TRAVERS SMITH

CORPORATION TAX UPDATE

TAX ON GROUP AND OVERSEAS PROFITS: EUROPEAN COURT FORCES RETHINK

INTRODUCTION

On 21 June 2007 the UK Government published a document entitled "taxation of the foreign profits of companies: a discussion document". Although downplayed in the document, it is clear that reform in this area has become necessary in light of decisions of the European Court of Justice ("ECJ") that have cast doubt on whether the UK's current regime is consistent with EU law.

The document contains proposals, described as broadly revenue-neutral, for reforming the UK's rules for taxing companies' overseas profits. In addition, current cross-border anti-avoidance measures are to be extended to apply domestically, in an unhappy echo of the introduction of intra-UK transfer pricing in 2004. Rightly or wrongly, we again see the Government preferring to impose a significant compliance burden on business rather than risking tax leakage.

Many of the proposals are intended to apply differently to small businesses as opposed to medium and large businesses (a small business for these purposes is one with fewer than 50 employees and whose annual turnover and balance sheet total does not exceed €10,000,000). Whilst this is put forward as an attempt to make small businesses' lives easier, in many respects this will not be the result. In particular, businesses that take on a few extra employees or sign an additional contract may find that they cease to be small, with the result that the basis of taxation of their subsidiaries changes. It appears that this could even happen as a result of exchange rate movements, since the financial tests for small company status are measured in euros. This is likely to be very troublesome in practice.

That said, the Government's thinking is not very advanced and the ideas set out in the document may change. The next step is further consultation, with any changes likely to be implemented in the Finance Bill 2009.

BACKGROUND

The taxation of dividends received by companies

UK companies receiving dividends from other UK companies currently suffer no tax on them. Dividends from non-UK companies are currently subject to tax, but with a credit for any withholding tax. In addition, but only in the case of shareholdings of more than 10%, credit is given for "underlying" tax, which is overseas tax on the profits out of which the dividends have been paid.

The ECJ has held that the current UK rules for portfolio shareholdings (less than 10%) contravene European law because the credit for overseas dividends only extends to withholding tax, not underlying tax. In the case of holdings of more than 10%, the ECJ gave a qualified ruling from which it is unclear whether the current UK rules are consistent with EU law.

The controlled foreign company rules

The UK's existing controlled foreign company ("CFC") rules prevent companies from avoiding tax by accumulating income in subsidiaries in countries with low tax rates. They operate by deeming the profits of the overseas company to be received by its 25%+ shareholders, subject to certain exclusions including a "motive" exclusion where tax avoidance is not a main purpose, and an "exempt activities" exclusion for ordinary trading companies.

The ECJ has held that in order to comply with EU law, the CFC rules can only apply to wholly artificial arrangements that are designed to avoid tax. The rules cannot exist solely to stop companies obtaining a lower tax rate. It seems unlikely that the existing rules meet this requirement. A proposed carve-out from the CFC rules for EU (and EEA) companies in this year's Finance Bill may still not achieve compliance with EU law.

THE GOVERNMENT'S PROPOSALS

- **A participation exemption for many overseas dividends**
- **Controlled foreign companies style regime to apply regardless of investee residence**
- **Only limited restrictions to interest**

THE DISCUSSION DOCUMENT: AN OVERVIEW

The discussion document contains the following key proposals.

- An exemption from corporation tax for some, but not all, overseas dividends paid to large and medium UK businesses.
- The replacement of the CFC rules with a regime for attributing "mobile" income of UK-controlled companies ("CCs") to UK corporate shareholders. The new regime would apply to CCs in the UK as well as abroad.
- A restriction of interest relief for multinational groups and a tightened anti-avoidance test in the loan relationships (corporate debt) and derivatives rules.

The document also notes the need to reform the taxation of portfolio dividends but its proposals in this area are at an extremely formative stage.

A PARTICIPATION EXEMPTION FOR DIVIDENDS

For participation holdings (10% or more) in overseas companies the document proposes an exemption for certain dividends received by large and medium UK businesses. This welcome proposal would complement the existing substantial shareholdings exemption from tax on capital gains.

To benefit from the exemption (subject to limited exceptions), either:

- the overseas company must be controlled by UK persons; or
- the dividend must be paid from profits that would be exempt under the new CC rules (broadly, it must not be paid out of "mobile" income).

It is proposed that small companies will be subject to a simplified credit regime. Even a simplified regime carries real practical difficulties and would appear an unnecessary complexity to impose where the default position is that portfolio dividends are exempt from tax.

CONTROLLED COMPANIES

The Government is concerned to prevent the exemption for foreign dividends leading to the transfer of income-generating assets into low-tax jurisdictions. The new CC rules would tax the UK parent company on specifically defined "mobile" income of controlled companies, with credit for any tax suffered at the level of the CC.

The trigger for application of the rules would be a 10% shareholding, in line with the proposed participation exemption. Most small businesses would be exempt from the CC rules, although not all. This means that there would be some businesses that are caught by the CC rules without benefiting from the participation exemption.

Controlled companies in the UK

The new rules would apply to controlled UK companies as well as controlled foreign companies. The extension to controlled UK companies is largely to head off any possible challenges to the regime under EU law on the grounds of discrimination.

For income apportioned to a UK parent from a UK subsidiary, there would be a system of compensating adjustments similar to that seen in the domestic transfer pricing field. Although the rules are intended to deliver a neutral outcome for UK groups, depending on the detail of the proposals there may be circumstances where neutrality cannot be achieved.

Mobile income

Mobile income is intended to catch income which can be located "artificially" anywhere in the group. It would include dividends (other than participation dividends), interest, annuities, royalties, rents, and income from intangible assets. Some capital gains would be included, where they arise from income streams which have been packaged into capital assets.

The principal exemptions would be for income from genuine active finance businesses such as banks and insurers, and a group treasury exemption for intra-group interest. Certain other exemptions would apply, such as for income incidental to a subsidiary's main trade.

Much further work is needed to firm up the proposals in this area. For example, should rental income, derived from the most immoveable of assets and often taxed at source, be seen as mobile?

INTEREST RELIEF

The document proposes restricting interest claimed by the UK members of a multinational group by reference to the group's total finance costs. In the Government's view, if the UK sub-group has higher actual finance costs than the entire group's external finance costs, this indicates that the UK sub-group's finance costs are not commercial. This may in some cases result in the disallowance of interest deductions for intra group borrowings.

The document also proposes strengthening the existing anti-avoidance rules within the loan relationship and derivative contracts regimes. The Government accepts that this will affect situations other than those involving the new participation exemption.

The document does however reject restricting the deductibility of interest on loans used to acquire equity. This is a considerable relief, especially as many other jurisdictions with participation exemptions have restrictions of this type. In some respects, the CC rules may be seen as the price of avoiding this measure.

PORTFOLIO DIVIDENDS

The Government acknowledges the ECJ-led need to amend the rules for taxing dividends from portfolio shareholdings (less than 10%). It offers three possibilities without stating a preference: a full exemption; giving credit for underlying tax as well as withholding tax for overseas dividends; and taxing both UK and overseas dividends giving credit for withholding tax but not underlying tax. The compliance issues associated with the last two options are such that we hope it will be possible to reassure the Government that a full exemption will not be prohibitively costly.

TREASURY CONSENTS

Following many years of lobbying the Government is proposing to repeal the archaic Treasury consent rules, which often require multinational groups with UK holding companies to obtain the consent of the UK Treasury to transactions involving shares or debentures in overseas subsidiaries. The document proposes that multinational groups would instead be subject to reporting requirements.

FURTHER INFORMATION

Further information on any topic covered in this note can be obtained from your usual contact at Travers Smith or one of the partners listed below.

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