



TRANSFER PRICING



VOL. 18, NO. 21

REPORT

MARCH 25, 2010

United Kingdom

United Kingdom Updates Thin Cap Manual; Practitioner Welcomes Expanded Guidance

H.M. Revenue and Customs Mar. 8 released a major rewrite of *Thin Capitalisation Cases: Practical Guidance*, International Manual INTM570000, updating its guidance to the nation's tax inspectors regarding 121 thin capitalization issues. [**International Manual, *Thin Capitalisation Cases: Practical Guidance*, INTM570000, H.M. Revenue and Customs, issued 3/8/10**]

Danny Beeton of Freshfields Bruckhaus Deringer LLP in London, who welcomed the expanded guidance, said it includes useful lists on:

- factors tending to increase an interest rate (at International Manual 577030);
- a typical private equity buyout funding structure (INTM580020);
- a model advance thin capitalization agreement (582090);
- the general form of third-party loan agreements (584010);
- factors that rating agencies use to determine credit ratings (586120);
- a list of ratings and how they should be interpreted (586140);
- factors that should be adjusted for when using market yields as interest rate benchmarks (586160); and
- an international survey of thin cap rules by country (581010).

Ratios. Beeton said the manual also acknowledges that financial ratios may be looser when loans are secured against assets, particularly property, in which case the loan-to-value may be the most appropriate ratio to consider (579010 through 579060), and other types of fees may be charged in addition to interest, including loan arrangement and facility fees (584040).

The updated guidance provides helpful examples including the calculation of interest cover (577130) and the debt-to-equity ratio (578110), he said.

Also helpful, Beeton said, are the references to sources used by HMRC such as the Bank of England Quarterly Bulletin (578060) and the De Montfort Uni-

versity report *The UK Commercial Property Lending Market* (579030), as well as the guideline figures from which HMRC operates such that "a debt equity ratio greater than 0.6:1 is rare in most publicly-quoted companies" (578040).

Further Development. Beeton said there may be scope for further development of how covenants in senior bank loan agreements can be adjusted to determine the appropriate financial ratio covenants for related-party subordinated loans (580070).

HMRC officials are aware of certain conventions in use in the U.K. transfer pricing marketplace, Beeton said, "but do not wish to be prescriptive on this point, and also wish to encourage each case to be considered on its merits."

Beeton said HMRC also has received submissions from U.K. practitioners expressing concerns that some taxpayers are regularly enjoying the benefit of certain conventions of which other taxpayers are unaware.

The practitioner said HMRC has informally invited suggestions on how this aspect of the guidance could be developed within the framework of HMRC's general principles.

Comparability. The revised guidance at 576020 recognizes that the debt ratios of similar independent businesses is the other common approach that can be used by taxpayers to determine the arm's-length debt ratios in the absence of bank loan covenants, Beeton said.

However, he said taxpayers have expressed a general concern that the revised guidance's discussion of this approach may be setting the comparability bar too high.

Beeton said the approach of the revised guidance would thus seem to follow a pattern established by the recent *DSG Retail Ltd.* case and the proposed revision to the Organization for Economic Cooperation and Development transfer pricing guidelines.

DSG international plc agreed April 30 to an income tax charge of £52.7 million (US\$85.3 million) following a decision by the U.K. Special Commissioners in March that rejected the taxpayer's comparables and found that DSGi had paid more than arm's-length compensation to its Isle of Man captive reinsurer for extended consumer electronics warranty coverage (18 *Transfer Pricing Report* 112, 6/11/09).

The OECD's draft of revised transfer pricing guidelines chapters I, II, and III, released Sept. 9, includes a new Chapter III that recommends a 10-step process for performing the taxpayer's comparability analysis (18 *Transfer Pricing Report* 402, 9/10/09).

Beeton pointed to the paragraph at INTM576020 of the revised guidance, which reads "comparables are usually presented to HMRC in a fairly superficial way, without detailed comparison of factors such as position in the market, risk profile, product range and durability, strength of management team, acquisitiveness, success of current strategies, and depth of innovation."

BY KEVIN A. BELL

□ *Thin Capitalisation Cases: Practical Guidance*, issued by HMRC on Mar. 8, may be found at <http://www.hmrc.gov.uk/manuals/intmanual/intm570000.htm>.

HMRC's sister thin capitalization manuals, *Intra-group Funding (International Manual 500000)*, *Thin Capitalisation: Legislation and Principles (INTM540000)*, and *Thin Capitalisation: FA2004 Legislation (560000)*, may be found at <http://www.hmrc.gov.uk/manuals/intmanual/Index.htm>.

□ For a discussion of transfer pricing in the United Kingdom, see 895 T.M., *Transfer Pricing: European Rules and Practice*.