Changes to the grouping rules and foreign denominated losses

BY BLAISE MARIN-CURTOUD
partner,
Jones Day

BY IAN REID
associate,
Jones Day

ON 18 DECEMBER 2008, THE GOVERNMENT announced that it proposed to introduce new legislation in the Finance Bill 2009 to address two distinct problems that have arisen as a consequence of the recent turbulence and volatility in the global financial markets. Although the issue has come to light with regard to the financial sector, the new rules will apply to all relevant companies and not only those companies within the banking industry.

PREFERENCE SHARES: GROUP RELIEF

Background

The Financial Services Authority (the FSA) regulates banks and ensures that they have sufficient capital reserves to satisfy customer demand, absorb losses and maintain liquidity, by means of prudential regulation. Regulatory capital is defined in the UK in terms of Tier 1, 2 and 3 capital, moving from equity to various kinds of debt.

Tier 1 capital is the highest form of capital of the bank and is regarded by the FSA as broadly equivalent to equity. To qualify as Tier 1 capital for regulatory purposes, banks must issue preference shares that are 'non-cumulative'. This means that these shares do not carry a right to a dividend where paying one would risk breaching the bank's capital requirements. These shares do not qualify as fixed-rate preference shares as defined for tax purposes on the basis that the dividend is not fixed.

As a result, banking groups seeking to boost their capital base in the present financial market conditions may no longer form a group for tax purposes in circumstances where they issue perpetual non-cumulative preference shares. This can trigger various tax charges and cause restrictions in the future on the surrender of group relief between members of a group.

The government proposes to change the rules for accounting periods beginning on or after 1 January 2008. These new rules will only apply to new share issues. This change will ensure that preference shares that would qualify as fixed-rate preference shares but for the issuer having the right to pay a lower dividend or no dividend in any accounting period in certain defined circumstances, be treated in the same way as fixed-rate preference shares for tax grouping purposes.

Draft legislation

HM Revenue & Customs (HMRC) has published draft legislation that will amend Schedule 18 to the Income and Corporate Taxes Act (ICTA) 1988. The rules in Schedule 18 establish who are regarded as the equity holders in a company and to what extent, by reference to their shareholdings or entitlement to share in the company's distributable profits or assets. The rules are used primarily to determine a company's entitlement to surrender or claim group relief from related companies for trading losses and other amounts.

An equity holder of a company is defined in paragraph 1 of Schedule 18 to ICTA 1988 as any person who:

a) holds ordinary shares in the company; or

b) is a loan creditor of the company where the loan is not a normal commercial loan.

The proposed amendment relates to the first condition.

A person who holds ordinary shares in a company is defined as an equity holder. Ordinary shares include all shares other than fixed-rate preference shares pursuant to Schedule 18, para 1(2). The definition of fixed-rate preference shares is set out in paragraph 1(3) of Schedule 18. To qualify as fixed-rate preference shares, the shares must not carry a right to a dividend, other than dividends that are limited to a fixed amount or a fixed percentage of the nominal value of the shares, representing no more than a reasonable commercial return on the new consideration received by the company.

The previous exclusion from treatment as an equity holder for holders of fixed-rate preference shares is replaced by a new exclusion for holders of 'relevant preference shares'. Relevant preference shares must be issued for new consideration, so cannot, for example be a bonus issue. They may carry no rights to dividends, or rights that fulfil the conditions set out in new paragraph 1A of Schedule 18 to ICTA.

Shares that carry no rights to dividends are treated as relevant-rate preference shares.

Where preference shares carry a right to a dividend, they will be relevant preference shares if they fulfil the 'reasonable commercial return' condition and one of conditions A, B or C set out in the draft legislation. The reasonable commercial return condition is carried over from the definition of a fixed-rate preference share, so is unchanged. Condition A will be satisfied by shares that carry rights to a dividend and would previously have been regarded as fixed-rate preference shares. Condition B will be satisfied where the dividend payable on the shares is not fixed absolutely, but is fixed by reference to a published variable rate, either a market rate of interest such as a central bank base rate, or to an appropriate retail price index. Condition C is met in cases where condition A or B would have been met, but for the fact that the company has a right to reduce the dividends paid on the preference shares below the nominal rate in circumstances that are covered by the 'relevant circumstances' set out in the draft rules. Broadly, a company will be permitted to reduce or not pay dividends when either:

1) the company is in severe financial difficulties at the time the dividend is or would have been payable; or

2) to comply with a legal requirement or to follow a recommendation of a relevant regulatory body.

FOREIGN DENOMINATED LOSSES

Background

Where a company computes its profits or losses for corporation tax purposes in a currency other than sterling, current tax rules require the company to carry forward or back any unused losses in sterling. This means that the measure of losses translated into sterling when incurred will offset a different measure of profits translated into sterling arising in a previous or subsequent accounting period. Accordingly, this leads to exchange exposure for both the company and the Exchequer.

This exposure has recently become a significant issue for several companies whose profits are computed for tax purposes in a currency other than sterling, due to exchange rate volatility. The present financial climate has brought this issue into sharp focus and it is an issue of particular concern to foreign banks trading in the UK.

In response to this, a written statement presented to Parliament by the Financial Secretary to the Treasury, dated 18 December 2008, announced the government's intention to allow companies to carry forward and back unused losses in the currency in which they were computed.

Draft legislation

The proposed new rules seek to ensure that where a company computes its profits or losses for corporation tax purposes in a currency other than sterling, any losses carried forward to future accounting periods or back to a previous accounting period will be translated into sterling at the same exchange rate as the profits they are offsetting.

The draft legislation changes the current rules to ensure that any unused losses at the start of a company's first accounting period beginning on or after 1 January 2008 will be converted into its functional currency at the spot rate for the start of the period and carried forward in its functional currency. All future losses will be carried forward in the company's functional currency.

Transitional rules

Transitional rules will apply where a company has unused losses brought forward at the start of the first accounting period after the commencement of these rules and those losses were computed in a currency other than sterling. In these cases, the brought-forward losses will be converted back into the currency in which they originated, although an election is available to allow companies to only apply the changes outlined above to losses incurred in accounting periods beginning on or after Royal Assent.

WHEN ARE NON-RESIDENT TRUST COMPANIES SUBJECT TO UK TAXATION?

Background

There have been longstanding tests to determine the residence of trustees, to establish whether the trust of which they are a trustee is subject to UK tax. However, these rules were different for income tax and capital gains tax, with the result that trustees could be UK-resident for income tax purposes but non-UK-resident for capital gains tax, or vice versa.

The Finance Act (FA) 2006 changed this position as part of the trust modernisation programme. Specifically, the government amended the trustee residence test and introduced a common test for both income tax and capital gains tax. The new legislation, s69 of the Taxation of Chargeable Gains Act (TCGA) 1992 (and for income tax, s475 of the Income Tax Act (ITA) 2007) took effect on 6 April 2007.

The rules include the provision (s69(2D) TCGA 1992 and s475(6) ITA 2007) that a trustee will be treated as a UK resident when they act as a trustee in the course of a business that they carry on through a 'branch, agency or permanent establishment' in the UK.

In practice there has been some confusion as to how these rules apply in certain circumstances. Accordingly, HMRC has issued draft guidance on the application of the residence tests in relation to overseas companies to clarify whether certain non-resident corporate trustees would be considered to be UK-resident. The draft guidance sets out several examples and highlights how HMRC would treat each of the scenarios in light of the new rules. The guidance will act as a useful aid for non-resident trustee companies and their advisers to determine whether and in which circumstances non-resident trustee companies may be treated as UK-resident.

Branch, agency or permanent establishment

HMRC accepts that for trustees the 'branch' and 'agency' tests apply to non-corporate trustees and the 'permanent establishment' test to corporate trustees.

In deciding whether the business of a particular trust is being carried on in the course of the corporate trustee's business through a permanent establishment, HMRC will generally pay special attention to where the core activities of the trustee are carried out. Broadly, if the core activities (and not those activities that are auxiliary or preparatory) are being carried on in the UK through the corporate trustee's permanent establishment, the trustee would be treated as UK-resident for the purposes of that particular trust.

What are trustee core activities?
The guidance published by HMRC states that the core activities of a trustee would be regarded as including:

i) the general administration of the trust;

ii) the over-arching investment strategy;

iii) monitoring the performance of those investments;

iv) making decisions on how trust income will be dealt with and whether distributions should be made; and

v) accounting, making tax returns and record keeping.

There are other activities that trustees carry out which are not core activities central to the conduct and management of the trust, but instead should be considered to be preparatory or auxiliary activities. These activities would generally include information-gathering meetings, such as meetings with independent agents, advisers or beneficiaries.

Preparatory work prior to the creation of any trust
A non-resident trustee company may carry out several activities in the UK before the trust is created. Generally, introductory meetings and discussions with specialist professionals about possible trust investments and assets will be regarded as preparatory or auxiliary activities and not core activities.

Trustees carrying out duties for the administration of any trust
The examples provided in the guidance indicate that when considering whether the corporate trustee is carrying on the business of a particular trust in the course of their business through the permanent establishment, HMRC will be particularly be interested in the frequency of the meetings, as well as their significance and quality.

Each case will depend on the particular facts and circumstances and whether the relevant meeting(s) will give rise to a permanent establishment will be dictated by the significance and frequency of the meeting(s).

> 'Where a company computes its profits or losses for corporation tax purposes in a currency other than sterling, current tax rules require the company to carry forward or back any unused losses in sterling.'

Activities carried on for the trust other than by the non-UK-resident corporate trustee
A trustee may also be treated as having a permanent establishment in the UK if activities are carried on in the UK on the non-resident corporate trustee's behalf by a dependent agent.

The activity of providing services to a non-resident trust, whether by a connected person or not, does not of itself create a dependent agency permanent establishment. It is necessary to consider the capacity in which the person provides the services to the trust on behalf of the non-resident trustee. Where the services that are provided to the trust are only those that the person is contractually obliged to provide under their agreement with the non-resident trustee and are remunerated at arm's length, then this is unlikely to create a dependent agency permanent establishment.

Whether there is a dependent agent permanent establishment will depend on the facts of the case. In circumstances where a UK subsidiary is providing services to a trust, then unless the powers granted to it by a non-resident trust company are such that it becomes a 'dependent agent with authority to do business on behalf of the non-resident trustee', HMRC will not contend that the UK company's actions cause the non-resident company to have a permanent establishment in the UK.

UK-resident directors or other employees of a non-UK-resident corporate trustee
It is also necessary to consider whether the activities of UK-resident directors or employees may result in the non-resident corporate trustee having a permanent establishment in the UK. If the UK-resident employee is not carrying out activities that would be regarded as core activities then the presence in the UK of an employee of a non-resident trust company could not, by itself, cause a non-resident trustee to have a permanent establishment in the UK.

Where the UK-resident employee does carry out trustee activities in the UK then it is possible that the non-resident trustee will have a permanent establishment in the UK. This will be the case if the employee operates from a fixed base, or does not have a fixed place but habitually acts on behalf of the non-resident trustee for the particular trust. The crucial point in relation to a dependent agent permanent establishment is whether the non-resident trustee company has in the UK a resident employee or director who has authority to conclude business on behalf of the non-resident trustee.

LATE-PAID INTEREST BETWEEN CONNECTED PARTIES

Background
In July 2008 HMRC issued a consultation document on options for amending the rules in Schedule 9 to the FA 1996. These rules apply where interest payable by a debtor company to a connected person remains unpaid 12 months after the end of the accounting period, and corresponding amounts are not brought into account for corporation tax purposes. In such a case, the interest is deductible for tax purposes only when it is paid, rather than on an accruals basis in accordance with the normal loan relationships rules.

Two alternatives were suggested by HMRC for amending this late interest rule:

i) to apply the late interest rule in all cases involving connected companies, including those where the creditor company is taxed under the loan relationships rules (in effect to apply it in a UK-UK context); or

ii) to repeal the late interest rule as it applies to connected companies and insert an anti-avoidance rule instead. Responses to the consultation document broadly favoured the second approach, with reservations about the anti-avoidance provision.

Draft legislation was published in December 2008. Broadly, the legislation would have disapplied the late interest rule in relation to 'connected' companies (currently paragraph 2(1A) Schedule 9 FA 1996) and 'major-interest' companies (currently paragraph 2(1C)), and the equivalent rule on deeply discounted securities (currently in paragraph 17), except where the creditor was not resident in a 'qualifying territory', or where the debtor company was party to an avoidance arrangement.

Responses to the draft clauses questioned the need for, and the application of, the anti-avoidance provision, and expressed the view that the amended legislation would not adequately address the application of the late interest rule where the creditor is a company that is a close company participator in the debtor company.

Revised legislation

The draft legislation will amend the rules in Schedule 9 to the FA 1996, which have been rewritten in the Corporation Tax Act 2009 and which came into effect for accounting periods beginning on or after 1 April 2009.

Under the amended draft legislation, the late interest rules will now only apply where the creditor is located in a 'non-qualifying territory'. In addition, the rules have been extended so that the late interest rules will not apply to circumstances where the creditor is a company that is a close company participator in the debtor company (currently in paragraph 18), unless the creditor is located in a 'non-qualifying territory'.

'Non-qualifying territory' is defined as any territory that is not a 'qualifying territory'. A qualifying territory is one with which the UK has a double taxation treaty that contains a non-discrimination article. HMRC has published a list of qualifying territories (see HMRC International Manual INTM 432112), which includes all EU countries and the majority of other normal tax jurisdictions. It excludes tax havens and similar jurisdictions.

The broad effect of these rules is that, in the majority of cases where the creditor is a company (unless that company is located in a tax haven), normal loan relationships principles will apply, and interest will be deductible as it accrues in the accounts, not when it is paid.

Transitional rules

A company may elect for the 'paid basis' to apply for the first accounting period commencing on or after 1 April 2009. This provides time for groups for which the 'paid basis' is advantageous to rearrange their inter-company loans. The election must be made by 31 March 2011, in the tax return for the period in question.

No special rules are prescribed for interest accruing but unpaid in accounting periods that began before 1 April 2009. Debits disallowed under the rule as it stood before April 2009 will be deductible in accordance with the rules before the amendments took place; that is, when the interest is paid.

By Blaise Marin-Curtoud, partner and Ian Reid, associate, Jones Day.
E-mail: bmarin@jonesday.com; ireid@jonesday.com.