Advance Thin Capitalisation Agreements

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The benefits to a business of agreeing an advance thin capitalisation agreement (an "ATCA") with HMRC are clear. The intention is that the business or group can then plan its operations and investment over a number of years safe in the knowledge that, within the agreed bounds set in the ATCA, interest payable on its debt will be deductible for tax purposes. HMRC wins too because agreeing an ATCA saves time and effort testing whether each entity’s debt complies with the UK thin capitalisation and transfer pricing regime.

An ATCA covers the thin cap treatment of one or more particular borrowers, and may extend, in appropriate cases, to other issues such as interest imputation and the taxation of finance and treasury companies. In much the same way that being party to an ATCA in the UK does not change or override any obligation to withhold from interest payments, the thin cap rules in other Member States generally operate independently of the rules on withholding.

In line with the HMT and HMRC’s efforts to deliver the Government’s "open for business" message, the publication of the revised Statement of Practice on ATCAs (SP 1/12) is to be welcomed.

STATEMENT OF PRACTICE 1/12

The new Statement of Practice does not differ dramatically from the Statement of Practice it replaced (SP 4/07). Taxpayers will welcome the fact that the Statement continues to reflect the principles which operate in practice when seeking to negotiate an ATCA with HMRC:

- the Statement acknowledges that as transfer pricing is particularly fact-sensitive it is helpful to be able to discuss the issues as close to real time as possible;

- applications for an ATCA are required to include background material providing a working knowledge of the business or group under consideration; and

- the model ATCA (included as an Annex to the Statement) is stated to be merely a possible template for the agreement – it is recognised that the model will not be appropriate for all applications, but should provide a useful framework.

The above demonstrates that ATCAs are not negotiated with HMRC in the abstract but are tailored to the position of the business or group. Companies can therefore discuss with HMRC the life cycle of their business, whether it is still developing in the relevant jurisdictions or mature, its need for capital, and whether the state of the UK business is broadly in line with the rest of the group or whether its needs are different. In consequence, an ATCA can be negotiated so as to, for example, apply different ratios to different accounting periods to reflect the anticipated growth of the business.
So far, so positive. However, looking at the approach taken to related-party debt in other European jurisdictions, the question arises as to whether HMRC could, or should, have gone further. In particular, the UK does not have any “safe harbours”, either in statute or in this Statement, and an ATCA only acts as a shield for a taxpayer threatened with interest disallowances under the thin cap regime; there is nothing to prevent debt which satisfies these criteria being disallowed by other provisions.

SAFE HARBOURS

Looking around Europe it is common to find that the thin cap rules provide one or more "safe harbours" that a taxpayer can rely upon without the need for recourse to bilateral discussions with the relevant tax authority. Common themes to these safe harbours include statutory debt to equity ratios, interest cover ratios or comparisons of the debt or interest burden in the local territory with the debtor interest burden of the worldwide group as a whole. The French experience is outlined in the box below, and taxpayers can also rely on safe harbours in Germany and Spain. At least superficially, these safe harbours would seem to offer taxpayers a clear and unambiguous shield against any attempt to disallow interest deductions, albeit perhaps at the cost of greater flexibility.

Pierre-Henri Durand of Bredin Prat comments on the French experience of safe harbours

French thin cap rules only apply to related-party loans (or deemed related party loans such as third party loans guaranteed by a related party). In short, they do not apply if the borrower fulfils either:

- a 1.5:1 debt to equity ratio threshold, or
- a 25% adjusted EBITA interest coverage threshold, or
- an interest income threshold.

French borrowers can also rely on an "overall group leverage" safe harbour if they can evidence that their debt to equity ratio is lower than that of their group.

Overall, these rules generally offer valued flexibility and a reasonable degree of legal certainty to French borrowers (mostly through the 1.5:1 debt to equity ratio). However, they lack an industry-specific safe harbour and they cannot be negotiated on a case-by-case basis with the French tax authorities.

OTHER DISALLOWANCES: PURPOSE OR QUANTUM

The Statement is clear that, consistent with HMRC’s approach during the negotiation of an ATCA, an ATCA "will only cover financing provisions within TIOPA 2010 s 218(2), and the only part of that subsection relevant to thin capitalisation”. This specific approach is understandable in the context of the anti-avoidance rules, such as the unallowable purpose test in CTA 2009 s441 and the anti-arbitrage rules. Just because an entity is not thinly capitalised does not mean that one of that entity’s main purposes for being party to the debt in question is not “bad” or otherwise unallowable.

02 SLAUGHTER AND MAY
Perhaps less justifiable, however, is the (lack of) interaction of an ATCA with other statutory restrictions on the deductibility of interest that relate to overall debt levels. Most notably, even though a multinational organisation has agreed an ATCA with HMRC confirming the “right” level of debt for the specific UK sub-group, that UK sub-group can still suffer a disallowance under the worldwide debt cap provisions in TIOPA 2010 Part 7 if the global debt position of the multinational changes. With no change to the operations or funding in the UK, and in particular no breach of the earnings to interest or debt to equity ratios that have been agreed with HMRC, the UK group can still find itself subject to a disallowance. This can be quite hard to explain to a non-UK tax client who had thought that the UK debt levels had been agreed with HMRC!

**SHOULD HMRC GO FURTHER?**

In relation to safe harbours, the attractiveness of “bright line” provisions is clear but even a fairly brief survey of the different debt profiles and funding arrangements for businesses, both within Europe and worldwide, reveals that greater flexibility can be a real asset when it comes to tax planning. Whether this flexibility reflects changing economic circumstances and the availability of bank finance or the evolving nature of the business in question, the UK’s approach allows a taxpayer and its advisers to have a sensible discussion with HMRC about what is most appropriate in their particular circumstances – and then reach a binding agreement which can last for up to 5 years.

In relation to the interaction with other elements of the UK tax regime, however, there is perhaps scope for an ATCA to go further. This is particularly so when deciding the “right” quantum of UK debt. Under the shadow of Wilkinson v HMRC [2010] SFTD 1063, Hanover Company Services Ltd v HMRC [2010] SFTD 1047 and R (on the application of Gaines-Cooper) v HMRC [2011] STC 2249, however, any such extension should be through primary legislation rather than HMRC statements of practice or guidance. Simply extending TIOPA 2010 s 218(2) to enable protection to be obtained as to the application of the worldwide debt cap, which is concerned solely with the quantum of the debt rather than purpose of the borrowing, would significantly increase certainty for taxpayers.

**CONCLUSION**

The advantages of agreeing an ATCA with HMRC remain clear – certainty and reduced compliance for business and less risk for HMRC. Each ATCA will necessarily need tailoring to reflect the operations and financing arrangements of the business or group in question. This means it will continue to be important for both business (and its advisers) and HMRC to be flexible in negotiating changes to the suggested model form (or any agreements already in place).

Although safe harbours or indeed other “bright line” tests can appear attractive in giving certainty, that certainty comes at a cost. There may well be potential to improve the scope and application of ATCAs in the future but retaining the flexibility and adaptability of the UK’s approach should give better results for business in the long term.

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