The Offshore & International Taxation Review

TRANSFER PRICING AND RENTAL INCOME: THE "THIN-CAP" CORPSE REVIVED

Stephen Brandon QC[1]

1 Introduction

1.1 The purpose of this Article is to test the strength of the Revenue's view that, where United Kingdom real property is purchased by a foreign with loan finance from a connected person, resident company (or from a bank, but with a connected person providing a guarantee or a back-to-back deposit) ICTA 1988, Schedule 28AA potentially has effect. Thus if the loan is of a higher proportion of the purchase price than would be obtained in an "arm's length" transaction, the deduction of interest from the rental stream should be restricted.

2 Are Not Back-to-back Loans Dead?

2.1 The "new" Schedule A business code allows the deduction of interest on normal accounting principles: see section 21A. There is, now, no requirement that borrowing be from a bank in the United Kingdom. Why, therefore, might a back-to-back deposit be relevant? The answer, briefly, is that a direct loan to our company, from a connected entity, might give rise not to interest which is Schedule D, Case V income, but to Case III income, bearing in mind the *situs* of the ultimate recourse for payment of the debt, the property (this is not the place to dwell on the *Greek Bank* debate). This could have a serious effect, since the interest may be directly taxable (if a United Kingdom resident lender), subject to withholding, or taxable on a foreign domiciled United Kingdom resident client under ICTA, section

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739 on the arising basis. Let us assume, therefore, that the back-to-back loan may still be with us.

2.2 There are two particular concerns:

(1) transfer pricing and the rental stream;

(2) transfer pricing and the deduction of the interest paid on a loan to fund the purchase of the rented property.

3 Transfer Pricing and the Rent

Shortly after the passing of the Finance Act 1998, the Revenue intimated that Schedule 28AA would apply where United Kingdom situate property, owned by a foreign resident entity, is occupied by an individual rent free, or at a reduced rental. The Revenue subsequently conceded that they would not seek to apply it in such circumstances. In my view, it cannot apply in a transaction between a company and a private individual not carrying on a business for reasons I set out below. It could, however, in principle, apply if our foreign company let the property to a business entity at less than a market rent but I assume that this is not the object of the exercise.

4 Transfer Pricing and the Interest Deduction

The major concern, therefore, is with the effect of transfer pricing where a property is rented out at a rack rent and the funds are borrowed directly from one of a number of sources: the client, or perhaps a connected person (trustees of a settlement or another company), or from a bank, with a guarantee or back-to-back deposit provided by the client or connected person. (As I set out above, it may well be desirable to borrow from a bank, under "back to back" arrangements, in order to secure that the interest is not taxable/subject to withholding tax.)

5 Connected Lender

I first take the straightforward possibility of a loan from the United Kingdom resident client, or a connected entity. Assuming that the client is resident in the United Kingdom, and further assuming the interest would be at the market rate, there should, in principle, be no transfer pricing concern. It might be argued, however, that the amount of the loan, and therefore the quantum of interest, is excessive. If, however, the client (or trustees of the settlement established by him

> 2. the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons."

Where the loan is at market rates from a bank, *prima facie*, the two parties to the transaction are the company and the bank. Since it is not likely that "the same person" would be participating both in the management, control or capital of the bank and of our company, we must ask whether the same persons were directly or indirectly participating in the management or control of each of the affected persons. *Direct* participation turns on whether our company is "controlled" by the bank, with the definition in ICTA 1988 section 840 being brought in. This means control over the business, through shares or the articles of association or other regulating document. The bank should not be in that position. "Indirect control", has the somewhat convoluted definition set out in paragraph 4, which disguises the simplicity of the concept: if, no matter what possible rights and powers the bank (or connected persons) *will* acquire, it would still not have "control" (unless there is something very unusual in the loan agreement). Simply because it is a loan creditor, albeit in respect of perhaps virtually the whole value of the company, that would not give it "control" within section 840.

8 Tax Bulletin: Issue 37

This, however, according to the Revenue, would not get us off the hook. They still consider that Schedule 28AA may apply. This point is made in two Revenue tax bulletins. First, in Issue 37, they state at page 581:

> "As provision may be made by means of a series of transactions, the situation where a related party provides a guarantee to a bank which then, on the strength of this, makes a loan, or an additional part of a loan, available to a UK borrower will be within the scope of the legislation. If, however, the effect of the guarantee is solely to reduce the rate of interest being charged and the UK borrower is not thinly capitalised the legislation will not apply, since no tax advantage is conferred."

9 Issue 46

Again, and more precisely, in Issue 46, they state at page 741:

> "The loan granted by the bank is one transaction but there is also another transaction involved, i.e. the associate giving the guarantee to the bank. So there is a provision (of funding) which has been made between associates by

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> means of a series of transactions and this is therefore within the scope of Schedule 28AA. If the interest arising is more than would have been obtained without the guarantee, e.g. because the principal loan is more, then the amount claimed should be recalculated as if no guarantee had been given.
>
> The same applies if the loan has been advanced because of a backing deposit, etc from an associate (a "back to back" loan), a letter of comfort or similar."

Accordingly, we *first* need to ask if the relationship between the depositor and the borrowing company could come within paragraph 1, (1), (b) read with paragraph 4. Obviously, if the depositor is the client, or an associated person, the question answers itself. Again, since the rights and powers of connected persons are brought in by paragraph 4(3), (c), even if the shares are held by trustees, we would still (on the Revenue's view) be within paragraph 1, (1), (b). Also, provision by associated companies will probably be caught.

10 Application to Individuals

The next question, if the depositor is the client, or trustees of a connected settlement, is whether Schedule 28AA can have application at all. I have already noted that, in my view, the Schedule cannot apply where one of the two parties to the transaction is an individual. Does the same argument hold good where (assuming, for the moment, in favour of the Revenue, that Schedule 28AA may potentially apply here anyway) the commercial transaction is between our company and another company (the bank) but the other "affected person" is an individual?

11 Actual Provision

The Revenue's argument, in Tax Bulletin 46, proceeds on the basis that the "actual provision" (the interest charged by the bank) is made or imposed between the "affected persons" (the client/trustees and our company) by a series of transactions. Viewed this way, the commercial role of the bank is virtually looked through. In my view (and assuming that the Revenue's argument is tenable) the corollary of this analysis is that one is viewing provision made between the client/trustees and the company, but since the client/trustees will not be carrying on a business, Schedule 28AA should not apply. This is because the *rationale* behind the Schedule, that it be construed in accordance with the "OECD Model" (paragraph 9 of the Model Tax Convention) is that it applies to the provision made between business enterprises. (The Revenue's abandonment of its earlier argument that

Schedule 28AA applies between a foreign company and an individual occupying property it owns is tacit recognition of the strength of this argument.) This point, however, has less force if the deposit, with the bank, is made by the company, connected with the client, that is to say, *prima facie*, a business enterprise.

12 Series of Transactions

The more fundamental point is whether Schedule 28AA paragraph 1 (1) can be construed in the way the Revenue contends *at all*. It depends on "the actual provision" (the interest paid to the bank) having been made or imposed by the client/trustees. It is difficult to see that the provision is "imposed" by anyone other than the bank. It could, however, be said to be "made", in a series of transactions, by the client/trustees. Is the provision "made" between the client/trustees and our company? This is a very loose way of interpreting the provision but, bearing in mind the extended meaning of "series of transactions" in paragraph 3(1) and (2), it is, just, a tenable construction.

13 OECD Model

It should be borne in mind, however, that the interpretation of the "provision" is to be in such manner as best secures consistency with Article 9 of (and the Commentary to) the OECD Model. Article 9(1), however, while it talks about direct or indirect "management, control or capital," only deals with conditions imposed "... between the two enterprises". Is it arguable that paragraph 1(1), so construed, allows the Revenue to rewrite a "provision" in such a tripartite situation? The position looks odd here, because the price paid by our foreign company is market rate interest. Suppose, however, that a United Kingdom Company ("UK Co") purchased stock from an unconnected supplier, normally sold at £100, and that UK Co's foreign associated company then arranged to purchase stock itself for 80, agreeing with the supplier that UK Co should be charged 120. Certainly the "provision" is excessive and one feels Schedule 28AA should apply. It can only apply, however, if the "provision" (120) is "made or imposed" between the two connected companies, albeit indirectly, through the unconnected supplier. If Schedule 28AA *does* apply to the 120 (and I think a Court would say that it does) it could, in principle, apply to other tripartite situations. The argument for saying that it does not apply to us here cannot be *simply* because of the tripartite nature of the imposition, but because the Revenue is actually attacking the charge of the market price, on the basis that, in the open market, this deal with its market price (that is to say, the loan of £X at Y rate of interest) would not have been available without the intervention of the depositor. I therefore turn to that question.

14 Can the Revenue Deem A Different Loan?

The first problem with the Revenue's approach here is that, if a bank were to loan (say) 100% of the value of the property, it would, if anything, require a higher, not a lower, rate of interest. The Revenue's answer to this (in Tax Bulletin 46) point is unconvincing:

> "Even if a 100% loan were on offer from a bank, which in our experience is not nowadays normally the case, a prospective borrower would not necessarily take this up if they considered the price would not give an adequate return".

Thus, the Revenue does not wish to challenge the "provision" made for what was supplied, rather it wishes to assume that a different supply took place (with a *pro rata* reduction from the "actual provision"). There is, as is the case of Article 9, no explicit reference to the supply of goods, services or facilities made by the other affected persons, so the next question is whether "the actual provision" covers *both* the consideration for the supply *and* that supply itself.

15 Arm's Length Provision

Presumably, the Revenue considers that it does, although talk of the "provision" being the "funding" is ambiguous, since it could be thought to refer simply to the loan made by the bank. I assume it is meant to cover all the transactions concerning the loan. If so, the "arm's length provision" could, presumably, comprise a re-writing of both elements. It is worthwhile concentrating on the words in para.1(2). The comparison is between the "actual provision" and the "arm's length provision". The "provision" which confers the tax advantage is, of course, the interest payable. Although the loan is a condition precedent to that interest, it is the interest which confers the advantage. Could "the provision", however, stretch to include (say) a back-to-back loan? In essence, the situation is analogous to the thin capitalisation argument and it is worth examining that for a moment.

16 Thin Capitalisation Analogy

Until the mid 1990's, the Revenue attacked arrangements seeking to obtain the advantage of an interest deduction in the United Kingdom, but with the interest received by an associated lender (in the USA) being categorised as interest on equity, not on a loan, so that, effectively, that interest was not taxable there. This was known as the "double-dip". The Revenue claimed that the special relationship provision in the article of the UK/US Treaty dealing with interest (Article 11(5)) allowed it not only to look at the interest paid but at the structuring of the loan. Article 11(5) simply provided that if the amount of interest "... exceeds for whatever reason the amount which would have been paid in the absence of such relationship ...", briefly, the excess was disallowable. Eventually, the Revenue gave in on this point and the Government passed ICTA 1988, section 808A. This, briefly, provides that where a double taxation convention includes a "special relationship" rule in respect of interest, there should be taken into account:

> "... (a) the question whether the loan would have been made at all in the absence of the relationship, and
>
> (b) the amount which the loan would have been ..."

17 Comparison with Section 808A

These points, now set out in section 808A(2), are precisely those which the Revenue is claiming apply in construing Schedule 28AA, yet similar provisions do not appear in Schedule 28AA. Does it matter? Interestingly, the US Treaty did not contain the words used in the OECD Model Article 11 "... having regard to the debt claim for which it is paid". This, together with the Revenue's contention on the words "for whatever reason" led it to argue that the scope of Article 11(5) went beyond the normal (OECD) "transfer pricing" provisions of Article 11(6), however, in my view, it clearly does not, as recognised by the OECD (see Thin Capitalisation; OECD Issues in International Taxation, Paris (1987), page 34).[2] In the absence of similar provisions to section 808A, does Schedule 28AA(2) really allow the Revenue not only to compare the deal struck by the parties, at price X, and substitute the market price, but also to say that arm's length parties would have struck a completely different deal and take the market price for that?

18 Article 9 Commentary

It is worth looking at the Commentary to Article 9, as amended by the OECD in 1992. Paragraph 1 states, in a nutshell, that the provisions only apply if special conditions have been made or imposed between the two enterprises. Paragraph 2, however, deals with the thin capitalisation issues and states:

> "(a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the

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2 It is interesting to note the terms of section 808A, subsection (5) and the Revenue's response set out in the correspondence with the ICAEW (19th March 1993) on its effect.

borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;

(b) the Article is relevant not only in determining whether the rate of interest provided for in a loan note is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

(c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic entity to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties."

19 Analysis of Commentary

Paragraph 2(a) allows each state to apply its own thin capitalisation rules but those rules (in section 808(A) and section 209) are not relevant here. Paragraph (b), however, is of more concern. First, the words "conditions are made or imposed between the enterprises" is said to cover more than just the rate of interest. It does not, however, go on to provide that regard may be had to whether the loan would have been made between unconnected persons. Rather, it is concerned with whether the "*prima facie* loan" is, for example, a contribution to equity capital. This does not seem to me to go so far as to rewrite the transaction, rather, it appears to be looking at what is the reality of the transaction, that is to say, what have the parties actually agreed, which may not necessarily be reflected in what they have called the documentation effecting it. (This approach the English Courts have felt able to do for many years, often by reference to *IRC v Wesleyan and General Assurance Society* 30 TC 11.) Turning to paragraph (c), the reference to "... the application of rules designed to deal with thin capitalisation" seems clearly to be a reference to paragraph 2(a), that is to say, to national rules, of which none applies here.

20 Conclusion

On the whole, these paragraphs do not seem to interpret Article 9 as if it gave a state the power to rewrite the actual transaction, under which the provision is made. Here, I think, is the clue to the interpretation of paragraph 1(1). We may look at the "series of transactions" that is (say):

(1) the back to back deposit;

(2) payment of interest on that deposit;

(3) agreement with the bank as to its "turn";

(4) loan to the foreign resident company;

(5) and its payment of interest.

It is as a result of that series of transactions that the "provision" is made, that is to say, the loan made and interest charged. Paragraph 1(2) allows the Revenue to look at that "provision" (in the Revenue's words, the "funding") and see if its terms are at arm's length. If they are (as here, they usually will be, since the bank would charge the market rate) that is the end of the matter. Schedule 28AA does *not*, however, any more than did Article 11(6) of the OECD Model or Article 11(5) of the US Treaty, allow the Revenue to hypothesise a different commercial transaction or series of transactions between the relevant parties. If this argument is correct, the existence of neither a guarantee, nor a back to back deposit, will allow the Revenue to disallow any of the interest paid on the loan taken out to purchase the property under Schedule 28AA.

Note: A fuller analysis of all these issues (and other concerns in respect of foreign companies owning United Kingdom rented property) is contained in my forthcoming Key Haven book on the Taxation of Foreign Resident Companies and Their Shareholders.