

2004 UK Budget - Transfer Pricing and Thin Capitalisation

The 2004 UK budget was announced on March 17, 2004. Legislative proposals are subject to detailed legislation in the Finance Bill, which may be altered during its passage through Parliament. However, we do not expect there to be any significant changes made to the bill during this process. We have summarized below the new treatments relating to transfer pricing and thin capitalisation, which will have a large impact on UK resident companies.

Transfer pricing

The Government has intended to legislate the reform of the rules on transfer pricing and thin capitalisation as a priority in the 2004 Finance Bill reform. This significant development has been driven entirely by the recent European Court of Justice (ECJ) rulings. According to the rulings, it has become clear that if the Inland Revenue is to continue to apply transfer pricing rules between UK and European group companies, similar rules must also apply for transactions within UK groups. Similarly, if the current thin capitalisation regime is conceded to be unenforceable, it needs to be backed up by a new regime without discrimination on grounds of residence.

The Inland Revenue has provided a consultation period for draft clauses relating to both transfer pricing and thin capitalization. The principal difficulty was the very large administrative burden, which UK-to-UK transfer pricing rules would impose on businesses. There was also widespread concern about the manner in which the Inland Revenue approached transfer pricing enquiries regarding risk assessment and the existing guidance on documentation, all of which were unwelcome areas of uncertainty for UK businesses. The Government has sought to address a number of these concerns by:

- Exempting small and medium-sized businesses from the transfer pricing rules
- Relaxing the penalty regime applicable to transfer pricing adjustments for a transitional period of two years
- Introducing a form of domestic compensation adjustment to ensure that the new UK-to-UK rules will not cause double taxation

- Providing new guidance on both the Revenue's risk assessment strategy and on documentation requirements.

Exemption for small and medium-sized businesses

The exemption for small and medium sized businesses from the requirements to apply transfer pricing rules is based on the European Commission's small and medium-sized enterprise (SME) definition. Broadly speaking, small businesses are those with less than 50 employees and with either a turnover of, or assets amounting to less than €10 million (£7 million). Likewise, medium-sized businesses are those that are not as small but have less than 250 employees with either a turnover of less than €50 million (£35 million), or assets of less than €43 million (£30 million). The Inland Revenue has said that this will "ensure that over 95% of businesses do not have to worry about transfer pricing when making a tax return", but that of course refers to all businesses – whereas those with related party transactions are typically not the smallest. Thus, the majority of businesses with more than one legal entity may be affected by these rules.

In addition, there are significant limitations to the exemption, particularly in relation to cross-border transactions:

- Tax Treaties

Small and medium-sized businesses will benefit from the exemption in relation to transactions with related businesses in the UK or "in a country with which the UK has a double tax treaty containing a suitable non-discrimination article". The effect of introducing this concept of qualifying and non-qualifying territories will, inter alia, be to ensure that transfer pricing remains relevant in relation to transactions with tax havens.

- Revenue Direction

In the case of medium-sized businesses (but not small businesses), the Inland Revenue proposes to have the power to request adjustments to be made where it believes that there has been blatant manipulation and a significant loss of UK tax, regardless of whether the transactions were domestic or cross-border.

Start date

The new transfer pricing rules comes into effect from 1 April 2004. Where an

accounting period straddles that date, profits made in the latter part of the period are to be calculated on the new basis.

Relaxation of the penalty regime

Under current self-assessment procedures, businesses failing to apply the new transfer pricing rules will incur a penalty. The government has introduced a temporary waiver of penalties that might otherwise arise as a result of a lack of transfer pricing documentation. This will apply for a transitional two-year period covering 2004/05 and 2005/06.

The draft clauses seek to set aside any tax-gearred penalty where the only evidence for negligence is the absence of records that demonstrate the use of arm's length prices. Once the new rules apply, businesses which are not covered by the small and medium-sized enterprise exemption need to apply arm's length prices to their UK-to-UK transactions. A negligent failure to do so would attract a penalty under the self-assessment regime.

Compensating adjustments and balancing payments

In order to avoid double taxation arising where transfer pricing adjustments are made on UK-to-UK transactions, amendments to the transfer pricing rules are proposed to allow compensating adjustments to be made within the UK. This is the mechanism under which the Inland Revenue hopes to avoid double taxation arising. It is supplemented by a new rule which enables a "balancing payment" to be made between the affected persons following any transfer pricing adjustment. Such a balancing payment can be made between the affected persons, up to any amount of the compensating adjustment, without further tax consequences. Essentially, this will enable the two parties to restore their cash position to its original state.

Risk assessment and documentation requirements

As a consequence of the large administrative burden about to be placed on businesses, the Inland Revenue's technical notes also contain new guidance in relation to transfer pricing documentation and Inland Revenue enquiries. However, the UK remains committed applying OECD Guidelines on transfer pricing, and will expect appropriate documentation of inter-company pricing. Indeed, even the revised guidance is at pains to reiterate that a business will expose itself to the risk of penalty if it does not make

available, within a reasonable period of time, evidence to demonstrate the appropriate arm's length results of the transactions to which transfer pricing rules apply.

Thin capitalisation

The thin capitalisation rules governed by ICTA 1988 section 209 are repealed. The new transfer pricing provisions are to be introduced into ICTA 1988 Schedule 28AA to enable this area of anti-avoidance to be dealt with under the transfer pricing regime. The proposed changes in relation to transfer pricing will therefore apply in relation to thin capitalisation regarding both UK-to-UK transactions and the exemptions and relaxations proposed. In particular, compensating adjustments will also apply to the thin capitalisation in order to avoid double taxation arising from the adjustments made on UK-to-UK transactions.

The new thin capitalization rules abolish the grouping provisions, such that the thin capitalization position will need to be evaluated on a company-by-company basis. There are new rules governing the treatment of the group guaranteed by third party loans, which provide the compensating adjustments to the guarantors.