THE TRANSFER PRICING PROVISIONS AND BENEFITS FROM OFFSHORE STRUCTURES

Robert Venables QC[1]

1 Introduction

1.1 Scope of Article

Finance Act 1998 has introduced into the Taxes Act 1988 a new Schedule 28AA "Provisions not at Arm's Length", which are transfer pricing provisions under another name. I shall call these provisions "the TPP". In this article I consider whether they can apply to gratuitous benefits conferred by a company otherwise than in a commercial context. One Inland Revenue view is that they can. James Henderson is of the same view in an article 'Inheritance Tax and Transfer Pricing: A New Problem?' published in the *Personal Tax Planning Review* Volume 6, Issue 3. In this article, I maintain the contrary thesis. In my view, one must not apply the old-fashioned English rules of construction, but those applicable to legislation which owes its origin to international conventions: see the recent decision of the Court of Appeal in *Memec plc v IRC* [1998] STC 754.[2]

1.2 TPP Control

The provisions are very complex and would merit a whole book to themselves. In an article 'Control" in the New Transfer Pricing Provisions' in the *Corporate Taxation Review* Volume 1, Issue 4, I consider principally the test of "control" for the purpose

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1 Robert Venables QC, Consulting Editor.

2 *Memec* is discussed in my article 'The Interpretation of Double Taxation Conventions: Residence of Dual Resident and Temporarily Non-UK Resident Individuals' at page 189 of this issue.

of the TPP (which I call "TPP control"), which is crucial in determining when they come into play. I also discuss the existing Taxes Act 1998 section 416 and section 840 tests of control and compare and contrast them with the test of TPP control. I point out that trusts will often provide a means of circumventing the provisions.

1.3 Basic Operation of the TPP

In brief, where the provisions apply, then for the purposes of income tax and corporation tax on income (but not capital gains tax) the Revenue can deem a transaction between two persons to be for a market value consideration. While these provisions were no doubt intended simply to allow the Revenue to adjust upwards the consideration paid by a business within the charge to United Kingdom tax to an associated business which is not, it is certainly arguable that they can have some unintended consequences in a non-business context.

1.4 Benefits from Offshore Companies

James Henderson instances the common case of a non-UK domiciliary resident in the UK who occupies on favourable terms a UK home which belongs to an offshore company. He may own the company himself or, more commonly, it will be owned by an offshore trust, usually one of which he is himself the settlor. If he has TPP control of the company, then, the Revenue argue, they are allowed to tax the company on the basis that it receives a market value rental. As the source of the income is in the UK, it will in principle be liable to UK income tax at the rate of 23% on that amount, after making any allowable deductions. The next question which arises is whether the deemed income of the company is deemed income for the purposes of the transfer of assets abroad provisions contained in Taxes Act 1988 Part XVII Chapter III ("the TAAP"). Mr Henderson considers this difficult question and considers that the provisions probably do not apply. I suggest in this article that if, contrary to my view, the TPP do apply, then the TAAP can indeed apply.

1.5 Benefits from Onshore Companies

If the Revenue argument is right, the problem is not limited to benefits received from offshore companies. In the case of a benefit received from an onshore company, the position is even more complex. In some cases, the conferring of the benefit will rank as a Schedule F distribution by virtue of Taxes Act 1988 section 209(3) (transfer of assets or liabilities between company and its members at an undervalue).[3] If it is a close company, it may constitute such a distribution by virtue of Taxes Act 1988 section 418 (close company incurring expense in or in connection with the provision

3 And/or arguably section 209(1)(b) (distribution out of the assets of the company in respect of shares in the company).

of benefits or facilities for any participator, or associate of any participator). A loan by a close company, even for full value, can oblige it to pay "quasi ACT", by virtue of Taxes Act 1988 section 419. A benefit conferred on a company by a director or employee can result in his being liable to tax under Schedule E under one or more of several provisions.

It might be asked whether the TPP can still apply where the transaction is between two UK resident persons. The answer is that in general they can, subject to a limited exception. That exception involves several conditions being satisfied, of which the most problematic in the circumstances is that the recipient of the benefit must be "within the charge to income tax or corporation tax in respect of profits arising from the relevant activities".[4] (That the expression "the relevant activities" is difficult to apply where the individual does not carry on any activities but, for example, is the spouse of a shareholder in a close company, is a further argument that the TPP were not intended to apply in such a context.)

None of existing charging provisions increase the taxable profits of the company conferring the benefit. If the TPP apply, they will. There is thus nothing in principle to prevent the charges being cumulative. Now it might be thought that if the company is deemed to receive full consideration, then that deeming is for all the purposes of income taxation. Unfortunately, it is very difficult to read Schedule 28AA in that way, on account of express, limited cases where the recipient of the benefit ("the advantaged person") is allowed to recompute his tax liability. Provided that, *inter alia*, he is "within the charge to income tax or corporation tax in respect of profits arising from the relevant activities" (whatever that may mean), then he may be entitled to "have his profits and losses computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision".[5]

2 Scope of Provisions

2.1 The Three Conditions

The Schedule applies where provision, known as "the actual provision", has been made or imposed as between any two persons, "the affected persons", by means of a

4 Taxes Act 1998 Schedule 28AA paragraph 6(2)(a). References in this article to paragraph numbers are to paragraphs of that Schedule, unless the contrary is indicated.

5 Paragraph 5(3)(a).

transaction or series of transactions. It is a condition precedent of the application of the Schedule that at the time of the making or of the imposition of the actual provision:

> "(i) one of the affected persons was directly or indirectly participating in the management, control or capital of the other;
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> or
>
> (ii) the same person or persons was or were directly or indirectly participating in the management, control or capital of each of the affected persons."[6]

The concept of "participating in the management, control or capital" of a company or partnership is a novel one. It was obviously adopted because the term "control" already has several defined meanings. Yet the expression is quite a mouthful. The Revenue, in their explanatory notes on the 1998 Finance Bill, simply use the expression "control".[7] That can only lead to confusion, especially where one is contrasting the concept with established tests of "control". In this article, I shall refer to a person "participating in the management, control or capital" of a company or partnership has "having TPP control".

The third condition is that, subject to certain exceptions, the actual provision:

> "(a) differs from the provision ("the arm's length provision") which would have been made as between independent enterprises, and
>
> (b) confers a potential advantage in relation to United Kingdom taxation on one of the affected persons or, whether or not the same advantage, on each of them..."[8]

The consequence of the conditions being satisfied is that, in general, the profits and losses of the potentially advantaged person or, as the case may be, of each of the potentially advantaged persons is to be computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision.

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6 Paragraph 1(1)(b).

7 See, for example, paragraph 12: "Paragraph 4 defines "control" for the purposes of the Schedule and sets out rules for attributing rights and powers to a person when considering whether that person controls a company or partnership..."

8 Paragraph 1(2).

2.2 An Illustration

The sort of case at which the provision is principally aimed is easy to conceive. A United Kingdom manufacturing company imports raw materials from abroad. Acting on tax advice, possibly bad tax advice, it arranges for a company to be incorporated in Jersey where central management and control of the business of the Jersey company abides. Henceforth, the Jersey company purchases the raw materials from abroad and then sells them on to the United Kingdom company at a mark up. A part of the profit is thus creamed off into the Jersey company. Of course, if the arrangement is badly structured, it may fall foul of the controlled foreign companies provisions or of the TAAP. Provided it does not offend these, or any other anti-avoidance provisions, then, subject to the transfer pricing provisions, the arrangement will be effective, at least as a matter of civil law.[9]

Where the TPP do apply, the Revenue can tax the United Kingdom company on the basis that the arm's length provision had been made. This would probably involve a reduction in the price it paid the Jersey company. The precise reduction would depend upon the circumstances. There are arguments, beyond the scope of this article, that the provisions as enacted will not always work in the way the Revenue have envisaged.

3 "**TPP Control**"[10]

3.1 The Need for a Corporation or Partnership

A person is participating in the management, control or capital of another person at a particular time, whether directly or indirectly, if, and only if, that other person is at that time (a) a body corporate or a partnership and (b) controlled by the first person. Thus, unless one can identify at least one controlled body corporate or partnership, the Schedule cannot apply. It cannot, for example, apply to dealings between trustees and their settlor or beneficiaries.

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9 As the decision of the Court of Appeal, Criminal Division, in *R v Charlton* [1996] STC 1418 has shown, the professional advisers may still finish up in gaol after being tried before a judge and jury, prosecuted and defended by barristers and having their appeal dismissed by judges of the Court of Appeal, all alike lacking expertise in tax law.

10 For a much fuller discussion of the subject matter of sections 3-7 of this article, see my article 'Control in the New Transfer Pricing Provisions' in the *Corporate Taxation Review* Volume 1, Issue 4.

3.2 The Use of Trusts

In my view, the use of trading and other trusts will often offer a sound means of circumventing the provisions. Care will have to be taken to ensure that the requirements of company law are not infringed. Corporate tax advisers will appreciate that the establishment of such a trust will involve complex tax questions outside their normal area of competence, including possible inheritance tax complications.

3.3 Direct TPP Control

A person is *directly* participating in the management, control or capital of another person at a particular time if, and only if, that other person is at that time:

> "(a) a body corporate or a partnership; and
>
> (b) controlled by the first person."[11]

The test of "control" (not "TPP control") is that set out in Taxes Act 1988 section 840.[12] In effect, it contains two separate tests, one for the control of a body corporate and the other for the control of a partnership.

4 Section 840 Control

Section 840 "control" means, in the context of a company, the power of a person to secure by means of a certain description that the affairs of the first-mentioned body corporate are conducted in accordance with his wishes. This is in my view no more than a statutory formulation of what might be termed the "common law" test of "control", laid down in cases such as *British-American Tobacco Co Limited v IRC,*[13] *J Bibby & Sons Limited v IRC*[14]and *Barclays Bank Limited v Inland Revenue Commissioners* [1960] 2 All ER 817.[15]

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11 Paragraph 4(1).

12 Paragraph 14(2).

13 (1942) 29 TC 49.

14 (1945) 29 TC 167.

15 [1960] 2 All ER 817. Walton J in *Irving v Tesco Stores (Holdings) Limited* [1982] STC 881 did not agree. See also the dicta of Moritt LJ in the Court of Appeal in *Steele v EVC International* [1996] STC 785.

5 Section 416 Control

By contrast, section 416 of the Taxes Act provides a much wider test of "control", originally used in the context of close company apportionment provisions but incorporated by reference into many other tax contexts, sometimes with variations. At first blush, it appears that because the draftsman of Schedule 28AA has adopted the narrower section 840 test, the Schedule will not have as wide a scope as it would have had had he adopted the section 416 test. Somewhat confusingly, however, he adopts a test of *indirect* participation in management, control or capital which in effect brings in much of section 416 by the backdoor!

6 Indirect TPP Control

Schedule 28AA paragraph 4(2) provides that, for the purposes of the Schedule, a person, referred to as "the potential participant", is *indirectly* participating in the management, control or capital of another person at a particular time if, and only if:

> "(a) he would be taken to be directly so participating at that time if the rights and powers attributed to him included all the rights and powers mentioned in sub-paragraph (3) below that are not already attributed to him for the purpose of sub-paragraph (1) above;[16] or
>
> (b) he is, at that time, one of the number of major participants in that other person's enterprise."[17]

The rights which can be attributed to a person to determine whether he has indirect TPP control are contained in paragraph 4(3) and (4). (Paragraph 4(5),(6),(10),(11) and (12) are also relevant.) Paragraph 4(3) and (4) provide:

> "(3) The rights and powers referred to in sub-paragraph (2)(a) above are:
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> (a) rights and powers which the potential participant is entitled to acquire at a future date or which he will, at a future date, become entitled to acquire;
>
> (b) rights and powers of persons other than the potential

16 Which contains the test of *direct* TPP control.

17 TPP control of a company through being a major participator is outside the scope of this article.

participant to the extent that they are rights or powers falling within sub-paragraph (4) below;

(c) rights and powers of any person with whom the potential participant is connected; and

(d) rights and powers which for the purposes of sub-paragraph (2)(a) above would be attributed to a person with whom the potential participant is connected if that connected person were himself the potential participant.

(4) Rights and powers fall within this sub-paragraph to the extent that they:

(a) are required, or may be required, to be exercised in any one or more of the following ways, that is to say:

(iii) on behalf of the potential participant;

(ii) under the direction of the potential participant; or

(iii) for the benefit of the potential participant;

and

(b) are not confined, in a case where a loan has been made by one person to another, to rights and powers conferred in relation to property of the borrower by the terms of any security relating to the loan."

7 Comparison Between 416 Control and TPP Control

7.1 Nominees, Agents, Trustees, Etcetera

Schedule 28AA paragraph 4(2), (3)(b) and (4) provide that in determining whether a person has indirect TPP control of another one attributes to him rights and powers to the extent that they:

"(a) are required, or may be required to be exercised in any one or more of the following ways, that is to say:

(i) on behalf of the potential participant;

(ii) under the direction of the potential participant; or

(iii) for the benefit of the potential participant."

Paragraph 4(4)(a)(i) and (ii) clearly cover any rights or powers of a nominee or bare trustee for a person. Paragraph 4(4)(a) generally goes somewhat further: precisely how much further is a moot point. "may be required" is potentially extremely wide. Does it mean "may, in any circumstances whatsoever, be required"? My own view is that these words cover only rights and powers which one is *entitled* to require the owner to exercise in one of the three types of ways specified. If one does so actually require, then the rights are "required" to be so exercised. If one is merely entitled so to require but does not actually so require, then the rights still "may be required" to be exercised in the specified way.

Even if I am right, a further ambiguity arises in that the use of the passive voice disguises who is the "one" who is entitled to do the requiring. My own view is that it must be the potential participant himself. If it were simply any person, then everyone would have indirect TPP control of many companies. For example, the controlling shareholder of a company whose shares are vested in the name of nominees for him could, if he so wished, require the nominees to cast their votes under the direction of, or for the benefit of, anyone in the world.

A further problem is the meaning of "benefit" in (a)(iii). What, for example, of rights and powers held by trustees of a trust to which anyone in the world could in theory be added as a beneficiary? If the propositus were, then the trustees would prima facie be required to exercise their rights and powers for his benefit (as well as that of the other beneficiaries).

7.2 Future Entitlement

Schedule 28AA paragraph 4(2) and (3)(a) provide that in determining whether a person is indirectly "participating in the management, control or capital of another" one attributes to him:

> "(a) rights and powers which the potential participant is entitled to acquire at a future date or which he will, at a future date, become entitled to acquire".

Note that one does not take into account rights and powers which the propositus *may* be entitled to acquire at a future time, whether certain or uncertain, e.g. as holder of an option. In the context of Schedule 28AA one also needs to take into account the possible application of paragraph 4(4), discussed above.

7.3 Rights and Powers of Connected Persons

In determining whether a person has *indirect* TPP control of another, one attributes to him "rights and powers of any person with whom [he] is connected".[18] Two persons are connected with each other for the purpose of the paragraph if:

> "(a) one of them is an individual and the other is his spouse, a relative of his or of his spouse, or the spouse of such a relative; or
>
> (b) one of them is a trustee of a settlement and the other is:
>
> (i) a person who in relation to that settlement is a settlor; or
>
> (ii) a person who is connected with a person falling within sub-paragraph (i) above."

"Relative" is defined to mean "brother, sister, ancestor or lineal descendant". "Settlement" and "settlor" have the same meanings as in the income tax settlement provisions contained in Taxes Act 1988, Part XV, Chapter IA.[19]

7.3.1 Direct and Indirect Connection

I shall refer to the paragraph 4(11) test as the test of "direct connection". As will be seen, rights and powers of a person (C) can be attributed to a propositus (A) even though C and A are not directly connected, in that any rights and powers of C which can be attributed, under paragraph 4(3)(c), to a person (B) with whom both A and C are connected, can then be attributed to A, with whom C is only indirectly connected. In the following discussion, I am concerned only with persons who are directly connected, unless otherwise stated.

7.3.2 Relatives

In the case of an individual propositus, all persons who are his "relatives" for the purposes of the section 416 test of control will also be "connected" with him for the purpose of the TPP control test. In addition, further classes of persons, will still be connected with him for the purposes of TPP control, even though they are not his "relatives" and not, on that account, his "associates" for the purposes of the test of section 416 control. These further classes will certainly include persons who are "relatives" of his spouse. Whether they will include spouses of his "relatives" or

18 Paragraph 4(3)(c).

19 Paragraph 4(12).

spouses of his spouse's "relatives", or both, is ambiguous. What is meant by "such" a relative? As a matter of good English, it means "the spouse of a relative of his spouse". Yet it makes little sense for such distant relatives to be included while spouses of his own relatives are excluded.

7.3.3 Partners

A partner of a person is not on that account connected with him for the purposes of Schedule 28AA.

7.3.4 Trustees

With whom are the trustees of a settlement "connected" for TPP control purposes? The mere fact that a person, whether an individual or a company, is a beneficiary of, or potentially interested under, a trust does not make him connected with the trustees. A beneficiary of a settlement will be connected with the trustees if and only if he is the settlor or related in a specified way to the settlor. Once the settlor is dead, he has no relative or spouse. Hence, in my view, no one will be connected with the trustees of the settlement.

7.3.5 Corporations

It would appear that a body corporate cannot be connected with anyone other than the trustees of a settlement of which that body corporate is a settlor. As the body corporate is not an individual, paragraph 4(11)(a) does not apply. For the same reason, nor does paragraph 4(11)(b)(ii). For example, if a body corporate is a settlor of a settlement, its subsidiaries are not connected with the trustees of that settlement. The converse holds in principle. In that case, however, the Revenue might be able to argue that the parent was a settlor, or at least an additional settlor, of a settlement ostensibly made by the subsidiary, with its own funds, if the subsidiary could not lawfully have made the settlement without the parent's consent. It will be readily perceived that this gap in the legislation can only facilitate the task of devising structures using trusts to circumvent the provisions.

7.3.6 Reflexive Relationships

It is made abundantly clear by paragraph 4(11) that the relationship of connected persons is reflexive, that is, if A is connected with B, then B must inevitably be connected with A.

7.3.7 Controlled Companies

An interesting omission from the TPP control test is that where one company controls another or both are under common control, neither is connected with the other. There is nothing corresponding to section 416(6) which allows to be attributed to a propositus "all the rights and powers of any company of which he has ... control or any two or more such companies". Where one is concerned with direct control, this omission is not surprising. If, applying the section 840 test of control, Company A controls Company B which controls Company C, then Company A will control Company C. But suppose that Company C sets up a trust of which it alone is the settlor. Although the rights and powers of the trustees can be attributed to it, as it is connected with them, they cannot be attributed even to Company B, let alone Company A.

If the rights and powers of a given person (B) can be attributed to A on the basis that they are connected, then this will usually involve A being treated as having the actual rights and powers of any company controlled by B. Where, for example, B controls Company X which has a 100% subsidiary Company Y, then just as B has section 840 control of Company Y, so A will be deemed to have TPP control of both Company X and Company Y. Where, however, Company X has only deemed control of Company Y, then it is possible that B will not have TPP control of Company Y and, even if he does, that possibly A will not.

7.3.8 Multiple Attributions

Suppose that B is connected with A and that C is connected with B but that C is not connected with A. One does attribute to A the powers and rights of C. The result is achieved by paragraph 4(2)(a) and (3)(d), the latter of which attributes to a propositus, A, "rights and powers which for the purposes of sub-paragraph (2)(a) above would be attributed to a person with whom the potential participant is connected [B] if that connected person were himself the potential participant". Such rights and powers include rights and powers attributed to B under paragraph 4(3)(c), namely the rights and powers of any person (C) with whom the potential participant (B) is connected.

If D is connected with C but not with B or A, can the rights and powers of D be attributed to A? Paragraph 4(6) prevents any argument that they cannot:

> "(6) In paragraph (d) of sub-paragraph (3) above, the reference to rights and powers which would be attributed to a connected person if he were the potential participant includes a reference to rights and powers which, by applying that paragraph wherever one person is connected with another, would be so attributed to him through a number of persons each of whom is connected with at least one of the others."

Even without paragraph 4(6), the result would arguably have been the same. The express inclusion of paragraph 4(6) merely prevents any argument that this idiotic position was reached by inadvertence.

In the case of individuals, the operation of these provisions is truly ridiculous. On the basis that everyone in the world is related to practically everyone else, then everyone will be indirectly connected with everyone else in the sense that for the purposes of TPP test, the rights and powers of everyone in the world will be attributed to him! Of course, there may be cases of persons who have no "relatives" at all in existence and who are not the settlor of any trusts, in which case the chain of connection would be broken, but these cases are likely to be the exception. In practice, the Revenue will have to draw the line somewhere - but where?

In the case of trustees, the position will normally be just as bad so long as the settlor is alive, but fine once he is dead.

In the case of companies, they will be connected with no one except the trustees of a settlement of which they are settlor, so that the danger might appear to be a very minor one. The difficulty reappears, however, if, as will often be the case, one or more individuals has section 840 control of a company if one imputes to them all the rights and powers of other individuals with which they are indirectly connected.

7.3.9 Joint Rights and Powers

It is made expressly clear by paragraph 4(10) that:

> "(10) References in this paragraph:
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> (a) to rights and powers of a person, or
>
> (b) to rights and powers which a person is or will become entitled to acquire,
>
> include references to rights or powers which are exercisable by that person, or (when acquired by that person) will be exercisable, only jointly with one or more other persons."

8 Who is a "Person"?

8.1 The Writer's View

The TPP apply where provision has been made or imposed as between any two "persons". This term is, as a matter of English, wide enough to cover a private individual acting in his private, non-business capacity. In my view, however, the word in its context can only mean a person carrying on a trade or, possibly, a business, whether or not that amounts to a trade, and does not catch transactions whereby gratuitous benefits are conferred on private individuals as an act of bounty and not by way of business. For the TPP apply only to "enterprises" within the meaning of the OECD Model Double Taxation Convention.

8.2 Incorporation of OECD Model

Paragraph 2 provides:

"(1) This Schedule shall be construed (subject to paragraphs 8 to 11 below)[20] in such manner as best secures consistency between;

(a) the effect given to paragraph 1 above; and

(b) the effect which, in accordance with the transfer pricing guidelines, is to be given, in cases where double taxation arrangements incorporate the whole or any part of the OECD model, to so much of the arrangements as does so.

(2) In this paragraph "the OECD model" means:

(a) the rules which, at the passing of this Act, were contained in Article 9 of the Model Tax Convention on Income and on Capital published by the Organisation for Economic Co-operation and Development; or

(b) any rules in the same or equivalent terms.

(3) In this paragraph "the transfer pricing guidelines" means:

(a) all the documents published by the Organisation for Economic Co-operation and Development, at any time before 1st May 1998, as part of their Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations; and

(b) such documents published by that Organisation on or after that date as may for the purposes of this Schedule be designated, by an order made by the Treasury, as comprised in the transfer pricing guidelines."

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20 Which deal with foreign exchange gains and losses, financial instruments and oil.

8.3 OECD Model

Article 9 of the OECD Model is headed Associated *Enterprises.*[21] It provides:

"1 Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2 Where a Contracting State includes in the profits of an enterprise of that State - and taxes accordingly - profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

It is, in my view, clear from Article 9 itself, from the Commentary thereon and from the rest of the OECD Model Treaty and Commentary that the provisions are intended to apply only to dealing between two "enterprises" and that an "enterprise" must be an entity carrying on business. There are so many illustrations that there is not space

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21 Italics supplied.

to reproduce them all. There now follows a modest selection. Should the Revenue continue to dispute my proposition, there are many more! The italics have all been supplied by myself.

"COMMENTARY ON ARTICLE 9

"Paragraph 1

"1 This Article deals with *associated enterprises* (parent and subsidiary *companies* and *companies* under common control) and its para 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the *accounts of the enterprises* if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the *two enterprises*."

The term "enterprise" is not itself properly defined. The nearest we get is Article 1 which indicates that an enterprise is "carried on" and is not simply a passive investor or recipient of bounty:

"1 For the purposes of this Convention, unless the context otherwise requires:

(c) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State."

Article 1(d) suggests that an enterprise has a place of effective management, which would exclude an individual (other than in a business capacity):

"(d) the term "international traffic" means any transport by a ship or aircraft operated by an *enterprise* which has its place of *effective management* in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State."[22]

Article 5, Permanent Establishment, also shows that an enterprise carries on a

22 See also the Commentary on Article 4.

business:

> "1 For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which *the business of an enterprise* is wholly or partly carried on."[23]

Article 7, Business Profits, is based on the foundation that an enterprise carries on a business:

> "1 The profits of an enterprise of a Contracting State shall be taxable only in that State unless the *enterprise carries on business* in the other Contracting State through a permanent establishment situated therein ..."

8.4 The Revenue Manual

The Revenue is a large organisation. One suspects that what has happened here is that the Revenue specialists responsible for putting Schedule 28AA onto the statute book thoroughly understand its limitations, whereas it is other Revenue officials who see it as an adventitious means of imposing tax charges on individuals.

The Revenue Manual "International Tax Handbook", January 1998 edition, taken from *Butterworths Books on Screen* December 1998 version, provides:[24]

"CHAPTER 15: TRANSFER PRICING

> "1500. Introduction
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> "This book has been concerned mainly with the structures adopted by multinational groups to reduce their United Kingdom (and other) tax liabilities. The Revenue's counter-measures have involved either showing that the structure is not in reality what it purports to be – for example by challenging the residence status of an allegedly tax haven resident company – or the introduction of statute law such as the CFC legislation which enables us to look through the structure. The Ramsay/Dawson approach and that of transfer pricing counter-measures are different in that, in the latter, the structure is accepted but the fiscal effect or the terms of transactions within the structure are challenged. The Ramsay/Dawson approach is probably of limited application in the international arena because there will rarely be no

23 And see the Commentary on Article 5 *passim*.

24 All italics supplied.

possible commercial justification for a transaction and the artificiality will normally be found not in the individual steps of a single composite transaction but in the lasting structure set up for use in numerous transactions whose purpose, when looked at one at a time, may not solely be to reduce tax liability. On the other hand the arm's length principle may be applied to adjust, for fiscal purposes, the terms of transactions in a wide range of circumstances.

"1501. The problem defined

"When we examine a *company's* accounts (and unless evasion is suspected) it is a reasonable assumption that the sales and purchases represent full value for the transactions with third parties. ...

"Where however transactions take place between a United Kingdom *company* and a non-resident *company* which are under common control we do have to look closely at the prices charged in respect of such transactions, that is to say the 'transfer prices'.

"...

" 1506. The arm's length principle [January 1998]

"The principle recognised by OECD is the well known 'arm's length principle'. The OECD 1979 Transfer Pricing Report expresses it as follows

> 'It is generally acknowledged that, in taxing the profits of an *enterprise* which engages in transactions with overseas associates, the profits should be calculated on the assumption that the prices charged in the transactions are arm's length prices. This is the underlying assumption in Article 9(1) of the OECD Model Double Taxation Convention on Income and Capital on transactions between associated enterprises.'

"The 1995 OECD Guidelines continue to endorse the arm's length principle as embodied in the OECD Model Tax Convention and in the 1979 Report (see Preface paragraph 14, page P-4 'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' OECD 1995).

"...

"1523. Treaty Law [March 1997]

"The evolution of the arm's length principle and its relevance to the computation of *trading profits for the purposes of Case I Schedule D* marched in step with developments on the international front when the United Kingdom began to negotiate double taxation agreements following the second world war ...

"It is necessary to look in some detail at the way in which double taxation agreements enable us to review transfer prices. Article 7 of the model treaty adopts the arm's length principle for the attribution of profits to a permanent establishment in one treaty country of *a company or other enterprise* resident in the other."

"Article 9 recites:[25]

"The principle underlying Article 9 is that *the company* which has understated its profits will have them uplifted and *the company* which has correspondingly overstated its profits will have them reduced, subject to the acceptance by the tax administration of the treaty partner of the adjustment proposed. An adjustment under 9(2) is commonly known as a 'corresponding adjustment'.

"...

" 1532. Development of principles continues [March 1997]

"The evolution of the arm's length principle in statute law, case law and treaty law has proceeded independently. It is important however to appreciate, when investigating transfer pricing issues, that we have a broadly based and internationally respected recognition of the importance of the arm's length principle in its application to the transactions between associated enterprises...

"Within OECD particularly, the process of arriving at a broad consensus as to how these principles should be applied is a continuing one. The Model Double Taxation Convention published by the OECD Committee on Fiscal Affairs in 1977 contained a commentary giving authoritative guidance on the application of transfer pricing principles between treaty partners. This is reproduced in the 1992 Model and supplemented by the 1995 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This publication is the OECD's latest statement on the application of the arm's length principle. The work on the guidelines is not complete, and additional sections to cover specific issues (for example, intangible property and

25 RV's note: see above.

> services) are expected to be published over the coming months. The 1995 guidelines develop the guidance given in two earlier publications 'Transfer Pricing and Multinational Enterprises' (1979) and 'Transfer Pricing and Multinational Enterprises – Three Taxation Issues' (1984). All these OECD publications contain detailed discussion of the application of the broad principles to a variety of situations. *These publications, representing the views of a body of international experts including British participants, can normally be taken as reflecting our views as well as those of others.*"

9 The Transfer of Assets Abroad Provisions

Suppose that I am wrong in my view that Schedule 28AA cannot apply to benefits conferred on an individual by, for example, an offshore company of which he has TPP control. Take the case of a non-UK domiciliary resident in the UK who occupies on favourable terms a UK home which belongs to an offshore company. Is the effect of the provisions applying simply to impose an income tax charge on the company or can the deemed Schedule A income of the company be taken into account for the purposes of, say, Taxes Act 1988 section 739 or section 740? Prima facie, it can. The deeming provision in the section must be taken to its logical conclusion unless there is some good reason not to. As Peter Gibson LJ put it in the Court of Appeal in *Marshall v Kerr*:[26]

> " For my part I take the correct approach in construing a deeming provision to be to give the words used their ordinary and natural meaning, consistent so far as possible with the policy of the Act and the purposes of the provisions so far as such policy and purposes can be ascertained; but if such construction would lead to injustice or absurdity, the application of the statutory fiction should be limited to the extent needed to avoid such injustice or absurdity, unless such application would clearly be within the purposes of the fiction. I further bear in mind that because one must treat as real that which is only deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs, unless prohibited from doing so."[27]

Why should the deeming not apply for the purposes of section 739 and 740? In the case of section 739, if the payer of the income were the person whose income it was deemed to be, it might be helpful to the taxpayer for section 739 to apply, as he would

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26 [1993] STC 360 at page 366.

27 He was approved on this point by the House of Lords [1994] STC 638 per Lord Browne-Wilkinson at 652.

then have an argument that there was no taxable rental income on the grounds that one cannot pay income to oneself.[28]

Mr Henderson accepts that in principle the income deemed to arise to the company under the TPP can indeed be taken into account for section 739 and section 740 purposes. His ingenious argument in the case of section 739, which I paraphrase, is that, for section 739 to apply, some person - the transferor or his spouse - must have "power to enjoy" the income and that, as it does not exist, no such person can have power to enjoy it. Passing over the possibility of a charge under section 739 based otherwise than on the existence of "power to enjoy",[29] I fear that this argument proves too much. If, say, I am a beneficiary of a trust, the assets of that trust can be used for my benefit and if they include shares in a company, any income of which can be used for my benefit, the only reason I do not have power to enjoy the deemed income of the company is that there is no such income. Yet the Revenue could argue with considerable force that that is the very fact the Schedule requires us to disregard. Of course, if the company's articles and the trust instrument were so drafted that the person in question did not have power to enjoy *any* income of the company, real or fictitious, that would be another matter.

Mr Henderson has a similarly ingenious argument why section 740 should not apply. The deemed income for section 740 purposes is not "relevant income" in relation to any individual because it cannot be used to benefit any individual, Yet if the only reason it cannot be used to benefit an individual is that it does not exist, then the Revenue could mount the same argument, with the same force, as in the case of section 739, *mutatis mutandis*.

If section 739 and section 740 do apply, the next question which would arise is whether the person who would be taxable in respect of the deemed income of the company could claim relief under paragraph 6(2) (Elimination of double counting), which provides that, in the prescribed circumstances, a "disadvantaged person" may claim to have his profits and losses computed for tax purposes as if the arm's length provision had been made or imposed instead of the actual provision. The expression "disadvantaged person" is a somewhat misleading one as it means the person who benefited by the actual transaction! In general, it is a condition precedent of relief being available that the disadvantaged person must be "within the charge to income tax or corporation tax in respect of profits arising from the relevant activities" within the meaning of paragraph 5(3). The difficulties of interpretation of this phrase have been glanced on at 1.5 above.

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28 The Revenue would have a counter argument.

29 See section 739(3).

10 The Offshore Beneficiary Provisions

If the TPP do apply to, say, a beneficiary who receives a benefit from a company owned by the trustees of an offshore trust, can the beneficiary rely on them as reducing to nil for the purposes of the Offshore Beneficiary Provisions[30] the value of the "capital payment" he in fact receives from the company, and is deemed to receive from the trustees, on the grounds that he is deemed to have given full consideration for it?

The difficulty is paragraph 13 of Schedule 28AA, which is headed "Saving for the provisions relating to capital allowances and capital gains". It provides:

> "13. Nothing in this Schedule shall be construed as affecting:
>
> (a) ... or
>
> (b) the computation in accordance with the 1992 Act of the amount of any chargeable gain or allowable loss;
>
> and nothing in this Schedule shall require the profits or losses of any person to be computed for tax purposes as if, in his case, instead of income or losses falling to be brought into account in connection with the taxation of income, there were gains or losses falling to be brought into account in accordance with the [Taxation of Chargeable Gains Act] 1992 ..."

Could one perhaps argue that if the beneficiary is deemed to give full consideration, then no capital payment at all is made to him; that as there is no capital payment, there is no imputed capital gain; that the question of the *amount* of the *computation* of a capital gain does not arise and that the relevant part of paragraph 13 is concerned only with the amount of the computation of a capital gain rather than its existence?

11 Conclusion

In my view, the new transfer pricing provisions do not apply to gratuitous benefits conferred by a company otherwise than in a commercial context. If I am wrong in that view, the consequences could be very serious indeed. Difficulties of interpretation exist in relation to the interaction of the Transfer Pricing Provisions with the Transfer of Assets Abroad Provisions and the Offshore Beneficiary Provisions.

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30 Taxation of Chargeable Gains Act 1992 section 87 onwards.