Recharacterisation of transactions: at a glance

The view from the OECD:

“
A tax administration should not disregard the actual transaction or substitute other transactions for it unless exceptional circumstances apply.

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(Chapter 1, Section D, paragraph 1.121 of the Transfer Pricing Guidelines)

The Baker McKenzie translation:

Taxpayers should NOT RELY on their view that a transaction is not exceptional. This is a very subjective area.

Five points to consider:

The post-BEPS changes to the Transfer Pricing Guidelines have prompted a reaction in some quarters that recharacterisation is now easier for tax authorities to implement. However, this view has been dismissed by the OECD, which has confirmed it is not trying to lower the bar on recharacterisation.

Tax authorities aggressively pursuing this approach are ignoring those aspects of the OECD Transfer Pricing Guidelines they consider unfavourable. The best defence when confronted with this line of tax authority argument is a thorough and accurate delineation of the transactions under question. Business arguments for reorganisations are often forgotten, so taxpayers should document the commercial rationale for structuring and changes whenever they occur.

Discussing recharacterisation with tax authorities can be dangerous. Instead, taxpayers should discuss the terms of the transaction while avoiding a debate on its structure. Alternative positions will be constructed on the tax authority’s terms and, if accepted, will likely lead to higher tax charges than would result from settling a dispute over the correct range of pricing to use for a given transaction.

The UK is currently riding the BEPS wave with Diverted Profits Tax used by HMRC as the main weapon to apply recharacterisation.

Questions remain as to whether we will see a transfer pricing case reach court in the UK anytime soon. Sensible case law in this area would be welcome, but the risks are high. We anticipate litigation only in very clear-cut cases, where one side has what they perceive to be an obvious advantage.