

COMPLIANCE COST REVIEW

REFORM OF RULES ON TRANSFER PRICING AND THIN CAPITALISATION (2004)

1. Introduction

1.1 Background

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published in March 2004 for the above-mentioned measure by the Inland Revenue (prior to creation of the new department, HMRC). The measure was implemented with effect from 1 April 2004. A copy of the published final RIA is attached.

This review re-assesses the compliance cost analysis published in the original RIA and addresses two main questions:

- whether the estimates of compliance costs used in the RIA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the RIA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

2. The published RIA

2.1 Description of the policy change

The purpose of transfer pricing and thin capitalisation rules is to ensure a fair division of taxable profits between businesses which are related to each other because they are under common control. The rules also prevent businesses that are liable to UK tax, from reducing their taxable profits by artificial manipulation of prices.

The RIA introduced a number of reforms to clarify uncertainty over the rules, following a number of litigation cases which had left a large number of tax liabilities unsettled. These included:

- extending transfer pricing and thin capitalisation rules to cover domestic as well as cross-border transactions;
- revising the thin capitalisation rules so that they worked in the same way as more general transfer pricing rules; and
- allowing businesses to make domestic corresponding adjustments to achieve the same effect as could be achieved under bilateral double taxation treaties.

The new rules came into force from 1st April 2004.

2.2 Anticipated compliance costs or savings

The RIA acknowledged that the application of transfer pricing rules can impose a significant compliance cost, and to mitigate this – especially for smaller businesses – the RIA proposed a number of concessions:

- exempting small and medium-sized enterprises from the need to apply transfer pricing rules (subject to certain conditions);
- allowing a 2-year transitional relaxation of penalties associated with not producing evidence to demonstrate that results are arm's length results;
- exempting dormant companies from the new rules; and
- improving guidance.

The RIA explained that:

- for small businesses, a reduction in compliance costs was expected (because the changes would act as a relaxation for those firms);
- for medium businesses the same applied, except in exceptional circumstances;
- for large firms, of whom 50,000-60,000 would be affected, the compliance costs would vary according to circumstances, but could be anywhere between “small” and “substantial” for an individual firm; and
- for multinational groups, the exemption for dormant businesses would have a significant mitigating effect.

Businesses were consulted on the likely costs associated with the changes, and ad-hoc responses suggested costs for a typical large business might range from £20,000-£60,000 one-off cost, plus £13,000-£35,000 recurring per year. But the main driver of these costs would be the number of transactions requiring transfer pricing, and whether a firm was already applying the old rules (cross-border transactions) or whether they needed to start from scratch (domestic transactions).

3. Conduct of the review

Each compliance cost review is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, the review was led by an HMRC project team supported by consultants. The staff in the review team were completely independent of those involved with the original policy change.

An essential element of the review was consultation with those actually affected, and consultants were commissioned to carry out a small number of targeted in-depth interviews with some of those affected. The research was not intended to deliver any degree of statistical robustness (to do so would have been costly and impractical) but instead to provide indicative findings. Coupled with the consultants' own knowledge and expertise, this has allowed the research to identify the major issues and any associated learning points.

The external research was complemented by an internal review of HMRC paperwork and electronic files.

4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	Comments
Were the specific types of cost and benefit identified in the RIA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?	<p>Recent consultation suggests a range of types of cost were incurred:</p> <ul style="list-style-type: none">• training, familiarisation and guidance;• systems adjustments;• engagement of external advisors;• in-house personnel costs; and• particular costs related to dormant companies. <p>In general, these costs were not significant (for example, nobody had seen a need for extensive training) but the handling of dormant companies turned out to be a lot more complex than expected. Apart from that, the impact of the legislation has been modest.</p> <p>None of the respondents have identified any cost savings or synergies arising from the policy changes, and they also stated that they did not feel any more assured by the tax consequences</p>

	of inter-company transactions.
Were costs/savings incurred at the expected time?	Yes – although some respondents predicted that some system changes might be needed in future (although no specific plans had been considered to date). Respondents confirmed that the transitional relaxation of penalties up to April 2006 had been helpful in reducing costs over the implementation period.
Were costs/savings incurred by the expected people?	Yes. It has not been possible to confirm precisely how many firms have been affected, but the types of firms affected remains as predicted in the RIA.
Were any other costs/savings, not identified in the RIA, incurred ?	Some respondents stated that the reforms had caused them to accelerate a programme of liquidation for dormant companies. This would probably have happened anyway at some point, and it is debatable whether the full cost of such liquidations should be attributed to this reform. But the costs can be significant and the RIA could perhaps have mentioned this possibility.
If the type of costs/savings varied from the original estimates, why was that?	In general, respondents felt that the RIA was reasonable and accurate in its identification of a modest impact on compliance costs. The RIA did not fully explain the requirements for documentation after 1 April 2006, making estimation of that aspect of compliance costs difficult.
Could such variances have been foreseen at the time?	Respondents suggested that the way dormant companies had been considered within the legislative process had generated uncertainty and this in turn meant a delay in being able to fully identify costs of compliance. This uncertainty was not necessarily new - the full implications of having dormant companies within a group may not have been appreciated by business earlier on. The RIA increased awareness of the issue in order to deal with it.
What is the assessment now of the total value of costs and savings?	Overall, the compliance costs of the new legislation are not considered to be significant on an ongoing basis. Where UK domestic transactions were already considered by companies and included in their transfer pricing

	<p>procedures and documentation, the compliance costs have been limited. Where companies have been forced to implement new processes and procedures, more significant costs have been incurred.</p> <p>The most significant cost of compliance arose with dormant companies, although the cost would have been higher if action had not been taken as part of the measure..</p> <p>The majority of costs were in line with the RIA, namely some one-off costs, but less of an effect on an ongoing basis. Costs were quite variable between different firms, and for different numbers of transactions.</p>
If different from the original RIA, what has caused the discrepancies?	The main difference related to dormant companies. These differences arose in part because at the time, it was not known to what extent businesses would want, in any event, to wind up such companies to simplify their structures.
With hindsight, were the compliance cost estimates accurate?	This is best summed up in the words of one respondent, who said they “agreed that this assessment was broadly in line with the actual impact experienced.” There are some differences, particularly for dormant companies, but the overall level of impact was in line with the RIA.

5. Was the process used to estimate compliance costs reasonable?

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

Question	Comments
Who worked on the original RIA?	The work was led by policy staff in HMRC, with appropriate support from economists and Better Regulation advisors.
Was an adequate audit trail maintained?	Yes.
Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?	Yes. The RIA was produced in line with the guidance in force at the time.
How much effort was devoted to compliance cost estimation, and	The RIA presented a lot of information about costs, although difficulty of measurement meant

<p>was that effort proportionate in the context of the policy measure?</p>	<p>that the figures were uncertain and/or based on consultation responses from individual firms. The amount of effort spent on estimation was proportionate in the context of the measure.</p>
<p>Were the right people (both internal and external) consulted, and were their views reflected appropriately?</p>	<p>There was a good amount of consultation with businesses, and the responses were used both to inform the RIA and to identify problem areas.</p>
<p>Did those who were consulted when the RIA was written express views on the reasonableness of the process?</p>	<p>Not at the time, no.</p>
<p>Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?</p>	<p>Despite the overall level of consultation being good, some respondents felt there had been insufficient research in relation to dormant companies and also on the overall gain/benefit of the legislation. In fairness, the RIA did identify dormant companies as an issue, and did propose a mitigating solution. The concern is simply that even with that mitigation, costs were still not fully anticipated.</p>
<p>Were compliance costs estimated for all options mentioned in the RIA?</p>	<p>The RIA didn't discuss alternative options in great detail, although it mentioned them briefly. The primary focus was on the recommended option.</p>
<p>Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?</p>	<p>In qualitative terms, yes. There were clear attempts to consider different sizes of business separately. Quantification was anecdotal and not very systematic, but having said that (and with hindsight) this was probably the best that could be done at the time.</p>
<p>Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?</p>	<p>The RIA quoted some very wide ranges of cost in both quantitative and qualitative terms, drawing on feedback from businesses. Despite the difficulties of doing so, there could perhaps have been a more concerted attempt to draw all the information together into a coherent statement of what the impacts would be.</p>
<p>Was there sufficient time to produce a robust assessment of compliance costs?</p>	<p>The complexity of the issue made it difficult to identify robust figures, but time was not a problem.</p>

Were any assumptions reasonable, given the circumstances at the time?	Yes.
Were any estimates of compliance costs caveated appropriately?	Caveats were few, despite the uncertain nature of some of the figures.
Were any risks correctly identified, addressed and explained?	The RIA states that there were no significant risks and this has been borne out in practice. The possible risk of high transitional costs was addressed by the transitional relaxation of penalties up to April 2006 - this was welcomed by respondents and eased the overall burden of the implementation of this legislation.
Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?	No. Respondents did question the value of a change in legislation that has no discernible impact on companies' tax liability. While companies understood that the legislation was necessary to comply with EU law, there was a consensus that its impact could have been moderated by a more risk-focused approach (i.e. less burdensome requirements for less risky businesses).
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	This RIA was broadly accurate and reasonable, with HMRC making an appropriate consideration of the compliance costs. Actual compliance costs were broadly in line with the projections of the RIA. A few learning points are identified in section 6 below.

6. Learning points arising from the review

6.1 Learning points for future work in this policy area

- There was uncertainty among some companies over what documentation requirements HMRC would expect after 1 April 2006. The more formal and detailed this requirement is, the more likely it is that the burden of future compliance will be higher. The RIA could perhaps have discussed this in more detail.
- Where relevant, the impact of reform on dormant companies should always be considered (as it was with this particular RIA).
- There are no other specific learning points, although respondents raised a number of issues outside the scope of compliance costs and these have been passed to the relevant policy staff for consideration.

6.2 Learning points for the RIA and compliance cost process in general

This RIA was broadly reasonable and accurate, and respondents did not suggest any wholesale changes to HMRC's assessment process. A few points to note are:

- The RIA didn't discuss alternative options in great detail and this section could perhaps have said more.
- The RIA quoted some very wide ranges of cost in both quantitative and qualitative terms, drawing on feedback from businesses. In future RIAs, a concerted attempt should be made to draw all such information together into a coherent statement of what the impacts are likely to be. If that is not possible, the RIA should explain why.
- Appropriate caveats should always be included if figures are uncertain.
- Where a reform might cause businesses to alter the timing or nature of something they were going to do anyway (liquidate dormant companies in this case) the RIA should mention the fact to help businesses plan for the change. Whether any resultant costs or benefits should be attributed to the reform itself would need to be considered on a case by case basis.

7. The way forward

Comments are invited on any aspect of this report or the wider compliance cost review programme. The learning points are being fed into the policy development process directly if particular to one RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

8. Contact points for further information

For issues relating to transfer pricing and thin capitalisation policy specifically:

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For issues relating to the compliance cost review programme generally:

Richard Bowyer HMRC 100 Parliament Street London SW1A 2BQ
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For issues relating to your own corporate tax affairs, contact our Employer helpline:

Telephone: 0845-714-3143 (Mon-Fri 8am-8pm, Sat-Sun 8am-5pm).

THE PUBLISHED REGULATORY IMPACT ASSESSMENT

[Reform of Rules on Transfer Pricing and Thin Capitalisation \(PDF 115K\)](#)