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In view of the deluge of anti-discrimination judgements by the European Court of Justice over the past few years, notably *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (Case C-324/00), it is not surprising that the United Kingdom has made some changes to bolster its thin capitalisation and transfer pricing rules. What *is* perhaps surprising is that the changes go far beyond a simple 'sticking plaster' to remove the discriminatory U.K.-U.K. exemptions; the U.K. has taken the opportunity to make the most significant revision of its transfer pricing and thin capitalisation rules for six years.

Even more surprisingly, a number of the changes are favourable to multinationals, though some are not. The purpose of this article is to explain the changes in relation to thin capitalisation and what they will mean for non-U.K. groups and their U.K. subsidiaries. The box overleaf provides a short explanation of the principles of thin capitalisation. As will be explained, the article is also potentially relevant also for U.K. borrowers, whether or not they are borrowing from an overseas associate; indeed, even if they are borrowing from an unrelated overseas lender or a related or unrelated U.K. lender.[1] All changes apply with effect from April 1, 2004, regardless of the taxpayer's accounting year end.

I. Impact of Repeal

Upon first glance at the new legislation (Finance Act 2004, which was enacted on July 22, 2004) one might assume that the most important change in relation to thin capitalisation is that the U.K. has repealed its thin capitalisation rules. However, for the last six years the U.K. has adopted the "belts and braces" approach of having two separate sets of legislation to counter thin capitalisation, only one of which has been repealed. (Arguably, there were yet more bits of U.K. tax legislation that might also be relevant in a case of thin capitalisation, but in practice only two were commonly used.)

The first set of legislation was a specific provision in the U.K.'s deemed dividend rules, plus some further associated provisions. For those who are interested in section numbers, these rules were scattered in several parts of the Taxes Act 1988: Section 209(2)(da), Section 209(8A)-(8F), and Section 212(1)(b). It is these that have been repealed. For the sake of brevity, we will refer to these henceforth as the "old thin capitalisation rules".

Since 1998, these rules were bolstered by the newly-introduced U.K. transfer pricing rules contained in Schedule 28AA Taxes Act 1988. These were specifically worded with the intention of applying to cases of thin capitalisation as well as transfer pricing, although this was achieved by wording the legislation in terms as wide as possible rather than making any specific mention of debt levels. Although this new weapon was often superfluous, because it had no additional effect over and above the old thin capitalisation rules, it did catch certain loans that would not otherwise be caught (such as cases where the control relationship between the lender and borrower was less than 75 percent).

On the other hand, it is doubtful that the old thin capitalisation rules caught any loans that were not caught by the U.K. transfer pricing rules, so the impact of the repeal of the old thin capitalisation rules is in fact relatively limited. Arguably, the U.K. government could have opted to respond to ECJ discrimination concerns by merely amending the old thin capitalisation rules to remove the exemption that was available for lenders that were U.K. corporation tax payers (which therefore effectively applied the rules only to cross-border loans). However, they appear to have decided to take the opportunity to allow the old thin capitalisation rules an honourable retirement, passing the full burden of countering thin capitalisation to the young, muscular understudy legislation.

II. New Transfer Pricing Rules

There are, however, a number of other changes to the transfer pricing rules. Some of the changes relate specifically to thin capitalisation, much of which closely replicates provisions that were included in the old thin capitalisation rules. Other changes apply to any transfer pricing issue, including thin capitalisation. The rest of this article will consider the effects on thin capitalisation, whether beneficial or detrimental, of the changes to the transfer pricing rules.

We will, for the sake of brevity, refer to the transfer pricing rules pre- and post-April 1, 2004 as the "old transfer pricing rules" and "new transfer pricing rules", respectively. It should be remembered, though, that the new transfer pricing rules are, in effect, also the new thin capitalisation rules.

III. U.K.-U.K. Loans

Perhaps the most fundamental change in the new transfer pricing rules is that there is no longer an exemption for U.K.-U.K. transactions. In the context of thin capitalisation, this means that any U.K. borrower needs to think about thin capitalisation, even if it is not borrowing from overseas and has no non-U.K. ownership.

Let's take a "plain vanilla" example. Up until now, a U.K. parent company that had a U.K. subsidiary with only £100 equity capital and, say, £10 million debt, would be unlikely to suffer any adverse consequences. From April 1, 2004, a deduction for the

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What is thin capitalisation?

Many readers will already be well aware of the principles of thin capitalisation, and they can safely skip this box. However, for anyone who is unsure of what thin capitalisation is all about, here is a very brief summary.

Thin capitalisation rules are the result of the simple fact that in most countries interest is a deductible expense for tax purposes, but dividends are not. It may therefore be advantageous from a tax perspective for a parent company to provide additional capital to its subsidiaries by way of debt, rather than equity capital. The subsidiary can therefore remit more of its operating profits to the parent by way of tax-deductible interest, leaving fewer profits that are subject to corporate income tax before being remitted by way of dividend. In many cases (though not always), this would reduce the overall global tax liability of the parent and subsidiary.

Governments and tax authorities are concerned about this, because they consider that there is nothing to stop groups of companies from abusing this situation by capitalising subsidiaries with "excessive" levels of debt (known as being "thinly capitalised"). When companies borrow from unconnected lenders, there are natural commercial constraints on the quantum of the debt. Equity capital reduces the risk for the lender, because any loss made by the borrower comes out of equity first. Setting aside various exotic derivatives, which muddy the picture, a borrower will only default on a loan after equity has been reduced to nil. But if debt capital becomes too high in proportion to equity the buffer provided by the equity may not sufficiently limit the lending risk, so the lender may refuse to lend or may require interest rates that are so high that most companies are unwilling to pay them. These constraints do not exist where the parent already owns the subsidiary, because it makes little economic difference to the parent whether, in the event of losses in the subsidiary, it has to write off debt capital or equity capital.

Many countries therefore have thin capitalisation rules, to prevent subsidiaries from being capitalised with "excessive debt", or rather to deny interest deductions for interest on such debt. How to determine what is excessive varies from country to country. Most countries have some sort of fixed threshold, such as limiting debt to a certain multiple of equity, or limiting interest deductions to a certain proportion of taxable profits. The U.K. is unusual in seeing it as purely a matter of the arm's length test, so a level of debt that is acceptable to the Inland Revenue for one taxpayer might give rise to a thin capitalisation adjustment for a less creditworthy taxpayer.

interest on a large portion of this debt would almost certainly not be available for the U.K. subsidiary, as it is thinly capitalised.

The adverse impact of this change has been considerably mitigated by the introduction of new compensating adjustment mechanisms, which will often mean that the interest remains fully deductible for the U.K. group as a whole, though not necessarily by the borrower. See the heading Compensating Adjustments, below. This means that in many cases, there will be no U.K. tax at stake in relation to U.K.-U.K. loans. Many taxpayers will be tempted to ignore thin capitalisation on such loans, on the grounds that they do not wish to waste their resources on situations where there is no tax at stake.

Unfortunately, E.U. non-discrimination principles mean that it is not that simple. The Inland Revenue cannot be seen to give more favourable treatment purely on the grounds that no U.K. tax is at stake. They have made it clear that taxpayers must properly self-assess their tax position under thin capitalisation principles as with any other tax issue, and should not ignore thin capitalisation on U.K.-U.K. loans. However, they have also made it clear that they believe it is legitimate for them to give a lower priority to examining transactions where there is little or no U.K. tax at stake.

Perhaps a sensible approach is to review U.K.-U.K. loans and, in cases where there is real U.K. tax at stake (for instance, because the lender has tax losses), carry out thin capitalisation analysis, and reduce debt levels if necessary. As we are already five months into the new regime, this should be done urgently. For loans where there is no net U.K. tax at stake and the debt levels are not obviously too high, few taxpayers will be willing to use any resources to do anything further. Where the borrower is clearly thinly capitalised, however, many tax directors and managers will feel uncomfortable signing a self-assessment tax return which is clearly wrong, even if there is no net U.K. tax at stake. Individual taxpayers will make their own decisions about what to do in such circumstances. One option might be to reduce the debt to what is judged to be a reasonable level, but without spending time or resources carrying out significant analysis to determine the exact "right" level.

IV. Unrelated Lenders and Guarantees

It should be noted that although, for the sake of readability, this article generally uses the plain English term, transactions, the term used in the legislation is "provisions". This is potentially far wider in meaning than just a simple transaction. For instance, it is intended to apply to a series of transactions, not all of which are necessarily between connected parties.

In the context of thin capitalisation, this means that the Inland Revenue believe they can apply the legislation to loans from unrelated lenders. In particular, they believe they can apply it to situations where, although the loan is from an unrelated lender, it was supported by a guarantee or back-to-back loan from the borrower's parent or other related party.

This is not new: the old transfer pricing rules were worded in a broad fashion, with the intention of having this effect. What *is* new is that the rules now contain specific reference to guaranteed loans, and a very wide definition of guarantee, which includes any arrangement or understanding that gives the lender the reasonable expectation that in the event of default by the borrower the guarantor will make good any loss.

It has long been Inland Revenue practice to allege a guarantee in cases where there is no formal guarantee, but this practice seems now to have been converted into statute. There are, however, some arguments that mean the Inland Revenue does

not necessarily have carte blanche to apply thin capitalisation principles. Unlike the old thin capitalisation rules, the transfer pricing rules are subject to the statutory requirement that they be interpreted consistently with the OECD transfer pricing guidelines, which may not always support the interpretation the Inland Revenue may prefer.

V. Types of Borrower

Thin capitalisation is normally thought of, in the U.K. and other countries, as applying only in the context of loans between companies. This appears to be reflected in the wording of the new transfer pricing rules, as the new specific references to thin capitalisation (let's refer to them as "the thin capitalisation paragraphs") that have been inserted are all only applicable to loans where the borrower is a company and the lender or the guarantor is also a company.

However, the rest of the transfer pricing rules (old and new) apply to more than just intra-corporate transactions. They apply where one of the parties to the "provision" (generally, this will be the borrower or the lender, or, in some cases, the guarantor) is a company or a partnership and the other such party is any legal person (including individuals, trusts, companies and partnerships) which controls the first. Draft guidance recently released by the Inland Revenue narrows this scope a little. It confirms that they consider the legislation to apply only to such persons if they are "enterprises". The guidance clearly contemplates that a lender may not always be acting as an enterprise when it makes a loan, although the discussion in the guidance does not set out clear criteria for determining this.

It was always maintained that the old transfer pricing rules applied to cases of thin capitalisation, even though there was no specific mention of loans. The relevant bits of the legislation that had this effect remain in the new transfer pricing rules. This therefore begs the question of how thin capitalisation is meant to be applied to loans where at least one party to the loan is not a company, so the thin capitalisation paragraphs do not apply. The writer's intuition is that the Inland Revenue would apply thin capitalisation to such loans in the way set out in the thin capitalisation paragraphs, despite such loans having been excluded (presumably deliberately) from the scope of those paragraphs.

VI. Exemptions

Although the removal of the U.K.-U.K. exemption is a detrimental change which subjects many more loans to thin capitalisation principles, the government has introduced some new exemptions that will (among other things) prevent many U.K.-U.K. loans from being caught. Many cross-border loans that were formerly caught will also benefit from these exemptions.

The most important exemption is for taxpayers who are sufficiently small, which means staff numbers must be fewer than 250, and either turnover is no more than €50 million (~£34 million) or assets are no more than €43 million (~£30 million). The thresholds are determined by reference to the entire worldwide group of the taxpayer, so even a one-man subsidiary will not be exempt if it is part of a group that does not meet the thresholds.

The exemption is subject to only two exceptions. First, the exemption does not apply to any transaction where (in the context of loans) the lender or borrower is resident in a country with which the U.K. has no double tax agreement (DTA), or the DTA has no non-discrimination article. The same would apply if there were a guarantor, or indeed any other party that is somehow involved in the loan, in such a country. It does not matter if the non-DTA party is completely independent from the other parties to the loan.

The second exception is that the Inland Revenue retain powers to withdraw the exemption if they consider that a "significant amount of tax" is at stake. As is typical for U.K. tax law, "significant" is not defined, but it is understood that the powers will only be used in extraordinary circumstances. The Inland Revenue will exercise this power by issuing what is termed a "transfer pricing notice" after the tax return has been filed. This will give the taxpayer 90 days to apply the arm's length principle to whatever transactions with associates are specified in the notice. However, transfer pricing notices cannot be issued to the smallest taxpayers: small enough to fall below a second set of thresholds.

The other exemption is in relation to companies that were dormant under the U.K. Companies Act 1985, as at April 1, 2004. In practice, it would be exceedingly rare for a dormant company to be a borrower, so this will rarely be relevant in the context of thin capitalisation.

VII. Compensating Adjustments

With the removal of the U.K.-U.K. exemption, compensating adjustments have now assumed a central role, in order to avoid double U.K. taxation. In the context of thin capitalisation on U.K.-U.K. loans, the way the adjustment will work is to give the U.K. lender the right to reduce its U.K. taxable income by an amount equal to any interest deduction denied to the borrower on thin capitalisation grounds. Or, where there is an associated U.K. guarantor, then, to the extent the guarantee would support the extra deduction, the guarantor can claim the compensating adjustment (or share it with the U.K. lender or other U.K. guarantors).

The latter mechanism has been used to replace and expand the "U.K. Grouping" mechanism in the old thin capitalisation rules, with which some readers may have been familiar. The U.K. Grouping mechanism included lengthy rules that specified which other group companies could be taken into account in assessing the creditworthiness of a U.K. borrower. The way it worked, and the way the new mechanism works, can best be summarised by the diagram overleaf.

The effect was that the borrowing capacity of U.K. Borrower was assessed on the basis of the creditworthiness of the U.K. Grouping as a whole. U.K. companies were not taken into account if they were not under common U.K. control with the U.K. borrower (*e.g.,* UK3). Overseas companies were only included if, like French co and German co, they were owned by U.K. companies that were in the U.K. Grouping.

Under the new rules, the old mechanism has been replaced with something completely different. The old rules would have given the whole interest deduction to the borrower, but from now on the borrower can only claim a deduction for the interest on the debt that it could have supported on its own merits. The compensating adjustment mechanism will potentially give the excess deduction to other members of the U.K. group.

Referring back to the diagram, if U.K. Borrower has insufficient creditworthiness to support its debt (whether the lender is connected to it or not), even after taking into account the assets and liabilities of its subsidiary, French co, then U.K. Borrower's interest deduction will be reduced to the arm's length amount. But there will then be an opportunity for other related U.K. companies (in this case, U.K. 1, 2 & 3) to use the excess deductions via a

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compensating adjustment, by making a claim that their own creditworthiness (including their own subsidiaries) supports the debt. Any creditworthy U.K. company under common control with U.K. Borrower may claim, so under the new rules U.K. 3 (and therefore Irish co) are no longer disregarded.

Some multinationals had, in the past, lost interest deductions due to having unusual corporate structures that fell foul of the U.K. Grouping rules. Others had to carry out costly restructuring in order to avoid this. Thankfully, this will no longer be necessary.

The Inland Revenue seem to have gone out of their way to be as helpful as possible, here. For instance, it seems to be unnecessary that the companies that claim the deduction have issued any guarantee. The very wide definition of guarantee discussed earlier is used here too, and it looks as though the Inland Revenue is prepared to deem there to have been a guarantee in almost any circumstance. To make sure, some groups may wish to put in place formal cross-guarantees between all U.K. members of the group.

Finally, there are further rules that allow (but do not require) the lender or guarantor/s to make "balancing payments" to the borrower of up to the amount of the compensating adjustment. These payments are non-taxable and non-deductible. This allows cash to be shifted to match the transfer pricing adjustments. If the balancing payment is equal to the full compensating adjustment, then it is as if the lender/guarantor has assumed the interest burden. The group may, however, prefer to set the balancing payment at 30 percent of the compensating adjustment, to equal the U.K. corporation tax rate. In that case it is as if the lender/guarantor has passed to the borrower the tax benefit of the deduction.

VIII. Withholding Tax

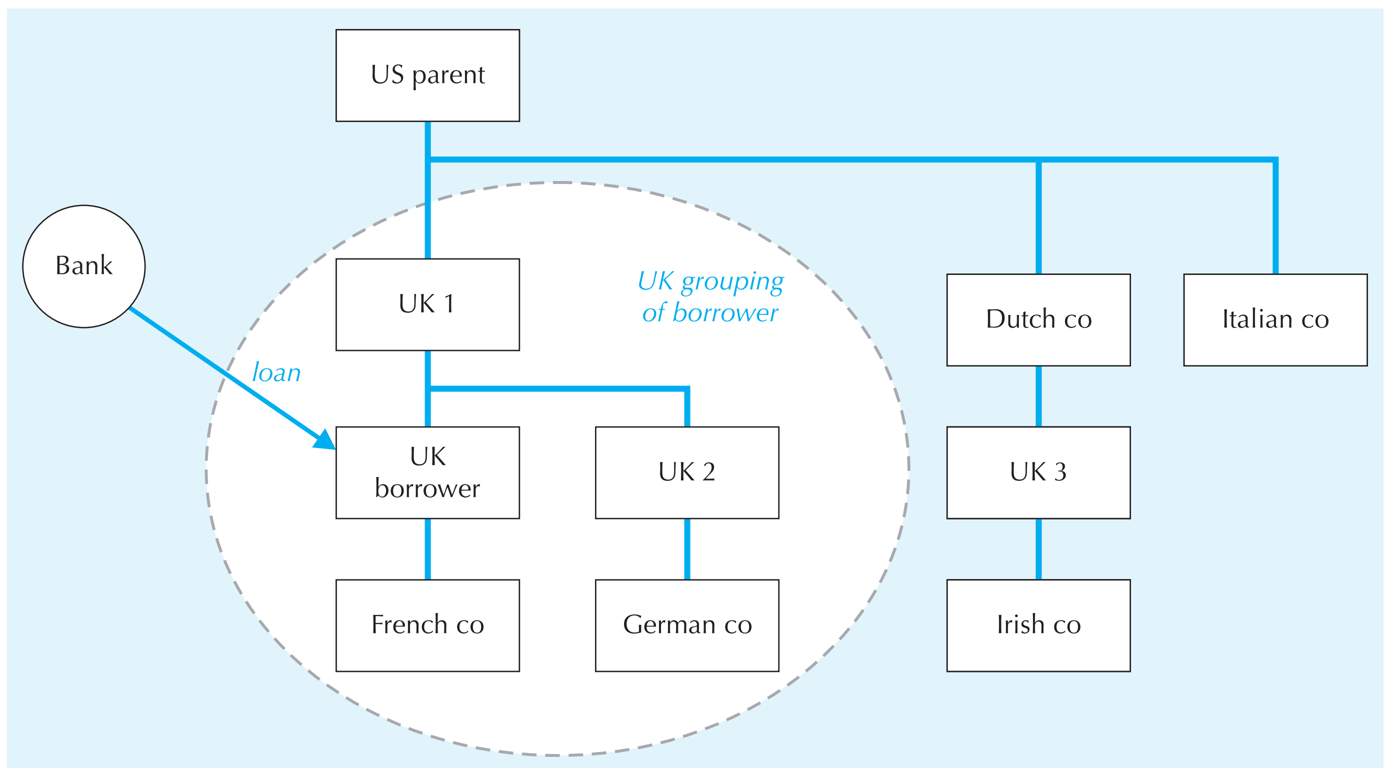
So far, we have only considered interest deductibility, but thin capitalisation also potentially has withholding tax implications.

The old thin capitalisation rules recharacterised "bad" interest (*i.e.,* interest on the portion of the loan that is thinly capitalised) as a distribution, but with the repeal of those rules bad interest remains interest. Therefore, the DTA Dividend Article no longer applies. In some cases, the Interest Article will apply, but the Interest Article in many of the U.K.'s DTAs includes a "special relationship clause" that has been specifically worded to disapply the Article in the case of thin capitalisation. The thin capitalisation interest might then be governed by the Other Income Article, which would generally forbid any withholding at source. In other cases, the interest may simply be outside the scope of the DTA, which would leave the interest subject to full U.K. withholding tax at 20 percent, as would also be the case if there is no applicable DTA.

Fortunately, this uncertainty is resolved by an addition to the new transfer pricing rules, to give the lender the right to make a compensating adjustment claim that will remove the liability to withholding tax and relieve the borrower of the obligation to withhold at source. This is in line with former practice of the Inland Revenue, who were usually content to have either a denial of an interest deduction *or* a withholding tax charge, but rarely insisted on a double hit. The creation of a statutory concession is a welcome development.

It will, however, continue to be necessary, as it has been in prior years, for borrowers from overseas lenders to apply for advance clearance to pay interest gross, but the nature of the application will change. The applicant will be asking for the Inland Revenue to confirm their acceptance that the arm's length portion of the interest is protected by the Interest Article in the relevant DTA and that the non-arm's length portion is protected by the compensating adjustment. Except in cases where the DTA allows a rate of withholding tax on 'good' interest of more than zero, it would seem unnecessary (for withholding tax purposes) to determine how much of the interest is non arm's length.

It would appear the Inland Revenue will continue to expect to review thin capitalisation at the time of the clearance application. Many taxpayers would prefer this practice to continue, as it gives an advance indication (though not an assurance) as to the amount of interest that will be deductible for the borrower. However, it would seem that taxpayers would have good



grounds to refuse to discuss thin capitalisation at the time of the clearance, if they wished, for instance if a deal would be held up by delays in obtaining withholding tax clearance.

It is interesting to note that although they no longer apply to thin capitalisation the U.K. deemed dividend rules will continue, as they always have, to recharacterise as a distribution any interest to the extent that the interest rate exceeds an arm's length rate, and the DTA Dividend Article will continue to apply. This part of the deemed dividend rules has always applied to U.K.-U.K. transactions, so is unlikely to be at risk from the ECJ. It was therefore unnecessary to repeal it, though equally it is difficult to see why it was retained. It is a pity that we now have the complication of a different treatment for "thin capitalisation" adjustments compared with "excessive interest rate" adjustments. In particular, the deemed dividend rules make no provision for compensating adjustments, which seems to mean that there could be double U.K. taxation in respect of certain U.K.-U.K. loans where the interest rate is too high.

IX. Concluding Comments

This article has covered most of the key developments in relation to U.K. thin capitalisation rules, for both foreign multinationals and U.K. taxpayers. However, space does not permit mention of all issues. There are also other transfer pricing issues that may affect intragroup loans, such as whether the interest rate is arm's length, and, if there is a guarantee, whether the guarantee fee is arm's length. However, these are for another article.

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1 Space does not allow coverage of transfer pricing in this article, though some of the key changes on transfer pricing were briefly reviewed in the author's article at page 18 of the April 2004 issue of this journal (Vol.5, No.4).

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