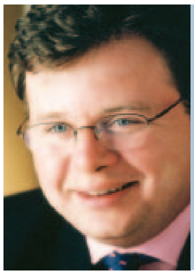
Finance Bill 2009 update: a new basis for the taxation of foreign profits



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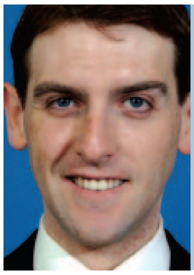

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OUR UPDATE THIS MONTH FOCUSES ON THE DRAFT legislation and explanatory notes produced by HM Revenue & Customs (HMRC) and HM Treasury in December 2008 that introduces a new regime for the taxation of foreign profits.

It is acknowledged in the explanatory notes that the legislation is very much in draft form to allow enough time to conduct a proper consultation process. However, the majority of the issues arising from the draft legislation stem from the underlying policies directing the legislation. After outlining the approach of the draft legislation, we consider some of the difficulties that taxpayers and advisers may face in adjusting to the new regime.

WORLDWIDE DEBT CAP AND EXTENSION OF THE UNALLOWABLE PURPOSE RULES

The introduction of the worldwide debt cap for large groups (s9(1) of the draft legislation) and the expansion of the unallowable purpose rules (para 13) is seen by the government as necessary to deliver a 'balanced and affordable package' of tax reforms in relation to foreign profits. The fear of the government is that without the restriction of interest relief the introduction of the dividend exemption would place too great a risk on the UK tax base.

The aim of the worldwide debt cap is to restrict groups of companies from pushing debt into UK entities that exceeds the group's external borrowing. In other words, the debt cap assumes that interest is only deductible if it represents the movement of external finance into a UK company.

The draft legislation achieves this by comparing two figures, the 'tested amount' and the 'available amount'. The amount of allowable deductions are restricted if the tested amount exceeds the available amount.

Tested amount

The tested amount represents the total intra-group finance expenses in the UK from the corporation tax computation of each relevant group company. 'Relevant group company' is defined as any UK company which is either:

i) the ultimate parent of the worldwide group; or

ii) a 75% subsidiary of the ultimate corporate parent.

The tested amount is calculated by adding the net loan relationship and derivative contracts debits to any finance costs from finance leases for plant and machinery and debt factoring arrangements from the relevant corporation tax computations.

The important point to note is that the tested amount is based on a tax figure, representing the finance expenses that would, apart from the application of the debt cap, be available after all other adjustments and anti-avoidance provisions have been applied. In other words, the calculation of the tested amount is based on the finance expenses that would be allowable after applying, for example, the transfer pricing rules and the unallowable purpose anti-avoidance legislation. The schedule also contains detailed provisions that allow certain amounts to be disregarded for businesses in the financial services industry, and an anti-avoidance provision to prevent companies reducing the tested amount by channelling intra-group financing through third parties under back-to-back arrangements.

Available amount

The available amount is defined as the non-UK external finance of the group less the external finance income of the group. These figures are derived from the consolidated profit and loss accounts of the group for the relevant period. UK external finance income is removed from the calculation as it is accepted that external financing is not within the scope of the debt cap and therefore should continue to be allowable. The draft legislation contains provisions that disallow certain amounts relating to businesses in the financial services industry that mirror the provisions in relation to the tested amount.

The available amount is therefore based on an accounting figure, rather than a tax figure. The draft legislation states that references to financial statements are to international accounting standards (IAS) consolidated accounts of the group. If the group accounts are prepared in accordance with another basis, such as local generally accepted accounting principles (GAAP), and those figures are materially different from the figures that would be produced if the company accounted under IAS, then the IAS figures will apply for the purposes of the debt cap. Whether or not required by law, the draft legislation requires a group of companies to produce IAS accounts to determine how the debt cap applies, if only to determine whether the draft legislation applies.

Disallowance of deductions

The finance expenses of the relevant group companies are disallowed to the extent that the tested amount exceeds the available amount. In other words, the available amount (representing the non-UK external finance expense) effectively 'franks' the tested amount (intra-group finance income of the relevant group companies).

The relevant group companies are then required to allocate the aggregate disallowed amounts amongst each of the entities and this is achieved through filing additional tax returns detailing the tested amount and available amount calculations and the requisite allocations. If the returns are not filed then the disallowed amounts are allocated according to a statutory formula.

In summary, the application of the worldwide debt cap has two broad effects:

1) direct external borrowings by UK companies remain allowable (subject to paragraph 13 of Schedule 9 to the Finance Act 1996); and

2) intra-group borrowing will be allowed provided it does not exceed the external non-UK financing of the worldwide group.

Exempt income

The debt-cap draft legislation also introduces the concept of exempt income where a relevant group company has to make a disallowance in respect of its intra-group finance expenses.

There are two exempt classes of income:

1) UK intra-group finance income to which there is a corresponding disallowance; and

2) non-UK intra-group finance income (but only from 75% subsidiaries).

The exempt income, regardless of which category it falls into, is limited to the total disallowed amount. The group is required to make similar returns allocating the exempt income that mirror the disallowance allocation described above.

Extension of the unallowable purpose rules

Paragraph 13 of Schedule 9 to the Finance Act 1996 contains an anti-avoidance provision that states that where a loan relationship of a company has an unallowable purpose (broadly, a tax avoidance purpose), the finance expenses in relation to that loan relationship will not be allowable as a deduction against profits.

The draft legislation extends the current anti-avoidance provision, as it will be necessary to consider not just the purpose of the loan relationship itself but also the purpose of the arrangements of which the loan relationship forms a part. In other words, interest expenses on a loan that has a genuine commercial purpose will not be allowable if the loan forms part of a wider scheme of arrangements with a tax avoidance purpose.

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A proportionate protection for the Exchequer?

The scope of the debt cap has been widely reported in the press as it was thought that the government would introduce an anti-avoidance provision targeting only up-stream loans. Limiting interest relief in such a general way appears to be at odds with the arm's length principle, in that a company can no longer claim interest relief on expenses that would have arisen had the loan finance been obtained from a third party. The government is now taking the approach that interest expenses are only allowable if they represent the movement of actual external finance into a UK company.

In addition, it would also seem arguable that the proposed debt-cap rules are not consistent with EU law, as UK intra-group finance and intra-group finance from outside the UK will give rise to different tax effects for a group. This is due to the fact that the combination of the disallowance of deductions and exempt income entails that UK intra-group finance is essentially disregarded. In response the government may argue that it cannot control the taxation of intra-group finance income in other jurisdictions. However, if the government was to fail to defend the charge that the draft legislation is not compatible with EU law, would it be able to argue that the legislation is a proportionate derogation to combat tax abuse?

On a more practical level, although the government has removed the burden of double tax relief calculations on foreign dividends, it has introduced a new compliance burden on taxpayers, both in calculating the available and tested amounts and completing the additional returns that will now be required.

Preserving the UK tax base and making the UK an attractive place for international business will always be a fine line for the government to tread. However, the overriding concern seems to have been with the lack of certainty over the UK taxation of foreign profits. The new debt cap does little to allay those concerns. At any point in time, how is a taxpayer to know whether an interest expense is deductible, when the issue is only ultimately determined when the tax returns and consolidated accounts for the group are completed? How can a UK company in a large group predict with any certainty whether their intra-group interest expenses will be allowable, when the matter depends on the gearing of other members of the group?

The extension of the unallowable purpose rules create even greater uncertainty, as even loans that have a genuine commercial purpose may fall within the widened provisions. For example, would a bank › have to consider whether the interest expense on capital it raises in the market is deductible if it lends the capital to companies that may be pursuing an otherwise unconnected scheme with a tax avoidance purpose?

It remains to be seen whether the government can answer these questions within the framework of the draft legislation it has created.

DIVIDEND EXEMPTION AND CFCs

The broad effect of the proposed exemption system for dividends is to provide an exemption from UK corporation tax for dividends received by large and medium companies, regardless of source. The reforms also include the restriction of some of the current exemptions that take overseas subsidiaries out of the current controlled foreign company (CFC) rules. The new regime represents a shift in Treasury policy towards a more territorial system of taxing foreign subsidiaries and aims to ensure that genuine profits earned in foreign subsidiaries will not be subject to UK taxation. The shift towards a territorial system of taxation signals the end of the credit system of taxation for the majority of dividends paid to medium or large companies, although it will still be relevant for small companies and limited distributions to medium and large companies.

The Treasury drafter, motivated perhaps by concerns over tax avoidance and EU compliance, has drafted a set of rules that are detailed and overly complex. Their task has been made more difficult by the fact that, to comply with EU law, the new draft legislation will apply to all dividends, with the current exemption on UK company distributions being abolished.

The major difficulty with the draft legislation is its structure. Taxpayers and advisers are required to navigate a series of hurdles before determining whether the new exemptions will apply. Even then, it is necessary to consider whether any of the prescribed anti-avoidance provisions apply.

The exemption

The proposed new rules will only apply to large and medium-sized UK companies and UK permanent establishments of large and medium-sized companies. Participation dividends paid to small companies (as defined by the European Commission Recommendation 2003/361/EC of 6 May 2003[1]) will remain taxable with a credit for any underlying tax paid.

Further, to qualify for the exemption, the distribution must not fall within s209(2)(d) or s209(2)(e) of the Income and Corporation Taxes Act (ICTA) 1988. These provisions relate to interest or distributions paid in respect of certain securities, and according to the guidance released with the draft legislation, HMRC's view is that, in practice, almost all of these amounts are not taxed as distributions and, accordingly, it would not be appropriate to exempt these payments from UK taxation. Although, there is some justification for HMRC's view, the draft legislation does create a new class of taxable distributions where the return on a security represents more than a reasonable commercial return and the charge on the recipient is not fully mitigated by a compensating adjustment under the transfer pricing regime.

In addition, for the exemption to apply, the dividend must not be tax-deductible in the payer's territory, nor be of a capital nature. Finally, a dividend will not be exempt to the extent that the dividend was paid by a CFC to pursue an acceptable distribution policy (ADP), which will still be possible in respect of accounting periods ending before the implementation of the draft legislation.
The government proposes to withdraw the ADP exemption at the same time as these new rules are introduced, but the proposed exemption will preserve the entitlement to an ADP exemption for earlier periods for which dividends are paid at a time when the dividend would otherwise be exempt.

Exempt classes

For all other distributions it is then necessary to determine whether the distribution falls within one of the exempt classes. There are five exempt classes of dividend that apply to both UK and foreign dividends. Distributions may fall within one or more of the exempt classes but it is sufficient to fall within one of them for a distribution to be exempt, provided the anti-avoidance rules (outlined below under 'Targeted anti-avoidance schemes') do not apply.

i) *Distributions from controlled companies*
The first exempt class applies whenever a distribution is paid to a parent company that controls the company making the distribution. The definition of control is taken from the CFC legislation at s755D ICTA 1988, which was extended in the Finance Act 2008 to include control exercised by income and asset rights in addition to control by voting rights.

ii) *Distributions in respect of non-redeemable preference shares*
The draft legislation includes a specific exemption for distributions paid in respect of non-redeemable preference shares. To benefit from this exemption, the draft legislation requires that the relevant shares are not

specifically redeemable under the terms of issue, and there must not be collateral or other types of arrangements to allow the investor to become entitled to amounts that are the same as what it might receive on redemption.

iii) *Distributions from portfolio holdings*
A distribution will fall into this class if the recipient of the distribution taken together with all connected companies, has 10% or less of the share capital issued for the class of share in respect of which the distribution was paid, and 10% or less of the rights to income or assets. This exemption ensures that the UK tax treatment is in line with EU law following the decision by the ECJ in *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* [2006].[2]

iv) *Distributions derived from transactions not designed to reduce tax*
This exempt class is available provided that no part of the distributable profits of the paying company arise through transactions whose purpose was to divert profits for the purposes of obtaining a UK tax advantage. A distribution will be treated as exempt if none of the transactions that give rise to distributable profits in the paying company achieved a reduction in UK tax, or, if the transaction did result in a reduction in UK tax, the reduction so achieved was minimal or else it was not one of the main purposes of the transaction(s) to achieve that reduction.

This class is intended to ensure that the exemption will still be available in circumstances where the distribution does not satisfy the conditions of the first three exemptions.

v) *Distributions in respect of shares accounted for liabilities*
The final class of exemption applies to dividends paid in respect of shares that are accounted for under GAAP as loan relationships. This would seem to include redeemable preference shares that would be wholly accounted for as debt under IAS. The intention is that returns on trust securities will be taxed under the new 'disguised interest' provisions to be introduced in the Finance Act 2009.

Targeted anti-avoidance schemes
Even if a distribution falls within an exempt scheme, the distribution will still be taxable if it falls within one of the five prescribed tax anti-avoidance schemes explained below, the main purpose, or one of the main purposes, of which is to obtain more than a negligible tax advantage.

i) *Schemes involving quasi preference shares*
This anti-avoidance rule is intended to prevent abuse of the exempt class available for ordinary shares. If a share is issued on terms that make it an ordinary share, but side agreements are such that the shareholder obtains rights consistent with those that might have been obtained from the preference share, then the share will be classed as a 'quasi-preference' share and the scheme or arrangement would fall within this prescribed scheme.

ii) *Schemes involving payments for distributions*
The dividend exemption will not apply in circumstances where the recipient, or a person connected with the recipient, makes a payment or gives up income in return for a distribution. Such dividends will be taxable with a credit for any underlying tax paid.

iii) *Schemes involving payments not on arm's length terms*
This prescribed scheme would apply in circumstances where goods or services are paid for on terms that differ from the arm's length price and the reason for the difference in price is that one of the parties expects to receive a distribution.

iv) *Schemes involving manipulation of controlled company rules*
This prescribed scheme focuses on the abuse of the CFC exempt class outlined above. Broadly, it protects against schemes that seek to obtain the benefit of the exempt class without exposing profits to the CFC regime by manipulation of the ownership of a foreign company.

v) *Schemes in the nature of loan relationships*
This prescribed scheme applies in respect of certain distributions that form part of an arrangement that produces an interest-like return for the recipient, together with any connected person. The draft legislation includes a number of carve-outs from this anti-avoidance rule, with the effect that this scheme will only apply where there is a connection between the payer and the recipient other than one that constitutes control of the payer by the recipient.

CFCs and Treasury consent
The proposed reforms also include the removal of some of the current exemptions that take overseas companies outside the scope of the CFC rules. The government has amended the existing CFC rules and removed the ADP exemption, which allows a CFC to be exempt if it distributes at least 90% of its profits back to the UK via a taxable dividend within ›

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18 months of the end of the accounting period. The second change to the CFC rules relates to the abolition of the special rules for holding companies that are included within the exempt activities CFC exemption. For companies with existing holding company structures there will be a 24-month transitional period, which will allow groups to restructure existing holding company structures before the rules apply.

A wider reform of the CFC rules will be deferred and will be subject to further consultation. No indication of timing has been provided by the government with respect to this consultation, but it is not expected that the process will be completed in time for inclusion in the Finance Bill 2010. There has been no indication of the scope of the new rules, however, it is still expected that objective of the new rules will be to modernise the CFC rules while aiming to protect against the artificial diversion of profits from the UK.

In conjunction with the proposed new dividend exemption rules, the government has abolished the Treasury consent regime and replaced these rules with a new reporting requirement for certain transactions with a value of more than £100m. The proposed rules do not include as many carve-outs as the previous Treasury consent regime. However, the draft provisions do provide for further transactions to be excluded by regulations. In any case, the removal of the criminal sanctions for both directors and advisers has certainly been welcomed by advisers and directors of companies.

A clear exemption?

The proposed new rules are unnecessarily detailed and complicated and, although the exemptions are wider than anticipated, a clearer exemption, similar to those in other EU jurisdictions, would have been preferable. The complications are driven by the government's wish to deal with anti-avoidance without the introduction of a general anti-avoidance rule that would create too much uncertainty over the application of the provisions. Although the draft legislation is overly complex, the government's decision to target only prescribed anti-avoidance scenarios may be a blessing in disguise. HMRC does not intend to introduce a specific clearance procedure for the dividend exemption, so taxpayers who are uncertain about the applicability of the new rules (and in particular whether the anti-avoidance rules will apply) will need to consider whether to make an application to HMRC under the Code of Practice 10 procedure to confirm whether the new exemption will apply to a dividend payment.

Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue [2006] Case C-446/04, 12 December 2006

Whether the proposed new rules will be sufficient to cease or reduce the number of corporate migrations from the UK to more favourable tax environments remains to be seen. The key issue for corporates and businesses will be the proposed reform of the CFC rules. Unless the new CFC rules are suitably amended, the latest package of reforms introduced by the Treasury will do little to reduce the number of multinationals considering migrating from the UK.

ALL BAD NEWS?

The shift to a dividend exemption and loosening of the Treasury consent regime will be welcomed by taxpayers, but the concessions come at a price. The dividend exemption is overly complex and its value will not become fully clear until the draft CFC rules are produced. The new debt cap and extension of para 13 are of even greater concern, due to the uncertainty they create over the availability of deductions. However, the rules are in their infancy. What remains unclear is whether the government will be able to substantially improve the draft legislation within the confines of its policy objectives.

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NOTES

1) Broadly, to be a treated as a small company, it must employ less than 50 employees and either have turnover or a balance sheet total that does not exceed €10m. For the purposes of these rules, no open-ended investment company, authorised unit trust scheme, insurance company or friendly society is included within this definition.

2) In this case the ECJ determined that the UK taxation of portfolio dividends contravened Article 56 of the EC Treaty by permitting neither exemption or credit for underlying tax.

REFERENCE POINT

The draft legislation discussed in this article is available on the HM Revenue & Customs website at:

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_029074