

Where next for taxation of foreign profits



There was a huge air of anticipation when the Treasury released their discussion document "Taxation of the Foreign Profits of Companies" on 21 June 2007, and since then it has been the subject of much discussion. We expect many of the issues raised to be finalised when the Chancellor delivers his Budget on 12 March.

The document was relatively short and covered the following:

- Dividends from 10% or greater shareholdings in overseas companies: a UK exemption was proposed.
- A new Controlled Company regime, to replace the existing Controlled Foreign Company rules, which would apply within the UK, as well as overseas.
- The abolition of Treasury Consent and the introduction of a new information regime.
- Interest restrictions: it was suggested that the existing anti-avoidance should be tightened up and that a new worldwide limit should be introduced.
- Small companies would be excluded from the Dividend and Controlled company proposals, retaining a simplified form of double tax relief.
- There would be consultation on what to do with portfolio dividends.

Dividend exemption

The proposed introduction of a dividend exemption was generally welcomed. It was perhaps a little surprising, following the European Court of Justice' judgement in the **FII** case (where they stated that a double tax relief system could be compatible with a domestic exemption system) and in view of indications from Treasury officials that they expect the introduction of an exemption system to cost more than a nominal amount.

The Treasury expects behavioural change from companies, but it would need several billion pounds to be brought back and placed at interest in the UK to compensate for cost of abolishing double tax relief.

It is still unclear whether and to what extent there may be transitional rules applying to historic profits and whether any limitations will be imposed on the types of dividend that will be exempt. It is to be hoped that this will not be the case, not least because if limitations are introduced, much of the cash currently held overseas might not be repatriated.

Controlled Companies

The UK's Controlled Foreign Companies regime has been in force for over 20 years, and focuses on the qualifying status of an individual company. In the **Cadbury Schweppes** case, the ECJ ruled that the CFC rules could not charge UK tax on "genuine economic activities" carried on in an EU company. There is some dispute over the precise meaning of "genuine economic activities" and it is likely that this will be the subject of a hearing before the Special Commissioners later in 2008.

The Controlled Company rules are intended to operate in a quite different manner. Instead of focusing on the status of the company, the rules focus on the status of income. Passive income is regarded as bad and potentially taxable in the UK. It has become clear from some of the consultation meetings that the Treasury is considering a wide ranging tax on intellectual property income. This has raised considerable concern, not least because the new regime was originally planned to be revenue neutral. If all overseas intangibles income were to be taxed in the UK, it seems that considerable additional UK tax would be payable.

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Many UK groups currently pay little, if any, UK tax on their overseas CFCs. Overseas financing structures are typically not subject to CFC taxation, despite the narrowing of existing exemptions over the last few years. The proposed new rules do include an exemption for group treasury companies, however, the addition of the qualification “appropriately capitalised” may substantially limit the benefits of this exemption. If the proposals result in higher tax charges for a number of treasury companies, in a revenue-neutral environment, this does not seem especially helpful.

There isn't very much discussion in the documents about the meaning of “control” in relation to controlled companies. However, the discussion documents note that some UK groups have been avoiding the CFC rules by exploiting the current definition of “control”. The documents suggest that the definition be expanded to include cases where the company's shares may in, legal form, be the property of another entity such as a partnership, trust or hybrid entity.

Treasury consent

The UK business community has campaigned for many years for the abolition of Treasury consent. This anachronistic law theoretically imposes a criminal sanction on anyone who does not see advance permission from the Treasury for various activities in relation to overseas companies. Finally, the Treasury proposes to abolish this. However the sting in the tail is the proposal to introduce some form of information requirement. This could potentially be unnecessarily burdensome, without offering material benefit to HM Revenue and Customs. It is to be hoped that the Treasury will take in more practical view.

Portfolio Dividends

The tax treatment of portfolio dividends is to be the subject of further discussion. The majority of portfolio dividends are received in the investment industry and, in particular, in life funds. It is thought that UK tax of several hundred million pounds is raised on overseas portfolio dividends and this is of course the one aspect of UK double taxation relief that has been declared unlawful by the European Court of Justice.

It remains very unclear how this issue will be resolved. It seems that the Treasury is unwilling to concede tax exemption and business is of course concerned to ensure that if dividends were taxable with double tax relief, it should be effective in practice. The issue here is that it is almost impossible to obtain the necessary underlying tax information, where the shareholder is simply a portfolio holder. One possible route might be based on the accounts charge, where an overseas dividend would be taxable with relief for an assumed amount of underlying tax, based on the overseas company's financial statements.

Small companies

At first blush, it seems quite surprising that the Treasury does not propose offering a dividend exemption to small companies. After all, if anyone lacks the resources necessary to prepare complicated double tax relief calculations, it must be small companies. The logic is that the dividends exemption offers room for abuse, which requires the imposition of the Controlled Companies regime. Their view is that this would indeed be too complex for small companies and the only sensible way forward would be to preserve a simpler version of double tax relief for such companies.

No doubt the Treasury is concerned that small companies could set up tax haven subsidiaries and reduce substantially the UK tax charge.

A number of commentators have suggested that applying the same dividend exemption and controlled company rules to small companies would be a better route. This is on the basis that genuine overseas investments would benefit from a dividend exemption, whilst the controlled company provisions would deter tax haven investments. The logic is that small companies would simply not make tax haven investments and thus, whilst the theoretical impact of the CC rules might be significant, it would be most unlikely to arise in practice.

Interest restrictions

The final area covered in the discussion documents is interest. The good news is that the Treasury does not propose introducing any form of blanket interest restrictions. However, it does propose limiting the UK deduction of interest to the total amount of external interest borne by the group. One of the useful aspects of the consultation meetings so far has been that a number of commercial situations adversely impacted by this have come to light. As a consequence, it seems that the Treasury will allow some limited relaxation of the proposed rules.

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