CHAPTER 6B

TRANSFER PRICING & LOANS

6B.1 Introduction

In this chapter we will look at how the transfer pricing legislation applies to transactions involving the lending of money.

6B.2 Excessive interest

The rules will apply where **both the parties to the transaction are companies** and the actual provision is in relation to a security issued by one of the companies.

Security is given a wide meaning that covers **any loan or other money debt** TIOPA 2010, s.154(6)

In deciding whether the interest charged differs from the interest that would have been charged in the absence of a special relationship, account will be taken of all factors including: TIOPA 2010, s.152(2)

a) **Whether the loan would have been made;**
b) **The amount for which the loan would have been made;**
c) **The rate of interest or other terms that would have been agreed.**

These tests are applied without taking account of the fact that the lender's normal business does not include the making of loans.

A special relationship exits where the control provisions relating to transfer pricing apply, as covered in the previous chapter.

In considering the above questions the Revenue will be looking at whether a company could be considered to be thinly capitalised.

In summary, a company is thinly capitalised when its level of debt far exceeds its equity. The Revenue are reluctant to say that the arm's length conditions will be met if certain debt:equity ratios or income cover ratios are met by the group. They stress the importance of looking at each case on its merits, considering the particular sector the company is in and market conditions at the time. Previously HMRC have conceded that with a gearing below 1:1 and an income cover of at least 3:1, the arm's length test should be met. However, in recent guidance issued in March 2010, HMRC have indicated a move away from such ratios, and that they will instead consider all the merits of a particular case.

The **borrowing company has to be looked at in isolation** in determining whether the loan would have been made and the level of interest. Thus no account is taken of any guarantee provided by a connected company. TIOPA 2010, s.152(5)(6)

Guarantee includes any arrangement - formal or informal - that gives the lender a reasonable belief that he will be paid if the borrower defaults. TIOPA 2010, s.154(4)

6B.3 Guarantees

The transfer pricing rules also covers the situation where a transaction includes: TIOPA 2010, s.153

a) The issuing of a security by a company which is one of the affected persons (the issuer); and
b) The provision of a guarantee by a company which is the other person.

In deciding whether an adjustment needs to be made for excessive interest regard should be had to **whether, in the absence of a special relationship:**

a) A guarantee would have been provided;
b) The amount that would have been guaranteed;
c) The consideration that would have been required for the guarantee and other terms that would have been agreed.

As for excessive interest, no account is to be taken of the fact the provider of the guarantee does not have a business of providing guarantees.

Again the borrowing company must be looked at in isolation from its parent group.

6B.4 Elimination of double counting

Where interest payments are subject to a transfer pricing adjustment, a claim can be made for **a compensating adjustment**, as with other sorts of transfer pricing adjustments. TIOPA 2010, s.181(2)(3)

A claim can only be made by the advantaged or disadvantaged person. A claim made by the advantaged person will be taken to have been made on behalf of the disadvantaged person. TIOPA 2010, s.181(1)(3)

The claim **can be made before the computation of the arm's length interest has been made,** however the deadline for the claim set down in s.182(4) TIOPA 2010 continues to apply, including the extension in the case of a late claim. TIOPA 2010, s.182(3)

A claim **will not be treated as being made within the tax return**. Instead it will be governed by the rules in Sch 1A TMA 1970 relating to claims made outside the tax return. TIOPA 2010, s.181(1)(3)

A compensating adjustment must be consistent as between the borrower and the lender. Once made a claim may be varied with in the time limits. TIOPA 2010, s.183-184

A claim for a compensating adjustment can also be made by a guarantor to a loan. A claim can only be made where the **guarantee has lead to the transfer pricing adjustment.** The claim is limited to the amount that an independent lender would take the guarantee into effect in determining the borrower's lending capacity. TIOPA 2010, s.191

The **guarantor** makes a claim to be **treated as if it had been made the loan and paid the interest** which was disallowed, thus giving the guarantor the right to an interest deduction. In the case of more than one guarantor, the amounts have to be split amongst them. TIOPA 2010, s.192(3)

If the lender also makes a claim for a compensating adjustment because it is connected to the borrower, then any **claim by the lender must take account of a claim made by the guarantor that has already been made. A claim by the guarantor cannot be made where a claim has already been made by the lender**. TIOPA 2010, s.193

For accounting periods beginning on or after 6 December 2006 a guarantor company may be deemed to have made a claim under s.192 TIOPA 2010. Corporation Tax Act 2009, s.452

A guarantor can make a balancing payment to a borrower to take account of transfer of the interest deduction to him with out a tax effect. There is no obligation to make such a payment. TIOPA 2010, s.198

A claim for a compensating adjustment by a guarantor can be made **by either the guarantor or the borrower,** a claim by the borrower will be taken to have been made on behalf of the guarantor.

6B.5 Advanced Thin Capitalisation Agreements (ATCAs)

SP 4/07

SP 4/07 deals with thin capitalisation agreements, only it does not in any way impact on SP 3/99 that we looked at in the last chapter. The provisions of SP4/07 can also be found within the updated thin capitalisation guidance, re-issued in March 2010, within the International Manual.

Situations suitable for ATCAs include, but are not limited to the following:

- o intra-group funding outside the scope of treaty applications, e.g. involving a quoted Eurobond or discounted bond;
- o financing arrangements brought into Part 4 TIOPA 2010 by the "acting together" rules in paragraph s.158 TIOPA 2010;
- o financing arrangements previously dealt with under the treaty route.

The potential scope of an ATCA is flexible. They may cover either the treatment of a single applicant's financial instrument, or the treatment of the overall debt position of a group, depending on circumstances.

An ATCA will be operative for a specified period from the date set out in the agreement. The current guidance is that thin capitalisation agreements negotiated under the treaty route should not be entered into for more than five years. It is therefore intended that the vast majority of advance thin capitalisation agreements will last for between three and five years.

While an ATCA will normally operate prospectively in relation to chargeable periods beginning after the time the application is made, it is possible that a chargeable period to which the agreement relates may have ended before the agreement is reached. S.224 TIOPA 2010 allows the agreement to be effective for that chargeable period and in accordance with s.224 TIOPA 2010 the agreement may set out any adjustments to be made for tax purposes as a consequence of the agreement.

Although a particular agreement does not relate to earlier periods, the conclusions reached in negotiating the agreement may be relevant to a return for an earlier period, or to the resolution of thin capitalisation enquiries raised for earlier periods, if the particular facts and circumstances surrounding those years are substantially the same. Consequently, in such circumstances, the business and HMRC may jointly agree to consider a "roll-back" of the ATCA as an appropriate means for amending a self assessment return and of resolving outstanding transfer pricing issues in earlier years. HMRC will not however use hindsight in any such roll-back.

Except where "roll-back" is being considered, the request for an ATCA in respect of future years will not in itself affect any transfer pricing enquiry in respect of earlier years. HMRC will co-ordinate the request in respect of future years with any transfer pricing enquiry in respect of prior years in order to improve overall efficiency and reduce duplication of enquiries.

6B.6 Interest adjustments - withholding tax

The rules give the lender (or the borrower on behalf of the lender) the right to claim a compensating adjustment that will remove the liability to withhold tax at source. TIOPA 2010, s.187

The overseas associated lender will apply for interest to be paid gross. HMRC will confirm that the non adjusted part is gross under the double tax agreement and that the adjusted part is covered by the transfer pricing rules.

This means that in the case of an **overseas lender, tax does not need to be deducted at source** under s.874 ITA 2007.