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HMRC ANNOUNCES THAT THE CHANGES TO CORRESPONDING ADJUSTMENTS WILL COME INTO EFFECT IMMEDIATELY

PRIVATE EQUITY

On 17 September 2013, HMRC issued a consultation paper proposing to prevent individuals from being able to obtain corresponding adjustments under the UK's transfer pricing rules. Our note on that consultation can be found here.

Further to that consultation, HMRC have today (25 October) announced that the changes will come into immediate effect. At the same time, HMRC have issued draft legislation which includes two changes from the original proposals.

BACKGROUND

Corresponding adjustments are a product of the UK's transfer pricing rules which require transactions between related parties to be taxed as if they had been entered into on arm's length terms. For example, if a loan is made to a company by a related party and, either because of the amount of the loan or the interest rate, the company incurs finance costs on that loan of a greater amount than would have been incurred on a loan from a third party, then the company will be denied a corporation tax deduction for the excess interest. However, the lender may then make a claim for a corresponding adjustment such that it will not be taxed on that excess interest.

This is a long established rule, but it does result in a tax rate arbitrage where the lender is an individual and the borrower is a company, as the individual's income (taxed at up to 45 per cent) is reduced, while the company's tax (at 23 per cent, this year) is increased.

HMRC have two situations in mind with the changes:

- First, in private equity transactions, it is standard for the fund (and co-investors, including management) to invest their capital into the Newco group for a combination of ordinary shares and preferred capital. Preferred capital is provided in the form of loan notes and/or preference shares, although often just loan notes. There are commercial reasons for this, including ease of repayment, but it also has a tax advantage in that the borrower group can obtain a tax deduction for the finance costs on the loan notes, to the extent the borrower group could and would have incurred those finance costs on a loan from a third party (in addition to any third party debt actually borrowed by the borrower group). The net result is usually that part of the interest on shareholder loans on a private equity deal is deductible and part is disallowed.

  As stated above, where interest is non-deductible for a borrower company under the transfer pricing rules, the creditor can claim a corresponding adjustment such that the interest is not taxable in its hands. This results in tax free interest for creditors, whether a company or an individual.

  The effect of these rules has been that when (as will almost always be the case) part of the interest on shareholder loans is disallowed, the UK individuals directly or indirectly holding these loan notes have been able to receive tax free distributions from the borrower group. This has benefited both management loan note holders and UK individual participators in the private equity fund.

- Another situation where corresponding adjustments have been claimed by individuals is LLPs setting up subsidiary service companies which employ their staff and incur other overheads and recharge these costs to the LLP at cost in circumstances where, on arm's length terms, a "cost-plus" mark-up would have been charged. In this situation, the application of the transfer pricing rules results in the service company having to increase its profits for tax purposes and pay more corporation tax (at 23 per cent) but the individual members of LLP can claim a corresponding adjustment to reduce their profits by the same amount and so save income tax and NICs (at 47 per cent). This arrangement has been implemented widely by professional service firms and in the financial services industry.

ORIGINAL CONSULTATION PAPER

The consultation document proposed to remove the ability for individuals to claim corresponding adjustments on transactions with companies. It was unclear from that paper whether the changes would impact only amounts accruing after the effective date or also include amounts paid after that time which accrued before the effective date. Further, as originally proposed, the amendments could have produced unfair results as not only would the company subject to the transfer pricing adjustment lose its deduction (on loans) or have its deemed taxable income increased (for example, for service companies), thereby suffering additional corporation tax at 23 per cent, but the individual would also be liable to income tax. This would have resulted in double taxation.

CHANGES IN FINAL RULES

The ability for individuals to claim corresponding adjustments on transactions with companies will cease from 25 October 2013. However:

- it has been made clear that the changes will only impact interest and service fees accruing after 25 October and corresponding adjustments will still be able to be claimed by individuals on interest or below arm's length service fees accrued before that date; and

- interest paid by a company to an individual which would previously have carried a corresponding adjustment will now be deemed to be a dividend, thus avoiding double taxation. However, this change will not apply to the service company situation and to avoid double taxation in that case, it will be necessary to transact on arm's length terms and to avoid a transfer pricing adjustment in the first place.

COMMENT

It is welcome news that HMRC have listened to responses received in the consultation and the proposed deemed dividend treatment for disallowed interest now produces the "correct" tax result for individual recipients. This effectively returns the law to how it was previously.

It is also welcome that the changes will not have retroactive effect. This will allow UK individual participators in private equity funds to benefit from corresponding adjustments accrued on UK portfolio company loan notes up to today. It may be advisable for funds to consider now capitalising loan notes which do not carry a tax deduction to try to ring-fence those corresponding adjustments that have accrued to date.

LLPs with service companies will now need to re-price their arrangements to the arm's length price and perhaps update their transfer pricing to ensure that the arm's length price is being paid as, if too low a price is being paid, double taxation will arise going forward.

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OCTOBER 2013

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