Chief Secretary announces Government action on tax avoidance

Technical Summary

1. As announced by the Chief Secretary to the Treasury, the Government proposes to take action to restrict the use of the compensating adjustments mechanism in the transfer pricing legislation where it generates income tax advantages. This is in response to tax advantages that can arise where such adjustments are claimed by individuals for transactions entered into with connected companies subject to a lower corporate tax rate. The following is a technical summary providing background to the announcement and the Government's proposals.

2. HMRC has become aware of two main arrangements that exploit the rules in order to generate the tax advantage:

    a. Interest receipts that arise to individuals from debt in excessively leveraged companies and/or excessive rates of interest.

    b. Companies that are under remunerated by partnerships for the services that they provide.

3. It is proposed that the compensating adjustments mechanism will be removed for taxpayers within the charge to income tax where the counter party to the transaction is a company. This will apply in relation to amounts arising on or after the date the legislation takes effect.

4. Additional detail on the transfer pricing rules the compensating adjustment mechanism and the detail of the proposed changes are outlined within this technical summary.

Background to policy

The legislation

5. The transfer pricing legislation concerns the prices charged in transactions between connected parties as, in such circumstances, the price charged may not necessarily be that which would have been charged if the parties had not been connected. The legislation imposes a price that would have occurred had that connection not existed, referred to as an "arm's length price".

6. The rules are mainly designed to ensure that the right prices are charged for goods and services between connected parties on international transactions but they also apply to transactions within the UK. Within the UK, if the transfer pricing rules adjust prices to increase one side's profit, a claim can be made to reflect the same price for the other side. This adjustment is known as a 'Compensating Adjustment'.

The 'Schemes'

First Scheme: Professional Partnerships

7. Large partnerships often employ their staff through a separate service company, which the partnership owns. This arrangement can be used for a number of reasons not related to tax. However, by choosing not to pay an appropriate fee to the company for providing this service, the partnership can activate the tax rules to gain an advantage. HMRC is aware that the structure has been promoted as a method to reduce tax liability for smaller partnerships.

Example

8. If a company is operating as a service provider to third parties and the total staff payroll is £100m, we would expect companies operating at arm's length to apply a mark up to the labour costs to reflect, among other things, the functions performed. Assume for this example an appropriate mark-up might be around 5%, so £5m on a £100m payroll.

9. Because the partners effectively own the service company the transfer pricing legislation will substitute an arm's length price where the actual provision is not at arm's length. So if payment only covers the costs of the staff wages to the service company of £100m, the transfer pricing rules will replace it with £105m for the purposes of calculating the taxable profit of the company. Following the numerical example this will mean substituting a price of £105m thereby increasing the taxable profits of the company by £5m. No cash payment is required by the partners to make good the shortfall and so the £5m remains within the partnership where it can be drawn by the partners.

10. The partners may make a claim for a compensating adjustment that replaces the £100m cost with a cost of £105m reducing their taxable share of partnership profits by £5m. The partners will however still receive their share of the accounting profit providing a tax benefit to the partners of the difference between the income tax and NIC on the £5M and the corporate tax rate.

Second Scheme: Excessive leveraging of companies by individuals

11. Individuals participating in a company are exploiting the rules by making loans that are not on arm's length terms. Typically the lending will result in the company being excessively leveraged with debt.

12. The UK transfer pricing rules apply where companies are overly indebted due to the fact that borrowing has been provided that would not have occurred at arm's length but for the relationship that exists between the lender and borrower. The legislation restricts interest deductions arising from this "non arm's length" debt calculating the taxable profit as if arm's length arrangements had been entered into rather than the actual arrangements. A compensating adjustment may be claimed by the lender so that its position mirrors that of the borrower. This effectively removes an amount of interest equal to the excess over the arm's length amount from the charge to income tax in their hands.

13. This has the effect of enabling the lenders to extract money from the company without paying income tax. The lenders' involvement in the company means that they are often taking a return on loans in place of a profit distribution.

14. The affected businesses will include private equity financing but this measure is not targeted at the private equity industry. The scheme is being used in a range of private companies and it is the misuse of the legislation that is the target.

Example

15. A company that is wholly owned by one individual has Equity of £100m and other third party debt totalling £100m. Assume in the particular circumstances of the case The 1:1 debt to equity ratio (taking account of other factors) is the maximum the company is able to raise from a third party financial institution. The owner of the company then lends £100m to the company at a rate of interest of say 15%pa. Ordinarily, the interest receipt of £15m will be taxed at 45% (current higher rate), so there will be income tax payable of £6.75m.

16. However the transfer pricing rules mean that the actual arrangements are replaced by the arm's length arrangements for the purposes of calculating the taxable profits.

17. The effect of the transfer pricing adjustment on the company is an increase in profits of £15m. To the extent that there are profits in the company that cannot be relieved there will be additional CT of £3m (assuming a rate of 20%). The individual may claim a compensating adjustment that will remove the £15m from the charge to income tax saving £3.75m.

<u>Policy proposals</u>

18. The Government proposes to withdraw the ability of individuals to claim compensating adjustments where the counterparty to the transaction is a company. This will apply to amounts arising on or after the date the legislation comes into effect. So where either of the schemes is used no compensating adjustments will be possible in respect of amounts of service fee income or interest arising to individuals on or after the effective date.

19. As there is no intention that these changes should adversely affect commercial arrangements, there will be a short opportunity for discussion on the policy proposals before the legislation comes into effect. If you have any comments, please contact: Richard Rogers on 03000 585521 or by email Richard.rogers@hmrc.gsi.gov.uk