HM Revenue & Customs

Amendments to Compensating Adjustments legislation: Technical Note and Draft Legislation

25 October 2013

1 The Government announced on 17 September that it would take action against arrangements involving the 'compensating adjustment' rules – part of the transfer pricing code – whereby tax advantages can be secured by individuals extracting profit from connected companies whilst paying tax only at corporation tax rates.

2 A brief period of technical consultation was announced, and a technical discussion document issued on 18 September setting out proposed changes to the transfer pricing code.

3 The informal consultation period has now concluded and the Exchequer Secretary to the Treasury has announced that legislation giving effect to the changes to the code will take effect from today.

4 This Technical Note contains draft legislation intended to be introduced in the next Finance Bill. The legislation implements the proposals in the discussion document with two refinements, described in paragraphs 19 and 20.

The Transfer Pricing Legislation– Part 4 of Taxation (International and Other Provisions Act) 2010

5 Transfer pricing legislation concerns the prices charged in transactions between connected parties. Where the actual price differs from the price that would have occurred had that connection not existed, the legislation replaces the actual price with the "arm's length price".

6 The rules are mainly designed to ensure that the right prices are charged between connected parties on international transactions but they also apply to transactions within the UK.

7 Within the UK, if rules adjust prices to increase one party's profit, a claim can be made to reflect the same price for the other party. This adjustment is known as a 'compensating adjustment.

8 The transfer pricing and 'compensating adjustment' rules can be used in ways such as those described below to increase the profit taxable at corporation tax rates and reduce the income taxable at the higher rate of income tax, but without affecting the cash position of either party. This has resulted in arrangements

whereby the rules are used by individuals to extract income from their businesses but with tax only at the corporation tax rate being charged.

The “arrangements”

First arrangement: Professional Partnerships

9 Large partnerships often employ their staff through a separate service company, which the partnership owns. This arrangement is 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 transfer pricing rules to gain an advantage. HMRC is aware that the structure has been promoted as a method to reduce tax liability for smaller partnerships.

10 For example, 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.

11 Because the partners 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. 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.

12 The partners may make a claim for a compensating adjustment that replaces the £100m cost with the adjusted 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 arrangement: Excessive leveraging of companies by individuals

13 Individuals participating in a company are making loans that are not on arm’s length terms. Typically the lending will result in the company being excessively leveraged with debt.

14 The UK transfer pricing rules apply where companies are overly indebted due to borrowing at rates that would not have occurred but for the relationship that exists between the lender and borrower and would not have been possible at arm’s length. 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.

15 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.

16 Some types of private equity financing will be affected but this measure is not targeted at the private equity industry. The scheme is being used in a range of private companies, including small owner-managed firms, and it is the misuse of the legislation that is the target.

Original consultation proposals and changes to these

17 The discussion document, issued on 18 September 2013, proposed to withdraw the ability of individuals to claim compensating adjustments where the counterparty to the transaction is a company, with this change applying to amounts arising on or after the date the legislation comes into effect. This change will prevent compensating adjustments being claimed in respect of amounts of service fee income or interest arising to individuals on or after the effective date.

18 Two changes to the original proposals have been made in response to the consultation responses, both relevant only to excessive leveraging arrangements.

19 The first change provides that the excess interest (over an arm's length amount) is to be characterised for income tax purposes as a dividend. This means that the excess will be taxed at dividend rates rather than at rates applicable to interest reflecting the fact that the excess amounts perform in substance an equity function in the company.

20 The second change concerns the treatment of interest accrued but not paid at the time that the legislation takes effect. Respondents have argued that it would be disproportionate for those amounts to be affected by the proposed changes. Respondents also argued that not exempting accrued interest would give rise to market distortions and unfair differences in tax treatment based purely on a company's ability to access a limited funding pool. The draft legislation therefore makes clear that interest accrued but not yet paid out will not be affected.

21 No changes have been made to the proposals relating to services companies. To fall outside the scope of the measure, the service company scheme will need to re-price at the correct economic prices. The legislation will apply only prospectively, to amounts of fee income referable to times after the legislation comes into effect.

Example: Commencement for service companies

22 An LLP contracts for services with a connected company for the accounting period ending 31 March 2014. The cost to the service company in providing the services to the LLP for the period is £5m. The contractual arrangement between the parties ensures that the LLP reimburses the service company at cost. The transfer pricing legislation will apply requiring a tax computational adjustment equal to an arm's length mark up for the period (say 5%). A compensating adjustment will potentially be available to the LLP for an amount equal to the mark up for the period to 25 October 2013. On the assumption that the costs to the service company are incurred consistently over the period the amount of the compensating adjustment will be £250,000 x (217/365).

23 Where a small or medium sized enterprise has elected into the transfer pricing legislation in order to obtain a benefit under one of the arrangements described above the same tax treatment will apply. The election for the transfer pricing rules will only apply for the period specified in the election and so the revised tax treatment need not apply for future periods where no election is made.

Draft legislation

Transfer pricing: restriction on claims for compensation adjustments

(1) Chapter 4 of Part 4 of TIOPA 2010 (transfer pricing: position of disadvantaged person) is amended as follows.

(2) In section 174 (claim by the affected person who is potentially advantaged), in subsection (3), before the entry for section 175 insert -

> "section 174A (claim not allowed in some cases where the disadvantaged person is within the charge to income tax),".

(3) After that section insert -

"174AClaims under section 174 where disadvantaged person within charge to income tax

A claim under section 174 may not be made if -

(a) the disadvantaged person is a person (other than a company) within the charge to income tax in respect of profits arising from the relevant activities, and
(b) the advantaged person is a company."

(4) After section 187 insert -

"Treatment of interest where claim prevented by section 174A

187A Excess interest treated as a qualifying distribution

(1) Subsection (2) applies if Conditions A to C in section 187 are met in circumstances where section 174A prevents a claim under section 174.

(2) The interest paid under the actual provision, so far as it exceeds ALINT, is treated for the purposes of the Income Tax Acts as a dividend paid by the company which paid the interest (and, accordingly, as a qualifying distribution)."

(5) The amendments made by this section have effect in relation to any amount arising on or after 25 October 2013, except pre-commencement interest.

(6) "Pre-commencement interest" means an amount of interest to the extent that it is, in accordance with generally accepted accounting practice, referable to a period before 25 October 2013.

Summary of changes

24 The main change will prevent persons (other than companies) within the charge to income tax from claiming a compensating adjustment where the counterparty is a company.

25 Where the compensating adjustment claim is denied but the claim would have related to excess interest paid by the counterparty, then the excess interest (over an arm's length amount) will be treated for income tax purposes as a dividend rather than interest. This means that the excess will be taxed at dividend rates rather than at rates applicable to interest.

26 The changes will take effect in relation to amounts that are referable to times on or after 25 October 2013. This means that any amounts accruing before that time, whether interest or service fees, are outside the scope of the measure.