HM Revenue & Customs

Compensating adjustments

Who is likely to be affected?

Individuals who use the compensating adjustment mechanism in the transfer pricing legislation to reduce their taxable income, particularly a small number of partners in professional service firms and individuals receiving interest from highly leveraged companies.

General description of the measure

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”.

Within the UK, if 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 measure will remove the ability of individuals to claim compensating adjustments where the counterparty to the transaction is a company.

Policy objective

The policy objective is to prevent individuals exploiting the compensating adjustment mechanism to generate an overall reduction in their tax liability and protects both Exchequer revenue and the fairness of the tax system.

Background to the measure

The government announced on 17 September 2013 that it would take action against arrangements involving the „compensating adjustment‟ rules.

A brief period of technical consultation was announced, and a technical discussion document issued setting out proposed changes on 18 September.

Detailed proposal

Operative date

The measure will take effect in relation to amounts that are referable to times on or after 25 October. Amounts of fee income or interest accruing before that time are outside the scope of the measure.

Current law

Transfer Pricing Legislation in Part 4 of Taxation (International and Other Provisions Act) 2010 concerns the prices charged in transactions between connected parties to address the risk that, in such circumstances, the price charged may not 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”.

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. If so, then any increase in the taxable profits of one party gives rise to a right of the counterparty to claim a corresponding tax reduction - the „compensating adjustment‟.

The transfer pricing and compensating adjustment rules can currently reduce the overall tax payable where the increased profits are taxable at Corporation Tax rates but the compensating adjustment is relieved at a higher Income Tax rate.

Proposed revisions

The main change prevents persons (other than companies) within the change to Income Tax from claiming a compensating adjustment where the counterparty is a person within the charge to Corporation Tax.

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 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.

The changes will take effect in relation to amounts that are referable to times on or after 25 October. Amounts of fee income or interest accruing before that time are outside the scope of the measure.

Summary of impacts

Exchequer impact (£m)	2013 to 2014	2014 to 2015	2015 to 2016	2016 to 2017	2017to 2018
	This measure is expected to increase receipts by approximately £70 million per annum. The final costing will be subject to scrutiny by the Office for Budget Responsibility, and will be set out at Autumn Statement 2013.				
Economic impact	The measure is not expected to have any significant economic impacts.				
Impact on individuals and households	This measure is expected to have no impact on individuals or households, as the measure is expected to impact on a small minority of partners in professional service firms and individuals receiving interest from highly leveraged companies.				
Equalities impact	No impact is expected on any protected equality groups.				
Impact on business including civil society organisations	This measure is expected to have no impact on businesses and civil society organisations outside its expected impact on a small minority of professional service firms and highly leveraged privately owned companies.				

Operational impact (£m) (HMRC or other)	It is not expected that implementing this change will incur any significant additional costs for HM Revenue and Customs.
Other impacts	Other impacts have been considered and none has been identified.

Monitoring and Evaluation

The measure will be kept under review through regular communication with affected taxpayer groups.

Further advice

If you have any questions about this change please contact Graeme Webster on Telephone: 03000 585820 (email: graeme.webster@hmrc.gsi.gov.uk).

Declaration

David Gauke MP, Exchequer Secretary to the Treasury, has read this Tax Information and Impact Note and is satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impacts of the measure.