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THIN CAPITALISATION RULES ARE COMING THICK AND FAST

The extension of transfer pricing and thin capitalisation rules to transactions within the UK will increase corporate red tape significantly.

UK transfer pricing rules currently apply to cross-border transactions between related entities and certain joint ventures. Their effect is to substitute an arm's length value for tax purposes, if that value is not actually used.

Thin capitalisation rules apply between 75% of connected companies, where an offshore parent lends to a UK subsidiary. Where the Inland Revenue considers the subsidiary to be thinly capitalised (eg, where the ratio of equity to connected party debt is deemed low), tax deductibility of excessive interest payments is denied, increasing the UK tax charge of the subsidiary.

New rules

The transfer pricing and thin capitalisation rules will be brought under one regime and extended to transactions within the UK.

Transfer pricing

The new transfer pricing rules will apply where:

- One party – or parties – participates in the management and control or capital of another, including joint ventures.
- There has not been an arm's length transaction.
- One party has enjoyed a tax advantage as a result.

The effect of the new rules

- An arm's length amount is substituted for the actual amount for UK income and corporation tax purposes.
- Records must be kept to show compliance, including primary accounting records, tax adjustment records, records of relevant transactions with associated businesses, and evidence to demonstrate the arm's length result.

Thin capitalisation

The new thin capitalisation rules will apply where:

- A security is issued that would not have been so issued without a special relationship between the parties; in other words, it will stop tax deductions for interest on loans from group companies where the borrower would not have been able to sustain the debt on its own.
- A loan is made because of a guarantee (including informal arrangements) given to the lender by a party related to the borrower.

If a company is thinly capitalised, the new rules will have the effect of denying a tax deduction for interest in the borrower.

The new rules apply to securities only. Deductions in other situations will not be denied; for example, for rental paid on a lease by a thinly capitalised company where the lease is supported by a parent company guarantee.

Not all guarantees will give rise to adjustments. For example, upward guarantees from subsidiaries would not be caught. The same compliance obligations apply as for transfer pricing.

Corresponding adjustments

Under both the transfer pricing and thin capitalisation rules, where tax adjustments occur in one party, the other can claim corresponding adjustments in order to avoid double taxation. This means that, where all parties are taxable at the same rate, effective tax neutrality in a group can be maintained. However, potential problems could occur where:

- The counterparty is not within a 100% group situation and cannot obtain information on the original adjustment made by the tax-advantaged entity.
- The counterparty does not have the taxable profits needed to benefit from the corresponding adjustment, and it is not possible to group relieve resulting losses to restore the overall group position.
- The recipient of the corresponding adjustment is outside the UK and so unable to obtain an advantage from the adjustment mechanism.

Balancing payments

For both transfer pricing and thin capitalisation, the new rules allow balancing payments to be made by the counterparty to the company suffering the initial tax adjustment. Such payments can compensate for economic loss.

Exemption

Transactions of small and medium-size businesses (SMEs) within the UK and certain other areas will be exempt from the new transfer pricing rules. The exemption will only apply, however, where transactions are between UK entities only, or where an offshore entity is resident in a jurisdiction that has a double tax treaty with the UK containing a non-discrimination article. The US meets this requirement; Jersey does not.

SMEs will not be exempt from the new thin capitalisation rules.

Key areas to watch

- Intra-group loans and the provision of management and other services. These are commonly made without charge and without formal documentation.
- Parent company guarantees and other forms of security for lending.
- Dormant companies lending monies they have on share capital account interest free to other group companies. The new imputed tax charges could bring them within the company law accounting regime and require tax filings.
- Joint ventures and PFI, where parties put most of the finance into a venture through a loan.
- Acquisitions. Warranties relating to corresponding adjustments and balancing payments will be required.

Effective date

The rules, though still in draft form at the time of writing, are due to come into effect from 1 April 2004. They will be applied under the current self-assessment regime. Penalties for non-compliance will apply, though there will be a two-year waiver of penalties for failing to have sufficient evidence of the proper arm's length price.

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Useful links

- **Berwin Leighton Paisner has produced an explanatory note outlining the draft rules and their implications, available at *www.blplaw.com/news/pdf_files/NewUKTransferPricing%2Epdf***