

Statement of Practice 04/07
Advance Thin Capitalisation Agreements under the APA Legislation

General

1. This Statement of Practice provides detailed guidance about how HM Revenue and Customs interprets sections 85-87, Finance Act 1999 which provide for advance pricing agreements ('APAs') and how it intends now applying this legislation in practice in thin capitalisation cases. It also refers to HMRC's International Manual ('INTM'), which is available online at www.hmrc.gov.uk/manuals/intmanual/index.htm.

UK Transfer Pricing Rules

2. Transfer pricing describes the process by which associated persons, principally members of multinational groups of companies, transfer goods, services, finance and intangible assets between one another and across national boundaries. There is broad international agreement that, for tax purposes, such transactions should be priced in accordance with the 'arm's length standard' expressed in article 9 of the OECD's Model Double Tax Convention.
3. Briefly stated article 9 requires that profits or losses reported in tax returns should be those which would have accrued to the taxpayer had the prices set for transactions with associates been the same as those which would have been set if the parties had been unconnected and dealing independently with one another. This may involve making computational adjustments in the tax return.
4. Generally HMRC should not disregard the actual transactions undertaken by the business. In accordance with OECD guidance, one exception to this is where the economic substance of a transaction differs from its form, in which case, HMRC is permitted to re-characterise the transaction in accordance with its substance. An example of such a scenario would be an investment in an associated enterprise in the form of interest bearing debt which at arm's length would have taken the form of equity.
5. "Thin capitalisation" is the main transfer pricing issue arising where the transaction under consideration is the provision of finance. The UK thin capitalisation rules have historically helped to ensure that inward investors do not finance their UK sub-groups with amounts and/or terms of debt that give rise to excessive interest deductions. The UK thin capitalisation rules require that such investors do not use debt that is in excess of the arm's length standard by reference to both the amount and the terms of the debt. This protects the Exchequer against excessive interest deductions that might otherwise artificially depress the profits realised in the UK.
6. The basic transfer pricing rule applies where a provision is made between two persons by means of a transaction or series of transactions and one of the persons controls the other or both are controlled by the same person or persons.
7. Once a control relationship has been established, the basic rule then requires that the actual provision be compared to the arm's length provision (which would have been made between independent enterprises). If the actual

provision confers a tax advantage on one or both of the affected persons, an adjustment is to be made to the taxable profits of the tax-advantaged persons. The comparison exercise can be complex and requires judgements to be made by both the business and HMRC. The process is not a scientific exercise and will frequently produce a range of figures all more or less equally reliable rather than a single correct answer.

Achieving Certainty

8. HMRC recognises that thin capitalisation is a difficult area and one in which the majority of customers want to get the right result when their returns are filed. Usually a taxpayer makes a self-assessment, files the return and then waits to see if HMRC open an enquiry within the statutory time limit. This may not happen for nearly two years after the end of an accounting period and so perhaps the best part of three years from when a particular lending transaction took place. Over this sort of timescale there is plenty of scope for key personnel to have moved on, making subsequent reviews more time consuming. Therefore the treatment of particular financing arrangements for future tax returns has habitually been dealt with in advance of the enquiry framework through the procedures associated with the operation of the UK's double taxation treaties ('the treaty route', described at INTM57000+). In recognition of the benefits of this advance process, ministers have agreed to widen the scope of the **Advance Thin Capitalisation Agreement (ATCA)** process by making it available to those for whom the treaty process would not be available.
9. This Statement of Practice has no impact on the guidance in SP3/99 which describes the process for entering into Advance Pricing Agreements ('APAs') with HMRC, which are usually on a bilateral basis. Although based on the same statutory provisions, the negotiation of APAs and ATCA's are separate processes. Therefore the operation of ATCA's is intended to be in accordance with this Statement of Practice and not with SP3/99.

Transfer Pricing Issues

10. S85(2) sets out the transfer pricing issues which can be the subject matter of an APA. Agreements under this Statement of Practice will be restricted to matters within S85(2)(d), that is the tax treatment of any provision made or imposed between the taxpayer and an associate. As this Statement of Practice relates to thin capitalisation the provisions involved will need to be financing provisions.

Applicants for an Advance Thin Capitalisation Agreement

11. An ATCA may be requested by any UK business, including a partnership, with financing provisions to which schedule 28AA, ICTA 1988 applies. Such a request is entirely at the discretion of the business.
12. Potential applicants need to bear in mind that the process is designed to offer assistance in resolving transfer pricing issues which, for any particular chargeable period, have a significant commercial impact on an enterprise's profits or losses.
13. HMRC's preference is for a widely available process. Therefore HMRC does not currently intend to exclude potential applicants from the ATCA process

simply by reference to the size of the financial transaction. However HMRC will continue to monitor applications received in order to evaluate best practice in terms of resource. One way in which resources may be used more effectively is where the application is based on a model ATCA (see paragraphs 59 to 62 below).

14. Guidance about a potential application may be obtained from HMRC and this Statement of Practice also indicates some circumstances in which an application might be declined.

Situations Suitable for Advance Thin Capitalisation Agreements

15. Situations suitable for ATCA's include, but are not limited to the following;

- intra-group funding outside the scope of treaty applications, e.g. involving a quoted Eurobond or discounted bond;
- financing arrangements brought into schedule 28AA by the "acting together" rules in paragraph 4A, schedule 28AA;
- financing arrangements previously dealt with under the treaty route.

Situations Unsuitable for Pre-Return Agreements

16. HMRC is likely to decline ATCA applications where the financing arrangements in place do not appear to be significant commercial issues for the company, or for example where, after an initial rejection, an applicant makes subsequent applications with minor variations, as this is not regarded to be as a sensible use of resources. Situations in which an application for an ATCA is rejected shall be monitored centrally and where necessary further guidance produced from the resulting data.

Scope

17. The potential scope of an ATCA is flexible. They may cover either the treatment of a single applicant's financial instrument, or the treatment of the overall debt position of a group, depending on circumstances.

Term

18. An ATCA will be operative for a specified period from the date set out in the agreement. The current guidance is that thin capitalisation agreements negotiated under the treaty route should not be entered into for more than five years. It is therefore intended that the vast majority of advance thin capitalisation agreements will last for between three and five years.

Retrospection and "Roll-Back"

19. While an ATCA will normally operate prospectively in relation to chargeable periods beginning after the time the application is made, it is possible that a chargeable period to which the agreement relates may have ended before the agreement is reached. S86(1) allows the agreement to be effective for that chargeable period and in accordance with S86(7) the agreement may set out any adjustments to be made for tax purposes as a consequence of the agreement.

20. In addition, although a particular agreement does not relate to earlier periods, the conclusions reached in negotiating the agreement may be relevant to a return for an earlier period, or to the resolution of thin capitalisation enquiries raised for earlier periods, if the particular facts and circumstances surrounding those years are substantially the same. Consequently, in such circumstances, the business and HMRC may jointly agree to consider a “roll-back” of the ATCA as an appropriate means for amending a self assessment return and of resolving outstanding transfer pricing issues in earlier years. HMRC will not however use hindsight in any such roll-back.
21. Except where “roll-back” is being considered, the request for an ATCA in respect of future years will not in itself affect any transfer pricing enquiry into earlier years. However, to the extent such an approach is appropriate and feasible, HMRC will co-ordinate the request in respect of future years with any transfer pricing enquiry in respect of prior years in order to improve overall efficiency and reduce duplication of enquiries.

Confidentiality

22. Information supplied by the business in relation to an ATCA request will be kept confidential in accordance with the confidentiality requirements of the Taxes Acts and the terms of any relevant DTA. However, such information will contribute to the pool of information held by HMRC about that business and no undertaking can be given that it will be taken into account only in relation to the ATCA. Thus, for example, where information is submitted under an ATCA which would appropriately enable the re-opening of earlier years for that business under existing law, the fact that the information was submitted under an ATCA would not in itself prevent reopening. To act otherwise could afford businesses seeking an ATCA an advantage over other businesses and may give rise to abuses.

Requests for Advance Thin Capitalisation Agreements

23. As provided by S85(1)(c) the ATCA process is initiated by the business making an application for clarification by agreement of what the effect would be of the arm’s length principle to the financial provisions in question.
24. This Statement of Practice is intended to replicate the existing pre-return enquiry process for cases both inside and outside the treaty route. As such the guidance beginning at INTM575000 outlining the possible course of a thin cap case remains relevant. For this reason HMRC does not intend to set out a formal ‘expression of interest’ process.

Initial Contact

25. The initial contact must clearly include a statement that agreement under S85 is being sought together with the applicant’s proposed treatment of the provisions in question. It will also need to include the group structure for the time at which the provision occurred, background providing a working knowledge of the business of the company or group under consideration, the finance in question and so on (see for example INTM575050+).
26. HMRC will endeavour to respond to the initial contact within 28 working days.

27. The application must also have due regard to the requirements of S85(5), which state that the application must set out the following;
- a) the taxpayers understanding of what would, in his case, be the effect, in the absence of any agreement, of the provisions in relation to which clarification is sought;
 - b) the respects in which it appears to the taxpayer that clarification is required in relation to those provisions; and
 - c) how the taxpayer proposes that matters should be clarified in a manner consistent with the understanding mentioned in paragraph (a) above.
28. HMRC's view is that the ATCA process will be more efficient, and therefore more likely to remain widely available, if applications contain the proposed terms of the ATCA. This should make a significant contribution to meeting the statutory obligations and focus attention on the most important issues (see paragraphs 59 to 62 for how this might be addressed in practice).
29. HMRC expect and would generally encourage a less formal approach to ATCA's than to APAs under SP3/99, far more in line with thin capitalisation practice as it stood prior to the introduction of this Statement of Practice. Emailed applications and documents in electronic form are welcome, however, for practical reasons, where there is extensive documentation it may be better for this to be provided by disc or in hard copy (see contact points below).

Review Phase

30. Once it has been decided to negotiate an agreement the next step will be to enquire into the thin capitalisation issue, for which HMRC's existing guidance will remain relevant (see INTM540000+).
31. Meetings between HMRC and the applicant will inevitably play an important part in the ATCA process. However it is important that HMRC has an opportunity to consider the written application prior to any meetings being arranged. The contents of the proposed ATCA in the application may mean that a meeting is unnecessary.

Agreement

32. In accordance with section 85 FA 1999, an ATCA between the business and HMRC represents a binding undertaking on the parties that the treatment of the transfer pricing issues covered by the agreement will for a specified period be determined in accordance with the agreement. However this Statement of Practice provides flexibility in that any ATCA shall cease to have effect if its terms are not observed such that the provisions leading to revocation, nullification, revision or mutual agreement over-ride as described below are triggered. HMRC considers this to be consistent with section 86(2) FA 1999 to the extent that such flexibility is included in the terms of the agreement.
33. In form the agreement between HMRC and the business will be based on the approach described at INTM582010 and will therefore include terms and conditions familiar from existing thin capitalisation agreements negotiated under the treaty route. This may therefore include terms relating to guarantee provisions and the availability of associated claims. To this will need to be

added the specific requirement in section 85(1)(d), Finance Act 1999 of a declaration that the agreement is one made for the purposes of section 85, Finance Act 1999 (see also paragraph 27).

Monitoring and Review

34. The agreement will contain provisions relating to its monitoring. As with monitoring agreements under the treaty route, the ATCA might include specific reporting requirements such as a requirement to show that agreed covenants have been satisfied in the corporation tax computation. The wording of any such reporting requirement would be incorporated into the ATCA and is in accordance with section 86(4).

Interaction with the Obligation to Deduct Withholding Tax

35. It is important to note that an application for an ATCA is made by a UK resident, whereas an application for treaty clearance for interest to be paid at a rate in accordance with a Double Taxation Agreement is made by a non-UK resident. The two processes are therefore entirely distinct. An ATCA cannot remove the withholding obligation under section 349 ICTA88 (as repealed as part of the Tax Law Rewrite and replaced by section 874 ITA 2007), on a UK business to account for income tax at source on payments of interest. Income tax must be deducted at the basic rate by the person making the payment unless, following a valid application under a DTA by the beneficial owner of the interest, they are notified by HMRC to apply a different rate of deduction (which in many cases will be 0%).
36. Revised procedures for applicants for treaty clearance were announced in 2007 and can be found online at www.hmrc.gov.uk/cnr/clearance-processes.htm. As the ATCA process and the treaty route are substantially similar means of reaching an arms length agreement, HMRC expects that the streamlining of the treaty clearance process will result in all future thin capitalisation agreements being negotiated under this Statement of Practice.
37. However, the option of entering into a thin capitalisation agreement outside of section 85 FA 1999, that is via the treaty route, is still available since the legal basis for pre-return enquiries in Statutory Instrument No. 488 of 1970 is unchanged (see the summary of its provisions at INTM543010). Therefore where there are good reasons for continuing to use the treaty route, the associated beneficial owner of the interest should, via the application for treaty clearance, notify the Charities Assets and Residence group of the intention to utilise the treaty route. It should be noted that an application for a thin capitalisation agreement via the treaty route will not benefit from the revised procedures for treaty clearance announced in 2007.
38. It should be noted that the extension of (former Inland Revenue) Code of Practice 10 (CoP10) is currently being considered (Review of Links with Large Business, Key Proposal 2). HMRC does not expect CoP10 to be used as a means to obtain clearance for thin capitalisation, as it is intended that ATCA's will provide for thin capitalisation agreements going forward.
39. This Statement of Practice provides a route to a thin capitalisation agreement for a UK business regardless of whether or not any treaty applications have or can be made by the lender. HMRC will only enter discussions for an ATCA if the prospective transactions have reached an advanced stage of preparation

such that the debt has been quantified and priced. For clarity, negotiations will not be entered on the basis of generic information or speculative proposals. The following examples illustrate the interaction with the treaty route.

Example 1

A UK resident company is funded with interest bearing debt other than on arm's length terms by its non-UK parent, which is resident in a jurisdiction with a Double Taxation Agreement with the UK. In these circumstances forward agreements on thin capitalisation could be reached either (i) through the treaty route once the parent company had made the relevant application or (ii) via an ATCA under this Statement of Practice regardless of whether or not the parent company had applied for treaty relief.

For the avoidance of doubt, the application for treaty clearance could be made under the revised procedures referred to above. Subject to the application meeting the appropriate criteria to be considered valid, an unconditional treaty clearance notice would be issued enabling the non-resident to access the appropriate treaty benefits. The UK company could then negotiate an ATCA under this Statement of Practice.

Example 2

A UK resident company is funded using discounted bonds other than on arm's length terms by its non-UK parent, which is resident in a jurisdiction with a Double Taxation Agreement with the UK. In this case, as discounted bonds are not within the treaty process, an advance agreement about the bonds' treatment could only be obtained by ATCA under this Statement of Practice.

Interaction with other legislation and clearance procedures

40. Since an ATCA can only cover financing provisions within schedule 28AA ICTA 1988, all other provisions in the Taxes Acts will continue to apply. For example, compliance with the terms of an ATCA would not prevent a further restriction of interest under the unallowable purpose rule in paragraph 13, schedule 9, Finance Act 1996 or the late interest rules in paragraph 2. Therefore HMRC would encourage businesses to consider all aspects of their financing arrangements before entering into an ATCA. Certainty regarding other tax issues will need to be pursued using different clearance procedures where they exist.
41. In particular the arbitration provisions in Sections 24 - 34 and Schedule 3 of Finance Act 2005 do provide a clearance process, although an arbitration clearance notice does not prevent the thin capitalisation rules from applying. In practice the two issues have often been considered together and therefore HMRC would also encourage businesses to consider whether they need certainty on the application of the arbitration legislation when applying for an ATCA. So long as the conditions laid down both in this Statement of Practice and the arbitration rules are met there is no reason why the two applications should not be submitted as a single document to the contact for ATCA applications.

Nullifying and Revoking ATCA's

42. S86(5) gives HMRC the power to nullify a pre-return agreement as if it had never been made where the business has fraudulently or negligently provided false or misleading information in connection with the pre-return agreement application. When considering using this power HMRC will also take into account the extent to which the terms of the agreement would have been different in the absence of the misrepresentation.
43. In accordance with S86(2) a pre-return agreement is only valid in accordance with its own terms. Therefore HMRC may revoke an ATCA in accordance with its terms, where the business does not comply with the terms and conditions of the agreement. It should be noted that in the event of nullification or revocation, HMRC would be obliged to reconsider the treaty clearance provided in respect of the related financing provisions.

Revising and Renewing ATCA's

44. The ATCA should where appropriate include wording to provide guidance and flexibility for potential revisions.
45. When an existing agreement is due to expire the business may wish to apply for another one. This will be a separate agreement, rather than an extension (as can be the case for agreements via the treaty route). It should be noted that where the business has remained substantially unchanged the new application is not intended to be any more onerous than a renewal under the treaty route.

Withdrawing from the ATCA process

46. HMRC may withdraw from the ATCA process if the business is not co-operating in providing the information necessary to consider the application properly. In cases where agreement cannot be reached with the business, HMRC will issue a formal statement recording the reasons. HMRC does not have any obligation to continue discussion beyond the point at which it has determined that agreement cannot be reached. Any withdrawal from the ATCA process will be monitored and controlled centrally by CT & VAT.
47. A business may withdraw from the ATCA application at any time before final agreement is reached.

Disclosure of Agreement

48. HMRC considers that ATCA information is subject to the same rules of confidentiality as any other information about taxpayers and that the unauthorised disclosure even of the existence of an ATCA will be a breach of confidentiality.

Penalties

49. Because an ATCA is an agreement between HMRC and a business which decides how certain issues will be determined for the purposes of the Taxes Acts, a return made on any other basis in relation to those matters during the currency of an ATCA will constitute an incorrect return. Consequently, a tax-

geared penalty will be chargeable where the business has acted fraudulently or negligently in making such an incorrect return and tax has been lost as a result. Where a return is made in accordance with the agreement, but it is discovered that false or misleading information was submitted fraudulently or negligently in the course of obtaining the ATCA, the legislation provides at section 86(5), FA 1999 that the agreement is treated as if it had never been made, with the result that questions relating to the subject matter of the agreement are no longer to be determined in accordance with the agreement. This may mean that returns made in accordance with the nullified ATCA are incorrect with the consequences for penalties described above.

50. A penalty not exceeding £10,000 may be imposed where false or misleading information is supplied fraudulently or negligently in connection with an application for an ATCA - section 86(8), FA 1999. There is no requirement for the agreement to have been finalised in order to apply this sanction. In practice, where a tax-geared penalty is obtained following the nullifying of a ATCA as described above, a fixed penalty under section 86(8), FA 1999 will be reduced so that the total amount of the penalties does not exceed whichever is the greater or greatest of them. Section 98 TMA 1970 will apply to information required as part of the process of monitoring an ATCA where there has been a failure to provide the information or where incorrect information has been fraudulently or negligently provided.

Appeals

51. In accordance with existing appeal procedures, the business has the right to appeal against the amount of any additions to profits arising as a result of the revocation or cancellation of an ATCA.
52. Where there is a mutual agreement made under and for the purposes of any double taxation agreements which is not consistent with the terms of the ATCA, it shall be the duty of HMRC to modify the ATCA to give effect to the mutual agreement reached with a treaty partner, in accord with section 86(3) FA 1999.

Roles and Responsibilities within HMRC

53. CT & VAT is responsible for the operation of the ATCA process. Any comments about its effectiveness or suggestions for improvements in the context of thin capitalisation should be addressed to the relevant contact below.
54. The initial contact concerning an ATCA should be sent to the relevant contact below. Where other HMRC officers have a clear interest in the case, such as the customer relationship manager in the Large Business Service, it would be appropriate to send them a copy of the application at the same time.
55. The central contact point is intended to assist HMRC's administration of the process. It is not the intention that all applications will be handled within CT & VAT, although an ability to deal directly with cases of particular significance or complexity will be centrally retained by CT & VAT. It is also intended that CT & VAT will centrally oversee all ATCA's.

Further Information

56. The contact addresses for more information about advance thin capitalisation agreements under this Statement of Practice are as follows;
57. For ATCA applications, the operation of the ATCA process and for any comments or complaints in respect thereof in all cases;

Miles Nelson
CT & VAT
100 Parliament Street
London
SW1A 2BQ
Telephone: 020 7147 2663
Fax: 020 7147 2647
Email: milesc.nelson@hmrc.gsi.gov.uk

Using a Model ATCA

58. HMRC would like a [model ATCA \(PDF 65K\)](#) to be available for use with applications under this Statement of Practice. At the moment the intention is that the model would present an outline of commonly used criteria, definitions and so on, which the applicant could adapt for their own circumstances. The object of a completed draft ATCA being included with the application would be to facilitate a more efficient resolution of the ATCA process for the parties entering the agreement.
59. HMRC's purpose in suggesting such a model be employed is to try to ensure greater consistency between agreements and to shorten the period of time it takes to reach agreement.
60. It is recognised that a model is not obligatory and will not be appropriate in all cases, but HMRC considers that it would cover a significant proportion of cases dealt with in Local Compliance, as well as some of those handled by the Large Business Service.
61. Work on the model ATCA is currently ongoing. If it produces a workable model then it is intended that this will be published as guidance within the International Manual.