Revised rules for the taxation of foreign profits

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IN THE 2008 PRE-BUDGET REPORT THE government announced a package of reforms to the taxation of foreign profits to be introduced in the Finance Bill 2009 (the Bill). Draft clauses were released for consultation on 9 December 2008, together with explanatory notes (the original rules). In *IHL*168 (p54), we focused on the draft legislation and explanatory notes published by HM Revenue and Customs (HMRC) and HM Treasury (HMT), and outlined the approach of the draft legislation.

At the time of publishing the original rules, HMRC and HMT acknowledged that the legislation was published in draft form to allow enough time to conduct a proper consultation process. The consultation process has now finished and has facilitated the development of fundamental changes to the legislation (especially in relation to the worldwide debt cap).

This article summarises the new rules published in the Bill (the revised rules), paying particular attention to the application of the worldwide debt cap and its application in practice.

WORLDWIDE DEBT CAP

Overview of legislative changes

The introduction of the dividend exemption was calculated by HMT to be a significant cost to the Exchequer, based on the anticipated 'behavioural change' by taxpayers as a result of the proposed regime. Accordingly, HMT introduced the concept of a worldwide debt cap to ensure that the government delivers a 'balanced and affordable package' of tax reforms in relation to foreign profits.

Not surprisingly, the worldwide debt cap rules in the original rules were met with strong resistance that has resulted in several significant changes being made. In fact, although the principles and underlying policies directing the new legislation remain broadly consistent, the revised rules are significantly different from the original rules.

It is intended that the worldwide debt test will apply for accounting periods commencing on or after 1 January 2010.

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 borrowings. The proposed legislation achieves this by comparing two figures, the 'tested amount' and the 'available amount'. The amount of allowable finance deductions is restricted to the extent that the tested amount exceeds the available amount.

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The proposed changes to the original rules primarily address several anomalous results created by the initial set of rules and aim to reduce the onerous compliance burden on those groups that are not intended to be caught by the proposed rules. It would appear that HMRC has made a valid attempt to address the concerns raised by businesses through the consultation process while operating within the constraints of its policy objective and the requirement to comply with EU law.

Under the original rules the tested amount represented the gross UK intra-group finance expense, whereas the available amount was defined as the net non-UK external finance expense of the group.

Under the revised rules the tested amount is defined as the sum of the net financing expense of each relevant group company. In other words, it is the total finance expense incurred by each relevant company less the total finance income derived by that company. The available amount is the worldwide group's consolidated finance expense and is defined as the sum of the amounts disclosed in the income statement in respect of:

1) interest;
2) amortisation of discount on borrowing;
3) amortisation of premiums on borrowing;
4) amortisation of ancillary costs of borrowing;
5) financing cost implicit in finance lease payments; and
6) financing costs relating to debt factoring.

The structure and underlying policy of the revised rules otherwise generally remains the same as under the original rules, subject to a few key changes that are outlined below.

Application of the revised rules

The revised rules will only apply to large groups of companies and will not apply to groups that satisfy the conditions of the gateway test.[1]

Gateway test

Broadly, if net UK debt exceeds 75% of the worldwide gross debt, the worldwide debt cap rules will apply. For the purposes of this test, the UK net debt is the average debt of the relevant group companies at the start and end of the accounting period of the worldwide group, and the worldwide gross debt is the average of relevant liabilities of the relevant group at the start and the end of the period.

The conditions to the gateway aim to identify those groups whose available amount will be at least equal to the tested amount, so that no disallowance would arise if the full debt cap rules were applied. While the gateway test is available to all groups, it is probable that the gateway is more likely to apply to inbound groups. It is intended that the figures for debt should be taken from the group's consolidated accounts and the relevant group company accounts. It is proposed that in addition to International Accounting Standards (IAS), generally accepted accounting principles applicable in the UK, US, Canada, Japan, India, China and Korea will also be acceptable for the purposes of the worldwide debt cap, both for the purposes of determining whether the gateway test will apply and for computing any disallowance of interest expense.

Disallowed deductions

Assuming that the worldwide debt cap rules do apply, there will be a disallowance of financing expense to the extent that the tested amount exceeds the available amount.

If a disallowance is made then the worldwide group can make a compensating adjustment in relation to the intra-group finance income received by UK members of the group. The worldwide group may reduce its taxable intra-group finance income of the UK members of the group, up to the amount of the disallowance.

Operation of worldwide debt cap in practice

Below we have considered how the worldwide debt cap is intended to operate in several practical scenarios. The following three examples determine whether any interest expense would have been disallowed under both the revised rules and the original rules.

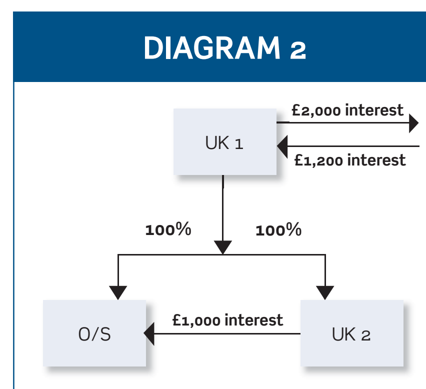
1) Under the revised rules, the available amount would be equal to the group gross finance expense as shown in the group's consolidated income statement, being £1,000. The tested amount is equal to the sum of the net financing expense of the relevant group companies, which is also £1,000 (UK1 £0; UK2 £600; UK3 £400). Accordingly, there would be no disallowance of the interest paid to UK 1 under the revised rules.

A different result would have arisen under the original rules. There would be no non-UK external finance expense of the group and therefore the available amount under the original rules would have been nil. This would have precluded debt being pushed down to UK 1 and UK 2, and UK 1 may have stranded non-trading loan relationship debits. (See diagram 1.)

2) Under the revised rules, the available amount would be equal to the group gross finance expense as shown in the group's consolidated income statement (ie the profit and loss statement), being £2,000. The tested amount is equal to the sum of the net financing expense of the relevant group companies, which is £1,800. Accordingly, there would be no disallowance of the interest expense under the revised rules.

A different result would have arisen under the original rules. There is no non-UK external finance expense of the group and therefore the available amount under the original rules would have been nil, resulting in a disallowance of interest expense of £1,800. (See diagram 2.)

DIAGRAM 2



3) Under the revised rules, the available amount would be equal to the group's gross finance expense as shown in the group's consolidated income statement, being £2,000. The tested amount is equal to the sum of the net financing expense of the relevant group companies, which is £1,200. Accordingly, there would be no disallowance of the interest expense under the revised rules.

A different result would have arisen under the original rules. The available amount would have been £800 and the tested amount would have been £1,200. Accordingly, there would have been a disallowance of £400. (See diagram 3.)

These examples clearly indicate that the worldwide debt cap rules have been relaxed and that the revised rules are significantly different from the original rules. The examples also highlight that groups with no external borrowings will generally be subject to a UK interest deduction disallowance to the extent that the group has net UK finance expense.

DIAGRAM 1

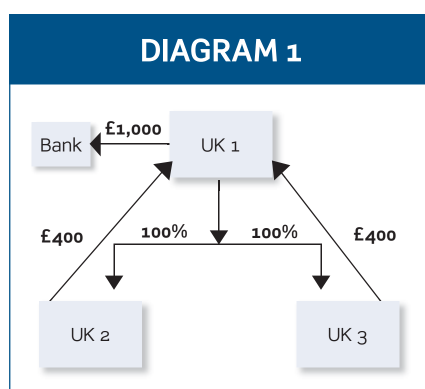
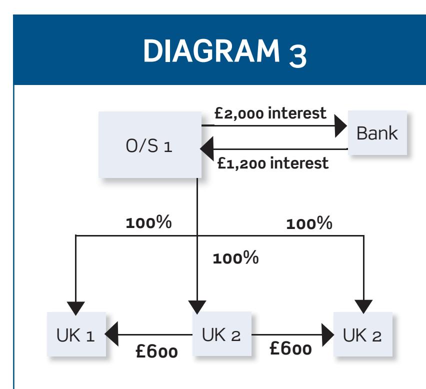


DIAGRAM 3



DIVIDEND EXEMPTION AND CONTROLLED FOREIGN COMPANIES (CFCS)

Dividend exemption

The broad effect of the proposed dividend exemption system remains to provide an exemption from UK corporation tax for dividends received by companies, regardless of the source of the distribution and shareholding in the company making the distribution.

The original rules only applied to large- and medium-sized UK companies and UK permanent establishments of large and medium-sized companies. Therefore, under the proposed rules published in the Bill, participation dividends paid to small companies would remain taxable with a credit for any underlying tax paid. The rules have now been expanded to include all companies and the revised rules now provide an exemption from UK corporation tax on dividends received by small companies.[2]

The structure of the majority of the new dividend exemption legislation is similar to the original rules. For the dividend exemption to apply, the distribution must not fall within s209(2)(d) or s209(2)(e) of the Income and Corporation Tax Act (ICTA) 1988 and the dividend must not be tax-deductible in the payer's territory. Both of these conditions are identical to the conditions contained in the original rules. As with the draft, for all other distributions it is then necessary to determine whether the distribution falls within one of the exempt classes and then to determine whether any of the targeted anti-avoidance rules apply. Even if the distribution falls within an exempt category, the distribution will still be taxable if it falls within one of the five prescribed anti-avoidance schemes included in the legislation, and the main purpose, or one of the main purposes, of the dividend payment is to obtain more than a negligible tax advantage.

The exemption classes and targeted anti-avoidance rules included in the Bill are similar to the original rules included in the draft legislation and, accordingly, we do not propose to consider these rules in any further detail.

Other measures

The new reforms also include the removal of some of the current exemptions that take overseas companies outside the scope of the CFC rules. Certain of the existing CFC rules have been amended and the acceptable distribution policy exemption has been abolished. These amendments to the existing legislation were required to ensure that the new dividend exemption regime operates as intended.

The changes to the CFC regime affect accounting periods starting on or after 1 July 2009 with provision made for accounting periods that straddle this date. However, the exemption for non-local and superior holding companies will be available for qualifying companies in a transitional form until 1 July 2011.

Proposals to replace the current CFC regime with an income-based CFC regime will be deferred and will be subject to further consultation. We understand that discussions between HMT and interested parties are ongoing, with draft legislation expected in summer 2010 at the earliest.

In addition to changes to the CFC regime, the government has finally abolished the existing treasury consent regime and replaced it with a modern post-transaction reporting requirement that applies to transactions with a value of £100m or more, subject to several exclusions. Broadly, these rules include exemptions based on the existing 'general consents' rules and an exclusion for trading transactions. There are not as many exclusions in the new legislation as currently found in the treasury consents regime. However, the exclusions can be extended by regulation and the removal of the criminal sanctions for both directors and advisers certainly outweighs this negative aspect. It is intended that the new reporting rules will apply to transactions undertaken after 1 July 2009.

The government has also decided, as a result of strong opposition from businesses and affected parties, that it will not strengthen the unallowable purpose test in relation to interest at this stage.

COMMENTARY

It would appear HMRC and HMT have considered the concerns raised by businesses and other affected parties when drafting the new rules. Generally, the dividend exemption rules and relaxation of the reporting requirements have been welcomed by businesses and affected parties. There is no minimum shareholding or holding period requirement under the new rules so the regime is more generous than some European countries with similar exemptions. However, it is slightly disappointing that the legislation remains overly complicated and detailed. Businesses and advisers will be required to analyse and consider the complicated legislation each time a distribution is received to determine whether that particular distribution will be exempt from UK corporation tax.

Further, if the objective of the government in reforming the taxation of foreign profits is really to improve the competitiveness of the UK as a headquarter location, it is questionable whether the worldwide debt cap is an appropriate measure and/or is required.

It is still too soon to determine whether the new rules will be sufficient to cease or reduce the number of corporate migrations from the UK. In the author's opinion, unless and until the CFC rules are suitably amended, the latest package of reforms will do little to improve the UK's international competitiveness or reduce the number of multinationals considering migrating from the UK.

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NOTES

1) A group is 'large' at any time if any member of the group is not at that time within the category of micro-, small- and medium-sized enterprise as defined in the Annex to Commission Recommendation 2003/361/EC of 6 May 2003.

2) To be treated as a small company for the purposes of these rules under s930R, the company must employ less than 50 employees and either have turnover or balance sheet total not exceeding €10m, and not be either an open-ended investment company, authorised unit trust scheme, insurance company or friendly society.