The impact of a defined benefit pension scheme on transfer pricing

Large Corporate



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We explore the impact of a defined benefit pension scheme on transfer pricing, and how the sound application of arm's length principles can help to navigate the complexities.

Key Points

What is the issue?

The Pension Schemes Act 2021 gives enhanced and simplified powers for The Pensions Regulator to require entities associated or connected to a sponsor of a defined benefit pension scheme to make payments to a scheme. Criminal offences have also been introduced which apply to directors, trustees and wide stakeholders (including advisors).

What does it mean to me?

Certain corporate activity could adversely affect or materially reduce the financial resources supporting defined benefit pension schemes. Additional governance is therefore needed around transfer pricing, corporate reorganisation and mergers and acquisitions.

What can I take away?

The risks associated with funding defined benefits can give rise to transfer pricing challenges. A transfer pricing policy, by determining how a company is remunerated for inter-company arrangements, can also be critical to enabling those accruing benefits to be funded by an employer.

The complexities surrounding transfer pricing and defined benefit pension scheme arrangements are not new. However, these have tended to arise only when pension liabilities crystallise. Liabilities can crystallise when an employer ceases to employ anybody who is eligible to join a defined benefit scheme (and therefore leaves the scheme), at a time when at least one other person continues to employ eligible employee(s). Under Pensions Act 1995 s 75, the employer leaving the pension scheme will then become liable for their share of the pension scheme's liabilities (known as a Section 75 debt). Issues with pension liabilities also arise when parties are grappling with deficits in the context of merger and acquisition activities.

The key change since the Pension Schemes Act 2021 came into force is that employers must now consider their general business activities more closely to avoid compromising schemes and thereby potentially leading to criminal prosecution and/or unlimited fines. In light of the Pension Schemes Act 2021, along with an environment where tax authorities continue to be active in transfer pricing interventions, the interaction between transfer pricing and defined benefit positions might be encountered more regularly.

The Pension Schemes Act 2021: a brief summary

We summarise below the key provisions of the Pension Schemes Act 2021 to enable you to better understand the interactions with transfer pricing.

Increased powers for The Pensions Regulator

‘Anti-avoidance’ (or ‘moral hazard’) powers: The Pensions Regulator has two main powers which can be used in certain circumstances against an employer of a defined benefit pension scheme (and those associated or connected with such an employer). These are the power to issue:

- contribution notices, which require the employer to make contributions to the defined benefit pension scheme; and
- financial support directions, which require the employer to put in place financial support for the scheme.

Information gathering: The introduction of the Pension Schemes Act 2021 has extended The Pensions Regulator’s information gathering powers. This gives it greater access to information sources, including reports, interviews and inspections.

Notifiable events: As well as The Pensions Regulator having the power to investigate and gather information, there are certain circumstances in which the employer (and in some cases a guarantor of an employer) needs to notify The Pensions Regulator and the trustees of activities. Currently, the fining regime for non-compliance has gone from a maximum of £50,000 to £1 million, with criminal sanctions for providing false or misleading information. Over the next year, we expect to see legislation that has stricter consultation requirements.

Criminal offences

Avoidance of employer debt: This can occur where a person (i.e. anyone regardless of connection with a scheme or sponsoring employer) without a reasonable excuse, acts or engages in a course of conduct (or fails to act) with the intention of:

- preventing the recovery of the whole or any part of a debt which is due from the employer in relation to the scheme on an employer’s exit;
- preventing such a debt becoming due;
- compromising or otherwise settling such a debt; or
- reducing the amount of such a debt which would otherwise become due.

Conduct risking accrued scheme benefits: This can occur where a person commits an act or engages in a course of conduct (or fails to do something) that detrimentally affects, in a material way, the likelihood of accrued scheme benefits being received. This applies where that person:

- knows (or should have known) that the act or course of conduct would have that effect; and
- does not have a reasonable excuse for engaging in such conduct.

The Pensions Regulator has the power to issue financial penalties in respect of these new powers, and there are new offences subject to criminal sanctions. For example, an offence – or aiding or abetting an offence – potentially carries a seven-year imprisonment and/or an unlimited fine. Providing false or misleading information during an interview, when notifying The Pensions Regulator or during an inspection, can result in an unlimited fine and/or two years' imprisonment when the person reasonably believes The Pensions Regulator will rely on such information. The Pensions Regulator suggests, however, that the criminal powers will only be applied to 'the most serious examples of intentional or reckless conduct'.

It should be noted that most of the criminal sanctions detailed above have equivalent civil penalties for individuals of up to £1 million. We expect these civil sanctions exist because they are likely to have a lower burden of proof to enforce them.

Transfer pricing and defined benefit pension schemes

In broad terms, actuarial gains and losses on the re-measurement of defined benefit liabilities, and the return on plan assets of a defined benefit scheme sponsor, are not recognised in its profit or loss statement. If a defined benefit pension scheme does not meet its statutory funding objectives, additional employer contributions may be required in later periods. Alternatively, the performance of the scheme may reduce future employer funding requirements.

These risks give rise to potential timing differences between the period in which the scheme benefits accrue (i.e. the period in which the employee carries out their duties) and the periods over which the total costs of providing those benefits are recognised and paid for by the employer.

For transfer pricing purposes, this risk potentially should be allocated to the parties to a transaction and represented in the transaction price. For example, a service provider provides a defined benefit pension scheme for its employees but is characterised as a ‘limited risk’ entity. The greatest functional control over the risks related to the service provision and the financial capacity to bear those risks should be with the counterparty; i.e. the service recipient. It may therefore be appropriate to allocate the financial upside/downside of the defined benefit risk to the service recipient for transfer pricing purposes.

A transaction net margin method with a cost based profit level indicator (i.e. a return on total cost method) may in these circumstances be an appropriate method to apply to the service provider. The transfer pricing conclusion may simply be that the defined benefit costs as they arise, plus a margin, should be charged by the service provider. The impact of deferred defined benefit costs on the value of the service provided at any particular time might be ignored for practical purposes or explicable considering this risk is allocated to the service recipient.

On the other hand, if an entity with a defined benefit pension scheme is an entrepreneur within a value chain, it should be exercising the most control over the risks and have the greatest financial capacity to bear those risks. The upside/downside risks of the defined benefit pension scheme would generally therefore be borne by that entity.

So far so straightforward?

Complications can start to arise; for example, where a transaction net margin method with a return on sales is applied to a tested party, such as a ‘routine’ distributor, with a defined benefit pension scheme. Any volatility in the costs for the distributor in maintaining the defined benefit will typically flow back to the counterparty to the transaction. This may be through reducing the value of goods sold. In extreme cases, net contributions might have to be made by the principal in order for the distributor to achieve the target margins. This ‘floor and ceiling’ approach to the transfer pricing policy for the distributor may increase the risks of enquiry or challenge for the counterparty if this causes material financial volatility or losses for them. We also note that there can be divergence between the quantum of cash contributions to the defined benefit versus the associated accounting charges. We have typically seen HMRC follow an approach where the accounting figure is

used in service fee calculations.

Cases involving significant defined benefit risk may be good candidates for advance pricing agreements (considering too the UK's complexity threshold for admittance into advance pricing agreements). This may provide certainty, particularly for the entity effectively bearing defined benefit risks. Consulting with the pension trustee may also provide comfort relating to Pension Schemes Act 2021 around the arrangements.

We would note also that the realisation of defined benefit risks may result in a divergence between the transfer pricing method applied for direct tax purposes and the method needed for customs valuation purposes.

A business which has undergone a functional transformation from a limited risk entity to entrepreneur (or vice versa) also faces complexity where scheme costs crystallise after employees' duties have been performed. Mapping scheme members and costs, and apportioning those costs to before or after the transformation periods, provides a basis for determining how additional scheme costs should be allocated within a group. Cases such as this have arisen in a tax enquiry context.

To complete the picture, legal documentation to govern the contractual arrangements should be tailored to take all the above into account.

Defined benefits and restructuring

Since the introduction of Pension Schemes Act 2021, it is even more critical that risks to accrued scheme benefits and employer defined benefit debts are managed when undertaking restructuring. Chapter IX of the OECD's Transfer Pricing Guidelines (the transfer pricing aspects of business restructuring) may be of assistance here, particularly considering the realistic options available: compensation for the restructuring itself, the valuation of assets transferring and the post restructuring remuneration.

Applying arm's length principles rigorously may support the reasonableness of a course of action for Pension Schemes Act 2021 purposes. So even if mandatory UK transfer pricing principles do not apply (e.g. for SMEs), observing arm's length principles and documenting transactions appropriately could give protection should an incidental detriment to a scheme arise at a later date. Better still, transfer pricing

principles and documentation may facilitate communication and consultation with trustees about the basis for a transaction before proceeding.

Care is also needed in the context of merger and acquisition activity to ensure that the defined benefit sponsor making any scheme recovery payments to address a scheme's shortfalls, or meeting liabilities under Pensions Act 1995 s 75, is doing so wholly and exclusively for the purposes of its trade (or non-UK equivalent).

If it is not the entity employing the scheme members, it may otherwise be making a 'chargeable provision' for transfer pricing purposes to another entity which should be remunerated.

Defined benefits and debt

The raising of finance, granting or extending of security and early repayment of loans also need to be reviewed through the specific lens of Pension Schemes Act 2021. The presence of a defined benefit pensions scheme should also be an economic factor when determining the amount of a loan (and/or guarantee) in an intra-group context.

Of particular relevance in the case of the extraction of cash by way of loan from an entity with a defined benefit may be whether the loan would have been made at all in the absence of the special relationship between the parties. Whilst observing arm's length principles could provide Pension Schemes Act 2021 safeguards, consultation with the pension trustees would always be recommended for material transactions.

Conclusion

Arm's length principles – including considering the realistic alternatives before taking a course of action and the allocation or controls over risks – can reduce Pension Schemes Act 2021 risks. Supporting documentation should be contemporaneous to the particular transaction, whereas transfer pricing is often tolerant to ex-post adjustments (or performance adjustment) and documentation. Pension trustees should therefore be consulted appropriately when reviewing existing or considering new arrangements.

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