

Finance Bill 2010

Section 38 – Transfer Pricing:

Some Questions and Answers

1. What are the main features of the legislation?

Section 38 of the Finance Bill 2010 sets out transfer pricing rules to be applied to trading transactions between associated persons. The main features of the legislation are—

- recognition of the arm's length principle as set out by the OECD in Article 9 of the OECD Model Tax Convention and the OECD Guidelines on Transfer Pricing;
- application of the arm's length principle where trading profits are understated for Irish tax purposes;
- the provisions apply to large businesses – SME's are excluded;
- companies are required to have documentation available in relation to their transfer pricing policies;
- the rules apply –
 - for accounting periods beginning on or after 1 January 2011,
 - in relation to transactions the terms of which are agreed on or after 1 July 2010.

2. What is Transfer Pricing?

The term *transfer pricing* describes the process by which members of a group of companies set the prices at which they pass goods, services, finance and assets between each other.

There has been a substantial worldwide increase in trade in recent decades, much of which now takes place within multinational groups. Transfer pricing is a normal and necessary feature of transactions within large groups of companies.

3. Do other countries have transfer pricing legislation?

General transfer pricing legislation is now the norm in EU Member States and most OECD countries.

A number of countries have recently modernised their transfer pricing legislation and have introduced additional compliance requirements. For example, the UK has incorporated the OECD Guidelines into their domestic tax legislation. There have also been developments in the area of transfer pricing in Australia, Canada, France, Japan, Netherlands, South Korea, USA, and New Zealand.

4. What is the “arm’s length principle”?

The *arm’s-length principle* asserts that intra-group transfer prices should be equivalent to those that would be charged between independent persons dealing at arm’s length in otherwise similar circumstances. This is the internationally agreed standard for setting transfer prices for tax purposes.

All member countries of the OECD, including Ireland, accept this principle. It is set out in Article 9 of the OECD Model Tax Convention and also in the “Associated Enterprises” article in Ireland’s Double Taxation Treaties¹. An agreed principle and standard approach make it less likely that companies will be subject to *double taxation*— which could result from different countries using different approaches to determine appropriate transfer prices (to be used in the calculation of taxable profits).

¹ Ireland has recently signed a number of Tax Information Exchange Agreements (“TIEA”) that include provisions similar to those contained in Article 9 of tax treaties.

5. How is the arm's length principle applied in practice?

At the heart of the application of the arm's length principle is the idea that each party to a transaction should be rewarded for the additional value it has generated – assessed in terms of functions performed, assets used and risks assumed – because that is how dealings between independent persons would be compensated. In a cross-border situation, each jurisdiction receives the tax due on the value generated by the commercial activity undertaken within its jurisdiction.

Although the arm's length principle may be stated simply, the setting of intra-group transfer prices can be a complex and difficult process. In practice, the detailed application of the arm's length principle is based on extensive guidance provided in the OECD guidelines.

6. Are there existing transfer pricing rules in Irish tax law?

The principle of arm's length pricing has been a part of Irish tax law for many years:

- The “wholly and exclusively” test in section 81(2)(a) TCA 1997, denies a deduction for an amount of a payment between connected parties in excess of the arm's length amount.
- Tax law as interpreted by the courts permits an upward adjustment to profits to reflect the arm's length price in certain cases.
- The most wide-ranging provision that specifically addresses transfer pricing in a domestic context is section 453 Taxes Consolidation Act 1997. The transfer pricing rules contained in that section apply to companies charged at the 10% rate of corporation tax, i.e. companies entitled to manufacturing relief. These rules will cease to have effect when the relief itself ceases on 31 December 2010.

7. Why introduce general transfer pricing legislation now?

In addition to protecting the Irish tax base, removing the uncertainty regarding the application of internationally accepted transfer pricing standards in Ireland will —

- align Ireland with best international practice by formally adopting the OECD Transfer Pricing Guidelines;
- position Ireland better in intervening on behalf of companies where other jurisdictions adopt transfer pricing positions that do not accord with the arm's length principle;
- enhance Ireland's capacity to influence the direction of future developments in relation to transfer pricing in international taxation.

8. What are the adjustments to profits that can be made under the legislation?

The legislation will have effect where trading profits for Irish tax purposes have been understated. It will deal with trading transactions between associated persons and—

- if the amount of the consideration payable under the terms of the transaction exceeds the arm's length amount, then it will require that the arm's length amount will be deemed to be the amount payable in substitution for the actual amount, and
- if the amount of the consideration receivable under the transaction is less than the arm's length amount, then it will require that the arm's length amount will be deemed to be the amount receivable in substitution for the actual amount.

The legislation provides that “arm's length” is to be construed in accordance with the OECD Guidelines. Revenue's long-standing approach, for example in mutual agreement procedures under double taxation treaties, is to address transfer pricing in accordance with OECD guidelines.

9. Will the legislation apply only to companies?

While most transfer pricing issues involve inter-company transactions, the provisions cover any situation where two connected persons are involved and one person controls the other or both are controlled by the same person. While the controlling person could be an individual, the controlled person must be a company.

10. Will the legislation apply to domestic transactions?

The legislation is written to cover both domestic and cross border transactions.

Administration of the legislation and deployment of resources by the Revenue Commissioners will take account of the risks involved in different circumstances.

11. Will self-assessment apply?

The application of new legislation falls within the normal self-assessment regime.

12. What is the position regarding documentation?

The legislation requires that documentation be available that would be sufficient to show that the pricing of transactions with connected persons complies with the arm's length principle. The documentation need not be prepared or kept in the State, where it exists elsewhere. However, the documentation must be prepared on a timely basis and be made available to Revenue on request.

13. What is the position regarding small and medium sized businesses?

Small and medium businesses ("SME") are outside the scope of the new legislation. The definition of an SME is based on the definition of medium-sized

enterprises in EU Commission Recommendation of 6 May 2003² and, broadly, includes groups of companies where the group

- employs less than 250 employees

and

- *either* has
a turnover of €50m *or*
assets of less than €43m.

The existing relevant rules, which will be superseded by the new provisions for large enterprises, continue to apply to SME's.

14. Will transfer pricing be subject to Revenue audit?

Compliance with the transfer pricing requirements will be subject to Revenue audit. The new provisions reserve such auditing to officers authorised for that purpose by the Revenue Commissioners. This ensures that the audits concerned will be undertaken by officers who appreciate, and are equipped to deal with, the complexities involved in applying the arm's length principle.

15. When will the legislation take effect?

While businesses may be familiar with the workings of the arm's length principle, nevertheless the introduction of new transfer pricing rules may impose some additional compliance requirements on businesses affected. In order to allow a reasonable time for companies to prepare for the new rules, the transfer pricing provisions will apply –

- for accounting periods commencing on or after 1 January 2011³
- in relation to transactions based on terms agreed on or after 1 July 2010.

² OJ No. L 124, 20 May 2003, Page 36

³ For businesses other than companies, the rules will apply for the year 2011 and subsequent years.