

Tax Law Rewrite

Response to Paper CC/SC (08) 24

Bill 7: Transfer pricing and APAs

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Transfer Pricing and APAs

Introduction

1. In July 2008 we published Committee Paper CC/SC (08) 24 on the HMRC internet website www.hmrc.gov.uk/rewrite. The closing date for responses was 18 September 2008. The draft clauses rewrite the legislation on transfer pricing.

2. The purpose of this response document is to provide details of the substantive technical points made and to explain our analysis and proposals in respect of them. Minor points, such as suggestions to improve punctuation, are not covered but all comments have been carefully considered.

3. We received written responses from the following:

- The Confederation of British Industry
- The Institute of Chartered Accountants in England and Wales
- Pricewaterhouse Coopers
- Dr David Williams

4. The following abbreviation for tax legislation is used in this response document:

- ICTA 1988 Income and Corporation Taxes Act 1988
- FA 1999 Finance Act 1999
- Sch 28AA Schedule 28AA to the Income and Corporation Taxes Act 1988
- OECD Organisation for Economic Cooperation and Development

General structural points

HMRC should consider bringing section 815B of ICTA (the arbitration convention) and sections 808A and 808B of ICTA (non-arms length interest and royalties) within the same Bill.

5. ***It is intended that these sections will be rewritten in the same Bill.***

The charging rule and the basic principles were all set out together in paragraph 1 of Schedule 28AA of ICTA. We would suggest retaining the basic rules on application and charging in clause 1- specifically what are currently proposed as clauses 1(1) and 12.

6. We agree that it is helpful and clearer to have the provisions of paragraph 1(1) and 1(2) of Schedule 28AA of ICTA 1988 set out together instead of being split between an introduction in clause 1 and the basic rule in clause 12. Accordingly they have been reunited as the basic rule in clause 1.

7. ***We agree and an amendment will be made.***

A basic framework for the legislation should be set out at the beginning from which the detailed rules then follow in subsequent Chapters. Preferably the basic rules that apply to the majority of straightforward cases would also be in Chapter 1. These would include the need for a transfer pricing adjustment, the basis for evaluating the actual and arm's length provisions, the opportunity for a compensating adjustment, identification of the exemptions and the basics for making adjustments. Thus the whole framework of the transfer pricing rules would be clearly set out in Chapter 1

8. To carry out such a restructuring would result in Chapter 1 becoming very long. Under the structure we are now proposing we have a basic rule followed by the interpretive provisions needed to work out whether the basic rule applies, exemptions from the basic rule and finally rules about what is to happen if the basic rule does apply but only to one of the parties. We consider that this structure is clearer than attempting to overburden Chapter 1. No other requests have been made for such a restructuring of Chapter 1.

9. ***We do not consider that an amendment is necessary.***

Although the majority of people discussing transfer pricing provisions make use of the term "related party" the legislation uses "person". It would almost certainly help considerably if clause 1(1) referred to "related persons" and if Chapter 2 (which as currently drafted contains the "participation" rules) consolidated all the related rules by defining "related persons" and then moving through the rules on direct and indirect participation.

10. It is preferable to keep the term "affected person" and the "participation condition" separate rather than incorporate them into "related party". There must first be affected parties before one begins to consider whether there is a participatory relationship. Furthermore the "participation condition" in clause 3 itself has two rules about *when* the two persons have to be related. In particular the two persons need not have been related at the time when the actual provision was made or imposed. So it is misleading for the opening proposition in clause 1(1) to be in terms of provision being made or imposed between two related persons.

11. ***We do not consider that an amendment is necessary.***

The consolidation of some definitions in Chapter 8 is very helpful in this regard and we consider there are other definitions that could be usefully moved there.

12. Although users familiar with the legislation may well be content with having all definitions at the end, it seems preferable to have relevant definitions where they are needed. For example, in order to understand clauses 1 and 2, Chapter 2 with its meaning of “direct” and “indirect participation” comes immediately after those clauses. In addition we do offer an index of defined expressions.

13. ***We do not consider that an amendment is necessary.***

The rules for financing transactions are sufficiently complex to warrant a chapter of their own.

14. Clause 6 (indirect participation) is a signpost to clauses 9 and 10 (indirect participation: financing cases). The user will have been reading a particular provision when a reference to indirect participation arises. Clause 6 signposts the user to the places where indirect participation is defined for the purposes of that provision which includes financing cases. Clause 6 would therefore need to refer to the same clauses as clause 9 and 10 even if they were placed elsewhere. There would be no greater convenience. The benefit of the finance clauses being integrated into the main provisions is that it will assist those less regular users than those who are specialists.

15. ***We do not consider that an amendment is necessary***

An identical set of rules is used several times in Schedule 28AA using the term “participatory relationship”. At the very least this could be defined once for the Part as a whole.

16. “Participatory relationship” is defined three times. Two of these definitions are similar and the third is different. It is normal in these circumstances for a drafter to repeat the same definition where it only applies twice.

17. ***We do not consider that an amendment is necessary.***

The terms “special relationship” and “participatory relationship” should be rationalised.

18. The term “special relationship” is defined only once. It is used in order to refer to the actual ways in which the affected persons concerned are in fact related as opposed to all the possible ways in which they could be related for the purposes of meeting the participation condition. The term “participatory relationship” cannot be standardized. As there are differences between the two terms they should remain separate.

19. ***We do not consider that an amendment is necessary.***

Clause 4: Direct participation

Subsection (1) identifies five clauses in Part 1 to which the definition applies, whereas the source legislation simply applies it "for the purposes of this Schedule". Presumably the five clauses are considered to be the only ones to which the definition is relevant, but the broader formulation in the source legislation is easier for the reader since it saves him having to worry whether there may be other clauses in which the phrase in question is used but with some different meaning.

20. Clause 4 explains what is meant by "direct participation" and lists the instances where the term is used on the Part. We agree that it would be more helpful to simply provide that the meaning is for the whole Part rather than the listed clauses.

21. *We agree and an amendment will be made.*

Clause 5 - Meaning of "control" in cases involving sales of oil

In subsection (1)(a) and in the first line of subsection (2) the rewrite refers to "the actual provision" where the source legislation simply refers to "provision". The latter seems preferable, particularly in subsection (2), since the Part does not actually have effect in relation specifically to the actual provision or the arm's length provision but rather to the difference between the two. The same applies in clause 41(3), even though in this case the source legislation does say "the actual provision". We note that the unqualified reference to "any provision" has been retained in clause 66(2) and (3).

22. While we agree that the Part does not apply "to" the actual provision, it does apply in a way that relates to the actual provision with a clear relationship between the two. We consider the use of "the actual provision" in this clause produces the same outcome as the source legislation and, on balance, prefer to retain these words. Because the Part applies in relation to the actual provision we also prefer the use of the term in clauses 41(3). In clause 66(2) and (3) the term is not used because it is not helpful for the clause to be governed by clause 1. Clause 66 should not take effect only if the Part applied, which would be the effect here of referring to "actual provision".

23. *We do not consider that an amendment is necessary.*

Clause 8: Indirect participation: one of several major participants

It is possible to read the legislation in such a way that the 40% test applies not to the relevant holdings but to the interests of the two investors themselves. This amounts to a 20% test – the two would need just over 50% of a corporate venture to have control and 40% of 50% is 20%. Given the line taken by the explanatory note we think it important to determine what the position actually is.

24. Paragraph 4(8) of Schedule 28AA reads:

“the 40% test is satisfied in the case of each of two persons wherever each of them has interests, rights and powers representing at least 40% of the holdings, rights and powers in respect of which the pair of them fall to be taken as controlling the subordinate.”

25. The explanatory notes to the draft transfer pricing clauses read:

“This clause provides that if two persons taken together control a body corporate or firm, and each of the two persons has at least 40% of their combined stake in the body or firm, then each of the two persons is indirectly participating in the body or firm,”

26. The explanatory note is incorrect in referring to “40% of their combined stake” and will be rewritten to make it clear that the 40% refers to all the rights and powers of the kind by means of which the two persons have achieved control in accordance with the example in paragraph 43270 of the International Manual.

27. *We agree and the explanatory notes will be changed.*

Clause 12: Basic transfer-pricing rule

It would be helpful to define “enterprise” by reference to the definition in the Annex to Commissions Recommendation 2003/361/EC.

28. The basic transfer pricing rule in paragraph 1(2) of Schedule 28AA requires a comparison of an actual provision between two persons and the provision which would have been made as between independent “enterprises”. Paragraph 5B of Schedule 28AA exempts the provisions from applying where the advantaged person is a small or medium-sized enterprise. Paragraph 5D(1) of Schedule 28AA refers to Commission Recommendation 2003/361/EC for interpretation of the terms.

29. “Enterprises” is not defined but paragraph 2(1) of Schedule 28AA requires the Schedule to be construed in such a way as best secures consistency between the effect given to paragraph 1 of the Schedule and the effect given to the OECD model treaty in accordance with the published transfer pricing guidelines. The commentary to the model treaty reads:

“No exhaustive definition of the term "enterprise" has been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business.”

30. A lengthier definition appears in the Commission Recommendation, incorporating “self-employed persons and family businesses engaged in craft or other activities, and partnerships or associations regularly engaged in economic activity”.

31. The lengthier definition is not a definition of “enterprise” used in OECD model treaties. Although one could argue that references to “enterprise” in Schedule 28AA probably have the same meaning as in the Commission Recommendation, one

could equally argue that the term has its ordinary meaning. If the ordinary meaning were in any respects narrower than the meaning in the Recommendation, that would affect the meaning of “medium-sized enterprise” since the latter has not only to fit into the Recommendation’s categories as described but also has to be an enterprise.

32. Accordingly, any attempt to define “enterprise” as it applies to paragraph 5D of Schedule 28AA would either involve changing the definition or imposing one and this is not a change in the law that we would wish to make, particularly since there is no attempt to define “enterprise” for the model treaty.

33. ***We do not consider that an amendment is necessary.***

Current HMRC policy is that the legislation only occurs between “enterprises” It would be clearer to state this in the legislation.

34. The wording of paragraph 1 of Schedule 28AA only requires the provision to be compared with the provision that would have been made between independent enterprises. In principle the provision may be applied between persons who are not enterprises (although this would be unusual) and this is the position we wish to retain.

35. International Manual 432090 states that the requirement in paragraph 2 of Schedule 28AA that the Schedule should be construed in accordance with the OECD model treaty suggests that the Schedule should be applied only where both parties are enterprises. This would be the normal application of Schedule 28AA but it is not the strict legal position.

36. ***We do not consider that an amendment is necessary.***

Why is it necessary to split the basic rule so that one or both of the affected persons are dealt with separately in subsections (2) and (4)?

37. Paragraph 1(2) of Schedule 28AA of ICTA gives the basic rule that the profits or losses of the potentially advantaged person or, as the case may be, each of the potentially advantaged persons should be computed as if the provision had been at arm’s length.

38. This has been rewritten in two separate subsections of the clause: subsection (2) dealing with the single advantaged person and subsection (4) dealing with each of the affected persons.

39. Where possible modern drafting tries to avoid confusing different cases. Rather than use the phrase “as the case may be” to apply two rules in one subsection, it prefers to deal with them separately in two subsections as here.

40. ***We do not consider that an amendment is necessary.***

Clause 15: Interpreting Part in accordance with OECD principles

The reference specifically to clauses 1, 3 and 12 looks rather odd. Why not include clause 13 as well, if the reference in the source legislation to "paragraph 1" is being literally translated as including all the clauses in which part of that paragraph have been rewritten

41. Paragraph 2(1) of Schedule 28AA (rewritten by this clause) requires the Schedule to be construed in such a way as best secures consistency between the effect given to paragraph 1 of the Schedule and the effect given to the OECD model treaty in accordance with the published transfer pricing guidelines.

42. We agree that clause 13 should also be included as a cross-reference in this clause, although a reference to subsection (2) of that clause is all that is necessary.

43. ***We agree in principle and an amendment will be made.***

In fact, however, a reference to section 12 alone, that being the actual operative provision, would surely be sufficient. The implication that this clause applies to clauses 1 and 3, but not to the various other interpretative provisions which also support clause 12 but happened to be included in different paragraphs in the source legislation, is actually rather misleading.

44. We consider that it is preferable to attach the clauses and subsection in which paragraph 1 is rewritten, not least because OECD terms are used in clauses 1 and 3.

45. ***We do not agree that an amendment is necessary.***

Clause 23: Meaning of "small enterprise" and "medium-sized enterprise"

The definitions of "small enterprise" and "medium-sized enterprise" could be relegated to Chapter 8; the definition could be reduced by referring directly to the Articles of the Annex to the Recommendation and to disapply Article 4 and set out the alternative rule.

46. The meaning of small and medium-sized enterprises is given in paragraph 5D of Schedule 28AA by reference to the Annex to the Commission Recommendation 2003/361/EC.

47. Because "small enterprise" and "medium-sized enterprise" are used only in Chapter 2 of the Part it would be unusual drafting practice to have the definitions of the terms outside the Chapter.

48. "Medium-sized enterprise" as used in Schedule 28AA is not defined in the Annex to the Recommendation but the Schedule 28AA definition works by excluding other categories in the Annex. "Medium-sized enterprise" cannot therefore have the meaning in the Annex to the Recommendation.

49. We consider it preferable to apply the Annex even in modified terms rather than disapply it, in part because the Articles should be interpreted by the remaining provisions of the Annex.

50. *We do not consider that an amendment is necessary.*

Clause 27: Interpretation of sections 25 and 26

The definition of “security” to include “securities not creating or evidencing a charge on assets” appears seven times as a result of the financing rules being integrated with the other provisions.

51. The reasons for integrating the finance rules are explained under the general structural points above.

52. The primary reason for repeating the definition is the need to be precise about the references that are and are not defined. In particular “security” is not defined in the full-out words of clauses 27(7), 29(4), 35(5), 45(3), 51(9), 53(8) and 55(80). It is easier to do this fine-tuning clause by clause, particularly where the definition is short, as it is here.

53. *We do not consider that an amendment is necessary.*

Clause 28: Claim by the affected person who is not potentially advantaged

A signpost to the definition of “the relevant activities” would be helpful, here and in clause 42.

54. The term “relevant activities”, defined in clause 71, is used in four other clauses as well as the two clauses mentioned in the response.

55. A signpost to clause 71 will be inserted into each clause that refers to “relevant activities”.

56. *We agree and an amendment will be made.*

Chapter 6: Balancing payments

It would be more useful to refer to “compensating adjustments” than to “balancing payments”

57. We consider that “compensating adjustment” is less helpful term to a non-expert looking at these provisions.

58. *We do not consider that an amendment is necessary.*

Clause 57: Elections made under section 54(1) and 56(1)

The reference to “paragraph (b)” should be to “paragraph (1)(b)” (of either section 54 or 56).

59. The reference in the clause is correct but could be made clearer. We will amend the clause to refer to the whole subsection.

60. ***An amendment will be made to clarify the subsection referred to.***

Clause 78

Q1. We welcome comments on the proposal to define “party” as any party to the agreement other than the Commissioners for HM Revenue and Customs.

We do not agree that the response relates only to administrative matters since a disapplication of an APA could result in a changed liability to tax.

61. It is accepted that the proposed change may not be a purely administrative matter in that it is clarifying the position of parties to the agreement in section 86(2)(b) and section 86(2)(4) of FA 1999.

62. ***No action is required as the change is to be removed.***

We agree that the rule relating to the provision of information by the taxpayer to the Commissioners applies only to the taxpayer. But it is less clear that the general rule on parties complying with the conditions applies only to the taxpayer.

There are often conditions set out in an APA and they are usually conditions on the taxpayer. Where this is the case, provided that section 86(2)(b) FA 1999 applies only to conditions expressly set out, the proposed change is as described in the explanatory notes.

What would be required is for the redrafted section to make it clear that this applies only to conditions expressly set out as such and not implied conditions or statements that might seem conditional elsewhere in the APA itself.

63. Each APA must be construed in accordance with its terms and conditions and the legislation governing APAs. It is not possible to redraft the legislation to ensure that failure by a party to the agreement to comply with a significant provision of the agreement means a failure by the taxpayer to comply only with the conditions expressly set out and not with implied conditions or statements that might seem conditional elsewhere in the APA. The position of the parties will be construed in accordance with the terms and conditions of the agreement and the legislation governing APAs.

64. In the light of the objections to the change suggested it would be preferable to leave the construction of the APA and the position of the parties to be carried out in accordance with the terms and conditions applicable and the legislation governing APAs and for this reason Change 1 will be removed. It is preferable not to introduce the Change solely for the provision of information as that would impose different interpretations on the same term (“party”).

65. ***We consider that Change 1 should be removed.***

Where section 86(2)(b) of FA 1999 applies this appears to result in a revocation of the entire agreement whereas section 86(2)(c) may apply to one question and not to others. This would make sense if section 86(2)(b) applied only to express conditions stated to be conditions on the APA having effect. “Significant condition” should therefore be defined as one expressly set out in the APA and “key condition” as not necessarily meaning something to which the entire agreement applies.

66. The clause uses “key condition” and “significant decision” to distinguish between the two types of conditions in section 86(2) of FA 1999. Paragraph (b) of that subsection refers to provisions of the APA, compliance with which is a condition of the APA (rewritten as “significant conditions”) and paragraph (c) refers to other conditions (rewritten as “key conditions”). There is no evidence that the “significant condition” should be expressly set out in the APA and it would be a matter of fact as to what constituted a “significant condition” as oppose to a “key condition”.

67. ***We do not consider that any amendment is necessary.***