PAUL MINNESS OF PRICEWATERHOUSECOOPERS LOOKS AT THE IMPLICATIONS OF THE NEW UK TRANSFER PRICING RULES, WHICH CAME INTO EFFECT ON 1 APRIL 2004.

OPERATING ON AN ARM'S-LENGTH BASIS

FIGURE 1
WHAT TO CONSIDER WHEN ASSESSING A FIRM'S BORROWING CAPACITY

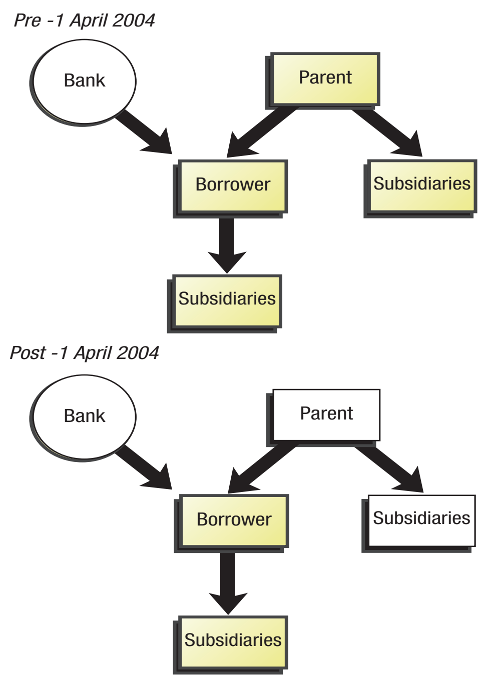


TABLE 1
TRANSACTIONS WITHIN THE SCOPE OF THE NEW LEGISLATION

Intra-group product sales
Provision of management services, including treasury services
Intra-group loans
Cash pooling
Guarantee fees
Use of intellectual property
Rent

On 17 March 2004, the Budget gave one of the clearest examples yet of UK tax legislation being affected by European law. A German tax case was taken to the European Court of Justice (ECJ) on the grounds that the German thin capitalisation rules were discriminatory, in that they did not apply to domestic corporations. The ECJ found in favour of the tax payer and this created a ripple of domestic tax changes across Europe.

In the UK, the Inland Revenue (IR) was concerned that the thin capitalisation and transfer pricing rules in force may also be considered discriminatory, because they contained UK company exemptions. The solution it has arrived at is to repeal the existing thin capitalisation rules, bringing that piece of legislation within the transfer pricing rules, and to remove the UK exemption for transfer pricing. Consequently, with effect from 1 April 2004, all intra-UK transactions between connected parties, where the companies are considered large[1], are required to be on arm's-length terms. *Table 1* gives some examples of the types of transactions that are within the scope of the UK-UK legislation.

WHAT DO THE NEW RULES MEAN? In summary, the introduction of the new rules mean that groups will have to consider what an arm's-length price would be for the products and services that flow between UK group members. Once they have estimated that price, they are required to obtain sufficient evidence to support it, and must fully document how they have arrived at it.

From a treasurer's perspective, the new rules mean that all intra-group loans need to be on an arm's-length basis – that is, the basis on which a third party would lend to the borrower. In assessing this, consideration would need to be given to the borrowing capacity of the company requiring funds, the terms of the loan, the interest rate charged, the level of security provided, if any, and any covenants enforced.

If the terms of the loan are such that it would not have been made by a third party to the borrower, then an adjustment will need to be made to the company's tax returns so that the taxable profits reflect what would have happened in a third-party situation. For example, an interest-free loan may be recalculated to be on an interest-bearing basis. Adjustments can be made in two ways: firstly, the terms of the transaction concerned could be changed so that arm's-length charges are made; or the terms could be left on the existing basis, but adjustments put through on the tax return.

Those of you who have dealt with transfer pricing before will remember that the UK rules incorporate a 'one-way street' concept. In other words, the rules work to increase UK taxable profits, but do not allow a company to reduce UK taxable profits to reach an arm's-length result. Given this approach, the IR accepted that it needed a mechanism for UK-UK transfer pricing to ensure that there was no double counting. The approach it has developed to deal with this is corresponding adjustments.

CORRESPONDING ADJUSTMENTS. The principle of corresponding adjustments is straightforward. Where, in respect of an intra-group transaction, a company has to increase its taxable profits, the provider of the product or service can make a corresponding adjustment in its tax return to reduce its taxable profits. The effect of this, in most cases, will be to return the group to the same tax-paying position. However, as the examples in *Table 2* show, if the companies concerned are not all paying tax at 30%, the transfer pricing rules could affect the amount of tax payable in any one accounting period.

The process for making a corresponding adjustment requires either party to the transaction to claim the adjustment on their tax return, but the critical point to note is that it does require a claim and it is not automatic.

One point that is worthy of consideration is the reason that the UK-UK legislation has been brought in – because the previous exemption which existed was discriminatory. If a transfer pricing adjustment is made in respect of a cross-border transaction, the IR cannot ensure a reduction in the overseas profits; instead, the group concerned would have to approach the local tax authority or, alternatively, seek to get an appropriate adjustment through a competent authority claim or the mutual agreement process. This is a far more complicated process than a simple claim on the tax return, leading to the issue of whether the new process is also, in fact, discriminatory.

THIN CAPITALISATION. As an extension to transfer pricing, the IR has introduced thin capitalisation rules for UK companies. It has done this by repealing the existing legislation and moving it into the transfer pricing regulations.

Consequently, the thin capitalisation rules state that a company will only be allowed to obtain an interest deduction on an arm's-length basis, being the interest payable on an amount of loan that it could borrow from an independent third-party lender.

When these rules have been applied to cross-border transactions in the past, the borrower has been able to take into account the balance sheets and income of all of its UK group, in assessing the maximum level of debt it could borrow. This approach, known as 'grouping', has now disappeared, since the transfer pricing rules require companies to be considered on a stand-alone basis. Furthermore, the change effective from 1 April 2004 means that the borrowing capacity of UK companies, in respect of UK-sourced loans, needs to be examined for the first time.

Figure 1 shows what can be considered when assessing a company's debt capacity, with the shaded areas representing the companies that can be included.

Ignoring some group companies from the calculation could significantly impact on the amount of borrowing capacity. In view of this, the IR has introduced some guarantee rules to try and return the group to the pre-1 April 2004 position.

The guarantee provisions operate by considering both the debt capacity of the borrower and that of the guarantor. Where the incoming loan exceeds the capacity of the borrower, the group can treat the excess amount as being a debt of the guarantor. The result of this is that, providing the debt capacity of the guarantor is not exceeded, the guarantor can obtain a tax deduction on the interest relating to the excess debt. Of course, if the guarantor in *Figure 1* is the parent company, then when assessing its debt capacity, it can include the other subsidiaries. The guarantee provisions do raise some questions concerning what exactly is a guarantee, since, as they are currently drafted, they have a broad definition and can include formal guarantees, letters of comfort and even an informal understanding that another group company will repay in the event of default. It is hard to see in the latter situation how a borrower may be expected to know that a lender is placing reliance on the fact that another group company could repay when nothing formal is in place. One further issue groups should consider is whether a guarantee fee should be charged for a particular arrangement.

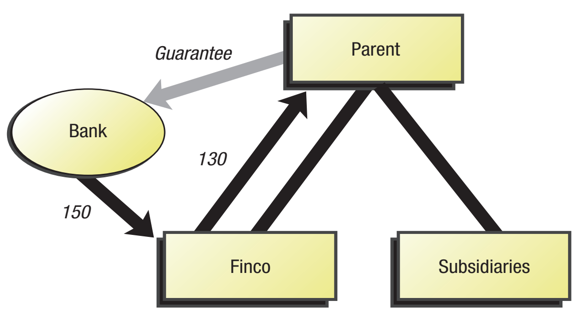
Initially, this approach appears to be an easy solution to address the problems of thin capitalisation. However, quite a lot of practical guidance is awaited, as there is more than one instance of apparent difficulty, including situations where the guarantee provisions could potentially lead to an element of double counting.

TABLE 2
CORRESPONDING ADJUSTMENTS

	Before pricing adjustment			With pricing adjustment		
	A Ltd	B Ltd	Total	A Ltd	B Ltd	Total
Example 1 – Two UK companies paying tax at 30%						
Profits	100	100	200	100	100	200
Adjustment	-	-	-	25	(25)	-
Total	**100**	**100**	**200**	**125**	**75**	**200**
Tax @30%	30	30	60	37.5	22.5	60
Example 2 – B Ltd has trading losses brought forward						
Profits	100	100	200	100	100	200
Adjustment	-	-	-	25	(25)	-
Losses	-	(100)	(100)	-	(75)	(75)
Total	**100**	**0**	**100**	**125**	**0**	**125**
Tax @30%	30	0	30	37.5	0	37.5

While it could be argued that the increase in tax in Example 2 is a timing difference, as the group will use its losses over a longer period, there is still the cashflow implication of the increase in tax liability.

FIGURE 2
DOUBLE COUNTING PROBLEMS



In *Figure 2,* we have a relatively common situation, where the group's borrowings are routed through a finance company. For the purposes of the example, assume that the overall group's borrowing capacity is 150. If we then assume that Finco has a borrowing capacity of 100, then the 150 from the bank will be regarded as non-arm's length and the company will be regarded as thinly capitalised. As the loan is guaranteed, though, the group can look to gain a deduction for the interest relating to the excess 50 in the guarantor.

In calculating whether the guarantor is thinly capitalised itself, consideration will need to be given to its current loans. In the example, the parent has an upstream loan of 130. When this is added to the excess amount on Finco's loan of 50, the total borrowing is regarded to be 180. This is actually in excess of the group's borrowing capacity. The result of the analysis, therefore, is that, because of the upstream loan, the guarantor can only get a tax deduction for the interest relating to 20 of the amount disallowed in Finco, with the overall result being that the group only receives a tax deduction in relation to a loan of 120, not 150.

The provisions accept that cross-guarantees may be in place and, in this scenario, they allow the group to decide which one of the guarantors takes the excess interest adjustment. Providing that the cross-guarantor has the borrowing capacity itself, this may provide the group with an opportunity for placing a tax deduction in a more favourable company. Of course, as with the corresponding adjustments, a question has to be raised as to whether these regulations are themselves discriminatory, since an adjustment will not be available to an overseas guarantor.

SECURITISATIONS. The IR took account of various representations that were made by businesses in the area of securitisation. One area of concern surrounded the issue of whole business securitisations. In these situations, the special purpose vehicle (SPV) created in the transaction may not necessarily hold assets itself, but will have a charge over the assets in a trading company.

As such, if the IR reviewed the SPV's borrowing capacity on a stand-alone basis, it may be regarded as thinly capitalised. The recent guidance, however, has clarified that it will not automatically take such a view, but, instead, will consider the facts and circumstances of each transaction.

The second area of concern is in respect of the situation where an SPV contains specific assets but none of the risks associated with the operating business. In these instances, the SPV would generally be able to obtain cheaper finance than the trader. When the SPV on-lends the borrowings to group companies, the terms of the intra-group loans should be changed to reflect what the borrower would have been able to obtain independently The effect of such an adjustment would be to increase the taxable profits, and therefore the tax liability of the SPV.

The IR has accepted that an increase to an SPV's tax liability could impact on its risk profile and, consequently, its credit rating – which, in turn, could increase the external cost of borrowing for the group. As this was not an intention of the new legislation, the IR has said that the increase in tax liability will, in certain circumstances, be transferable to the company that could claim a corresponding adjustment under the transfer pricing rules. This claim is subject to specific requirements and needs the approval of the Board of the IR.

HEDGING LOAN. One area that is impacted by the need to have arm's-length terms on loans is that of hedging loans. It has long been standard practice for companies to use interest-free currency loans to achieve a tax hedge for foreign currency borrowings and investments. There was a concern, when the initial rules were drafted, that if these loans were to thinly capitalised companies and interest were charged on the loans, some foreign currency interest may not be deductible, potentially leading to a mismatch on the foreign exchange position.

However, the IR has clarified that the foreign exchange relating to interest on currency loans will be dealt with by the corporate debt rules and will not be subject to transfer pricing adjustments – the result being that tax hedging loans can be made.

DORMANT COMPANIES. A further area of concern regards dormant companies. A large number of groups have dormants, which are financed by way of an interest-free, connected party loan, often arising on the hive across of assets on a divisionalisation exercise. If these loans were to be put on an arm's-length basis, interest would need to be either paid or imputed and, potentially, the result of the rules would be that the dormant company would cease to be dormant. This would lead to a requirement to file a tax return and, possibly, to have a statutory audit carried out.

The IR accepted that the result of the rules in this area would be an unacceptable level of administrative burden and has introduced grandfathering provisions. These provisions state that if a company is dormant before the new rules come into force, that company will remain outside the transfer pricing regulations until the company ceases to be dormant. Other dormant companies will not be exempted from the rules.

A BIG STEP FORWARD BUT CARE IS STILL NEEDED. The new rules represent a significant development in UK tax and, while all intra-group transactions need to be considered, it is probably the financing transactions that offer the most cause for concern, especially in the area of thin capitalisation. Of course, even if companies undertake planning to ensure that corresponding adjustments and guarantees are in appropriate places, so ensuring they have no increase in tax, there is always a risk that in a few years' time, the new rules will also be taken to the ECJ and deemed discriminatory.

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[1] *In the legislation, a company is 'Large' if it has more than 250 employees and either assets in excess of €43m or turnover in excess of €50m. If the number of employees is between 50 and 250, and assets or turnover are between €10m and the above limits, the rules only apply if the Board of the IR so directs.*