Acting Together

GARETH GREEN explains the proposed transfer pricing rules for persons 'acting together'.

FOR TAXPAYERS AND advisers still trying to get to grips with last year's extension of transfer pricing rules to UK-UK transactions, the last thing they needed was some further new rules to be puzzled out and perhaps they have been given some breathing space by the forthcoming election. Since this article was written, the amendments to the transfer pricing rules were removed from the Finance Bill 2005, together with most other controversial innovations. It is, however, expected that these proposed changes will be reintroduced following the general election, and most likely will remain back-dated to 4 March 2005. The rest of the article therefore remains as previously written.

These latest (proposed) rules have largely been billed as relating to private equity investments, and certainly this is the primary target of the legislation, but not the only one. This article is aimed at readers who would like to understand whether (and how) they are likely to be affected.

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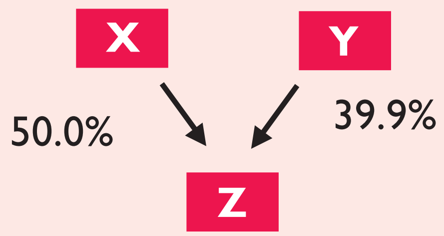
Key effect of new rules

In a nutshell, what has happened is as follows. The transfer pricing rules only apply (broadly speaking) to transactions between persons where one person controls the other or both are under common control of another person. For transactions that are 'financing arrangements', control will now additionally be determined by amalgamating the rights and powers of any persons that have 'acted together in relation to the financing arrangements'.

Each of the persons that have acted together is therefore effectively tainted by the fact that the persons collectively meet the control tests, even if those persons are otherwise unrelated to one another. Loans (the main form of 'financing arrangements') that would not previously have been subject to transfer pricing rules are now drawn in.

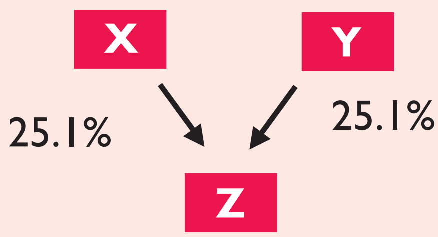
Previously, control generally arose if any person had more than 50% of voting shares. To catch 50:50 joint ventures, a special rule also caught holdings of 40% or more, in cases where another person also had at least 40%. ***Example 1*** shows the maximum shareholdings that two unrelated persons, X and Y, could therefore have in a third person, Z, without being subject to the transfer pricing rules in respect of transactions with Z.

Example 1



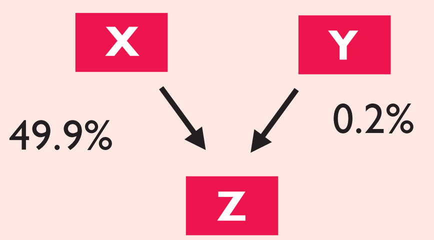
Until now, that is. These will remain the thresholds in respect of transactions that are not 'financing arrangements', but loans and other 'financing arrangements' will now be caught with much lower levels of shareholding. For instance, if X and Y act together in relation to financing arrangements for Z, they could be caught even if their shareholdings were as shown in ***Example 2***.

Example 2



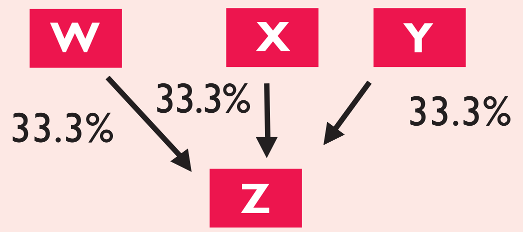
Even the smallest holding could be caught. For instance, if X and Y acted together they would both be caught, even if Y had a holding as small as shown in ***Example 3***.

Example 3



And of course if more than two persons act together in relation to the financing arrangements, there are – as a 'for instance' in ***Example 4*** – almost endless permutations that are caught.

Example 4



Control with no equity interest?

Example 3 above, where the transfer pricing rules apply to Y even with only a 0.2% shareholding in Z, might seem extreme, but the rules may be even wider-reaching that that. Judging by the draft legislation, it would seem possible for the transfer pricing rules to be applied to a loan even if the lender has absolutely no equity interest in the borrower.

All that is necessary is that the lender has acted together with other persons in relation to the financing arrangements and the equity interests of those other persons are sufficient to give rise to control (whether or not such control is actually exercised). The lender will be caught by the control test, notwithstanding that it has no equity interest itself.

Of course, if the lender is lending on a truly independent basis, then it should follow that it meets the arm's length test, so no transfer pricing adjustment is necessary. However, one can foresee some disputes arising on this from time to time.

Consequences

The consequences for loans that are caught are potentially severe. Interest deductions will be denied to the borrower to the extent that the interest is in excess of the interest that would have arisen on an arm's length basis, i.e., were it not for the control relationship. This is the case whether the interest is excessive as a result of the interest rate being too high or the quantum of the loan being more than an arm's length lender would have advanced (known as being 'thinly capitalised').

It should be remembered that the transfer pricing rules now apply not only to cross-border transactions but also to domestic ones, so the potential impact is quite widespread. In answer to Parliamentary questions, Dawn Primarolo has revealed that 'the changes prevent tax avoidance that could otherwise have reduced current and future tax revenues of about £300 million a year'.

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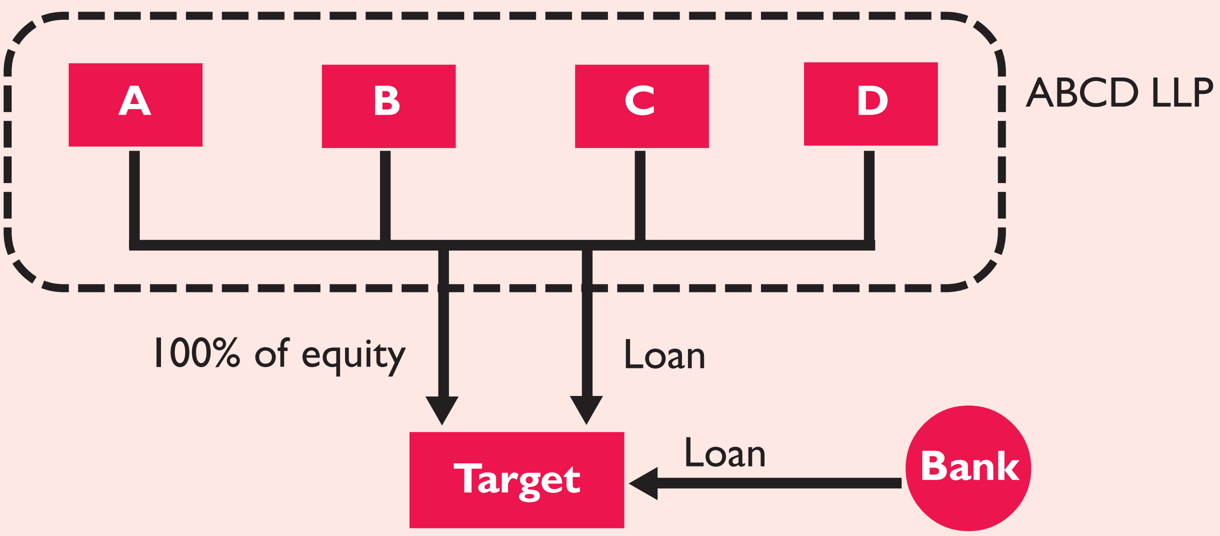
'Acted together'

The linchpin of these new rules is the phrase 'acted together'. As illustrated by the above examples, *any* loan to a company or partnership is now potentially subject to transfer pricing principles if the lender has acted together with other persons who jointly exceed the control thresholds.

Acted together appears not to be defined in the legislation, which is perhaps understandable as it would be difficult to do so. Some patterns will fairly clearly be caught, such as where two or more shareholders make loans at the same time, on the same terms and in proportion to their shareholdings. This is such a loose term, however, that one can foresee some fearsome arguments about what is encompassed at the margins.

Example 5



Private equity

The new rules may apply to virtually any minority interest that involves acting in concert (like a partnership or joint venture) and taxpayers should carefully consider whether they have any such arrangements. However, the main targets are private equity funds. The typical situation is illustrated by the simplified diagram in ***Example 5***.

ABCD LLP is a private equity fund, with four investors, A, B, C, and D, who each own 25% of the fund, which is a limited liability partnership. Such funds often have many more investors, of course, but we will assume just four investors here to keep the example simple. The consequences would, however, be the same no matter how many investors there are.

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The fund has carried out a leveraged acquisition of a company, so it owns 100% of the equity. As is typical of such investments, a large loan has been obtained from an independent bank and has been supplemented by a further large interest-bearing loan from the fund.

It is currently a matter of dispute whether the transfer pricing control tests apply as if a partnership is a legal person or on a partner-by-partner basis. The Inland Revenue recently withdrew what had previously been understood to be an undertaking given in 1998 that it would not treat private equity partnerships as a single legal person. For more than six years, the private equity industry has operated on the basis that transfer pricing and thin capitalisation rules did not apply to debt injected into targets provided no partner/investor individually exceeded the control thresholds. This is now being challenged.

This dispute will continue to be fought regarding periods prior the application of the new rules (see below), but the original Finance Bill 2005 proposals would seem to make this dispute irrelevant going forward. If a partnership such as ABCD LLP *is* a person, the control tests are clearly met, so transfer pricing principles will apply to the loan. If the partnership is *not* a person, the partners nevertheless acted together in making the loan, so the control test catches each of them, even though they each own no more than 25% equity interest.

The new rules also block alternative structures that might have been used if it is confirmed that a partnership is a person, for instance if A, B, C and D each form their own separate investment vehicle instead of the partnership.

Transition

The new rules were announced on 4 March 2005, in advance of the Budget. Although draft legislation was not made available (as Schedule 14 of the original Finance Bill 2005) for more than two weeks, and final legislation will now be deferred until after the election, the original rules were to have effect for new loans from 4 March 2005.

Existing loans are 'grandfathered' and remain unaffected until 1 April 2007, or, if earlier, the date the loan is varied.

Compensating adjustments

In some cases, there may be no net tax impact from the application of these rules. If the lender is a UK taxpayer, it ought to be entitled to a compensating adjustment, reducing its interest income to the arm's length amount, to match the tax deduction for the borrower. If the lender is an overseas taxpayer, it will often be entitled to a 'corresponding adjustment' under the double tax agreement, giving rise to a similar effect.

There will, however, be many cases where, for a variety of reasons, the parties were relying on obtaining the full deduction and this may now be frustrated.

One trap to beware of is that the draft legislation denies a compensating adjustment in relation to securities that have been guaranteed, where the person who would otherwise be entitled to the compensating adjustment is related (under the control tests) to the guarantor. This may in some cases give rise to double taxation.

Conclusion

Many taxpayers and transactions that have not previously been subject to transfer pricing principles will not be affected by these latest changes. However, in cases where taxpayers have acted together in making loans and other financing transactions, it may now be necessary to demonstrate that the interest rate and the quantum of the loan are not in excess of an arm's length rate/quantum. ■

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Loose End

VAT in the world ...?

Taxware, a supplier of global tax calculation and compliance software, has published a selection of its favourite VAT anomalies from around the world.

In Morocco, the operation of Turkish-style baths and public showers are exempt from VAT but if you want to emerge clean as well as relaxed, tax of 7% must be paid on all soap used. In Portugal, the selection of pasta can prove to be taxing as spaghetti and penne incur only a 5% VAT rate, whereas if you choose ravioli, cannelloni or tortellini, you will be slapped with a 19% VAT rate. In San Marino, alternative medicine is catching on with the general public but this is not reflected in the country's VAT policy. While traditional drugs carry a small 2% VAT rate, alternative medical treatments, such as homeopathy for instance, may incur 17% VAT.

The UK, of course, has its own anomalies, of which Taxware highlights the fact that, despite food being generally zero-rated, the supply of hallucinogenic 'magic mushrooms' is standard-rated.

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