreement was reached on a political commitment by inclusive framework members to respect amount B outcomes when applied by a group of so-called covered jurisdictions identified by reference to certain World Bank low- and middle-income country classifications, including certain OECD or G20 countries that expressed willingness to apply amount B (including Brazil, Mexico, and South Africa).

The OECD recently published a model competent authority agreement (MCAA), which can be used to implement the above political commitment when there is a tax treaty in place between two jurisdictions. The MCAA can also be used by inclusive framework members to definitively extend the political commitment to jurisdictions not included in the list of covered jurisdictions.

Interestingly, and in a departure from prior treaty policy, the MCAA includes a notification requirement where a competent authority has knowledge of a downward adjustment regarding a transaction in-scope of amount B (whether actually priced under amount B or the remainder of the OECD guidelines). The relevant competent authority must notify the counterparty jurisdiction on a timely basis to prevent potential double nontaxation. This notification can be made under information exchange provisions contained within tax treaties. The United Kingdom has more than 130 double tax agreements that contain an information exchange article.

The OECD MCAA framework shows how increased use of information exchange between tax administrations can alleviate the concerns underlying a strict OWS approach to transfer pricing.

'One Way or Another'

There are various potential modernization options that could be considered for the U.K. OWS rule, including:

1. Adopt something similar to the U.S. exception to the OWS, allowing supported downward adjustments to correct margins outside the arm's-length range, provided they are made in a timely filed tax return;
2. Adopt a more limited measure tied to either the application of amount B, or

[8] *See* OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023)," section 118.20 (Apr. 2024).

restricted to where the counterparty is resident in a "qualifying territory," or the adjustment relates to the implementation of true-up adjustments under the company's formal transfer pricing policy (or under the governing intercompany agreement); or

3. A bolder, wide-ranging exception to the OWS allowing downward adjustments in tax returns, including via filing an amended return within the prescribed time limits, but subject to guardrails. The guardrails could include specific tax return disclosure requirements or a separate notification requirement that covers the following:
   - the amount of the adjustment;
   - details of the counterparty and jurisdiction where it is resident;
   - a brief description of the transfer pricing method applied and basis for the adjustment and why it was not possible to process this through the accounts; and
   - confirmation that the counterparty is taxable on an equivalent transfer price in its tax return for the corresponding period (i.e., no asymmetry arises from the adjustment). This last requirement could also apply to options 1 and 2 if considered necessary.

'The Times They Are a-Changin"

The OWS is a long-standing feature of the U.K. transfer pricing rules. But it imposes a procedural hurdle to substantive compliance with the arm's-length principle. Its practical consequences are significant because it is a source of complexity that can lead to unintended errors and, when correctly applied, can lead to the reporting of non-arm's-length outcomes in U.K. tax returns. At worst these outcomes create unresolvable double taxation; even at best, they necessitate remediation procedures that are a drain on taxpayer and tax administration resources.

In light of developments in the international tax environment, our view is that there is a strong case for relaxing the OWS. The risk that this sought to protect against has significantly diminished and is now outweighed by the benefits taxpayers and tax administrations could expect from a more flexible approach. A range of options exist that would alleviate problems with the OWS while retaining an appropriate level of protection from the risk of double nontaxation. Tax compliance burdens on multinational businesses grow every year and this is an opportunity to take a small but significant step in the opposite direction.[9] ■

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[9] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.