

Double Taxation Relief

Trade Receipts

Inland Revenue Draft Guidance

Introduction

1. This guidance sets out the principles that should underlie claims to credit relief where foreign tax is paid on a trade receipt, and practical ways in which those principles may be put into effect
2. The overall aim is to develop practical and pragmatic approaches that give a fair level of Double Taxation Relief (DTR), while preventing surplus foreign tax arising in one part of a trade from being set against tax on profits arising in a different part. Approximate methods are specifically allowed in legislation and should almost always be used, provided that they are not used to circumvent the intended limitations on credit given for foreign tax.
3. The legislation applies to both individuals and to companies, although the application to individuals will be relatively rare. This guidance uses the term “company” throughout, but the principles apply equally to individuals.

Net Basis for DTR

Outline

4. The purpose of DTR is to prevent the imposition of UK taxes resulting in double taxation on the same income. Therefore, the credit for foreign taxes should never exceed the amount of UK tax due in respect of the income that gave rise to the foreign tax payment. Credit against UK taxes should not be used as a surrogate means of obtaining repayment of excessive foreign taxes through relief for foreign taxes against income which has not suffered double taxation at all or to the same extent.
5. Where an item of income is subject to tax without deduction of expenses – “pure income profit” – this principle is relatively straightforward to implement. But where tax is charged on the basis of a calculation of profit, representing a balance of income and expenses, it is necessary to estimate the proportion of those profits that is properly attributable to the full range of transactions that gave rise to the foreign tax, while excluding profits from other transactions that are independent of the foreign tax.
6. In practice, this means attributing expenses and profits or losses from related transactions to an item or items of income that represent trade receipts, in order to arrive at a figure of profit or loss. The purpose of this guidance is to identify what

expenses and related transactions should be taken into account, and which should be excluded.

Scope

7. These principles apply in all cases where foreign tax is paid on an item of income that is taken into account in calculating the profits of a trade, or to any other income taken into account in an equivalent profit calculation, and there is a claim for credit against UK tax in respect of the foreign tax payment. Examples are:
 - Tax withheld from interest or foreign dividends received by financial traders
 - Tax withheld from royalties taken into account in calculating trade profits – for example, in the entertainment industry
 - Technical and management service fees
 - Tax withheld from rents received in a Schedule A business

Commencement

8. For companies, the rule applies to claims arising in respect of foreign tax paid on or after 16 March 2005, irrespective of the accounting date of the person making the claim. For individuals, the rule applies to foreign tax paid on or after 6 April 2005

Expenses

9. Some expenses are incurred directly in the course of earning an item or items of income. For example, brokerage fees in respect of a transaction in shares can be directly attributed to a dividend from the same shareholding. Such expenses should be deducted from the income to which they relate.
10. Other expenses are in the nature of general overheads, and a proportion of these should be allocated against the item or items of income where they cannot be specifically allocated. A just and reasonable basis of allocation should be used. What is appropriate in any case is a matter of judgement, but the possibilities include allocation on the basis of any of the following:
 - Profit as calculated before deduction of the overheads
 - Headcount
 - Floorspace
 - In an equities or derivatives trade, the number of deal tickets
 - or any reasonable combination of such factors.
11. Expenses to be allocated may be offset by incidental income, such as interest on short term deposits, to the extent that it is reasonable to identify it with the expenses.

Related Transactions

Income Bearing Assets

12. In some trades where income is derived from an asset, changes in the value of the asset are taken into account in calculating trade profits. **Income derived from the asset should be aggregated with gains or losses from the asset giving rise to the income**, and any other income or expenses arising directly or indirectly from the asset. For example, dividend income received in the context of a financial trade should be aggregated with gains or losses (whether realised or unrealised) from the same shareholding.

Derivatives

13. If a derivative is held or issued whose value is derived from an income bearing asset, then profits or losses from the derivative should be aggregated with those from the asset in determining the amount of any profit attributable to the income. The profits or losses from the derivative should include all receipts and payments made under the derivative contract as well as gains or losses.
14. In some cases it will be necessary to include only part of the profit or loss from a derivative. This will be the case if:
- If the derivative takes its value partly from the income bearing asset and partly from other subject matter; or
 - If the asset represents a hedge against part but not all of the risk taken on by the issuing or holding of a derivative.
15. In such cases, the profits or losses from the derivative should be included to the extent that their value is matched with the asset value. For example, if a derivatives trader issues equity derivatives and hedges part of the risk by holding equities, the profit or loss from the unhedged part of the risk should be kept separate from any claim for credit relief in respect of tax withheld from the dividend income.

Example 1: Allocation of overheads

In respect of patent rights held by a company, gross royalties of 100 are received in an accounting period and no direct expenses are incurred. For the whole of the Case I trade, profit before deduction of interest and overhead expenses are 1000, overhead expenses are 250 and interest 200.

An allocation of overheads and interest should be made on an appropriate basis, which we take here to be in proportion to profits before deduction of these expenses, which gives:

$$\frac{100}{1000} \times 450 = 45$$

The net profit attributable to the receipt of the royalty is therefore $100 - 45 = 55$. If tax is paid at 30%, the maximum credit relief that may be given in respect of tax deducted from the royalty is $30\% \text{ of } 55 = 16.5$

Example 2: Related Transactions

A shareholding is valued at 1000 at the start of an accounting period. During the period, a dividend of 100 is received with tax withheld of 10; a further acquisition of 500 is made; a second dividend of 200 is received with tax withheld of 20; a sale is made realising proceeds of 600; and at the end the remaining shares are worth 800. Other expenses attributable to the holding are 150.

The net profit is given as follows:

Opening stock	-1000
First dividend	100
Acquisition	-500
Second dividend	200
Sale	600
Closing stock	800
Other expenses	150
Net profit	50

Therefore the limit on credit is $50 @ 30\% = 15$. Therefore of the tax withheld of 30, credit should be limited to 15.

Deduction for Foreign Tax

16. Where credit for foreign tax has been denied, a deduction may be given against trade profits based on the lower of two figures:

- The amount of foreign tax paid for which no credit was given;
- The amount of loss (if any) calculated in accordance with the above principles, after deducting the foreign tax.

Example 3

Sale of shares	930
Gross dividend	100
Purchase of shares	-1000
Overheads & interest	-10
Net profit	20

In the above, tax withheld from the dividend was 15, but credit relief was limited to the tax on 20, which was 6. Hence there is a potential deduction for the balance of 9 foreign tax. However the deduction is limited to any loss on the transaction, after excluding the foreign tax from income. There was a profit of 20 and foreign tax of 15, so in this example, there was an overall profit of 5, so no deduction may be given.

Example 4

In the above example, if the sale proceeds were 920, the net profit would be 10, so credit relief would be restricted to 3, leaving a potential deduction of 12. The loss after excluding foreign tax would be 5, so this would be the actual tax deduction.

Example 5

If sale proceeds were 910, there would be no profit and so no credit relief. The loss after excluding foreign tax would be 15, so all of the foreign tax is deductible

Approximate Methods

17. In practice it will not usually be possible to subdivide trade profits between each class of share, bond or other income bearing asset. Where derivatives are involved, it may be similarly unrealistic to expect an apportionment of each derivative by reference to the underlying subject matter, or the extent to which the derivative is hedged by each class of equity holding.
18. Therefore, in practice, it will be necessary to allow results to be aggregated, so that for example more than one class of shareholding are considered together. This sort of approximation is acceptable only if it uses all information that is available, or that can reasonably be made available, to the extent that such information is likely to produce a more accurate result.
19. It may often be the case that the use of approximate methods will not lead to any material difference in the calculation of credit relief. Where this is the case, even if information enabling a more precise calculation is available approximate methods may be used.
20. In designing an approximate method, it will often be necessary to exclude altogether certain trade results from the calculation of the profit for which credit relief is available. For example:
 - If an equity trader includes both UK and foreign dividends in a portfolio, the results of the portfolio should be apportioned on a reasonable basis between profit attributable to UK equities and that attributable to foreign equities.
 - If a derivatives trader hedges risks that result from the issue of derivatives by acquiring equities, only that part of the derivatives' profit for which the risk is hedged by foreign equities should be included in the calculation of tax credit for tax withheld from dividends received in respect of the foreign equities. Where, or to the extent that, the derivatives are unhedged, or hedged by other means, their profit or loss should be excluded from the calculation of the limit on foreign tax credit. A reasonable basis should be used to apportion a derivative, or a portfolio of derivatives, between the part that is in a hedging relationship with foreign equities and the part that is not.
21. This may require an apportionment to be made of portfolio results, and this can be done on any reasonable basis, such as asset value, headcount, floorspace or deal tickets, or any reasonable combination of such factors. Where appropriate, these values may be taken from balance sheet date information. The basis should be used consistently but may include some flexibility to take account of changing circumstances. Having identified the gross profit, it is necessary to deduct funding cost and overheads. Here also, a suitable approximate basis may be used – for example, apportionment of expenses on the basis of profit calculated before deduction of funding expense and overheads may be appropriate.

Example 6

The results of an equities trader whose UK and foreign trades are highly integrated has results as summarised below:

Gross Profit		Expenses			Net Profit
Equities	Derivatives	Funding	Overheads		
UK	Foreign				
100	500	200	400	200	200

The derivatives are used to hedge risk from equities, and the hedging policy is the same for UK or foreign equities. As gross profit on foreign equities is 83% of the total, for the purpose of this example, we attribute the same proportion of the profit on derivatives, and of expenses. It follows that 83% of the net profit, which comes to 167, is attributable to the foreign part of the business. The maximum credit relief that can be given for tax withheld from the foreign equities is therefore 30% of 167 = 50. This method of allocation is only illustrative, and in other cases, a different basis of allocation may be preferable.

Example 7

A derivatives trader's results are summarised below:

Derivatives hedged by equities		Equities profit		Expenses		Profit
Profit	% Hedged	UK	Foreign	Funding	Overheads	
1000	60%	100	300	700	500	200

On average 60% of the risk attaching to derivatives is hedged by holdings of equities, and profits from these holdings are 75% foreign, 25% UK. Hedging policy is the same for UK or foreign risks, so it is reasonable to attribute 75% of 60% of the derivatives profit to the foreign equities, giving a figure of 450.

The gross profit attaching to the foreign equities is $300 + 450 = 750$ out of a total of $1000 + 100 + 300 = 1400$. Again assuming allocation on the basis of gross profit, the amount of expense to be attributed to this figure is

$\frac{750}{1400} \times 1200 = 643$. Therefore net profit attaching to the foreign equities is $750 - 643 = 107$ and the limit on credit relief is 30% of $107 = 32.1$.

Combining Results

22. In some cases, the trades of more than one company may be linked to a payment of foreign tax. There are two possible approaches where this is the case:

- One approach relies on transfer pricing to ensure that when there is a link between two trades, a suitable price is paid for any service provided by one for the other. This approach allows the attribution of income and expenses to the foreign source to remain within the legal entity, but may include amounts imputed under transfer pricing rules. This approach will be appropriate for provision of services such as marketing, back office services and so on.
- In other cases, trades may be managed centrally by a group to ensure they are complementary in ways that cannot wholly be described in terms of provision

of service. For example, risks taken on by derivatives and equities traders may be chosen partly to cancel each other, so that the group's aggregate risk is minimised. In these cases, it may be necessary to include expenses, gains or losses from a different company from the one that incurred the foreign tax payment when calculating the limit on credit relief, as if the two trades were carried on in a single company

23. Where the above does not apply, it will generally be necessary to consider only expenses incurred by the company receiving the taxed income. However, where there has been manipulation with a view to reducing the expenses of that company, it may be necessary to consider expenses incurred in related companies. For instance, if the company receiving foreign income has a significantly lower proportion of debt funding than the group as a whole, and the difference cannot be explained on commercial grounds, then it may be necessary to include some of the interest expense incurred in an associated company. For individuals, only expenses incurred by the individual [or exceptionally their spouse] need to be considered.

Subsequent Years

24. The profit attributable to foreign income should be determined by the same method year by year unless there is good and sufficient reason to do otherwise. A method of allocation should not be changed merely because in a particular year some other method gives more or less favourable results.

Examples

1. If the profit attributable to income on which foreign tax has been paid is 40% of the total profit of the trade, then if the balance of UK and foreign income remain roughly the same, it may be reasonable to apply the same percentage to total profits in subsequent years
 2. If the profit attributable to taxed income is 30% of that income, then if the profitability of the foreign business remains more or less stable, then it may be reasonable to assume that the same percentage will apply in subsequent years
25. The method should be reviewed periodically, for instance at 5 year intervals, to ensure that the underlying assumptions remain valid.

Other Rules

Transitional Rule

26. There is a transitional rule for the period from 16 March 2005 to 31 December 2005, which applies to foreign tax paid in respect of dividend income. For this type of foreign tax payment, nothing in [this legislation] shall deny credit relief for more than half of the foreign tax paid by any person in respect of dividends received in this period.

Manufactured Overseas Dividends (MODs)

27. MOD set-off rules should be applied wholly independently of the limitation on DTR determined by the profit arising from a transaction. For any person, the amount of DTR available should be the lower of:
- The amount of relief available under MOD rules
 - The UK tax on the profit attributable to the foreign income
28. For example, if MOD rules give DTR of 70 and the amount of UK tax attributable to the foreign income totalled 75, then credit of 70 should be given against UK tax. If the UK tax figure was 60, then the credit should be 60.

Royalties

29. All foreign royalties derived from the same intangible asset are treated as a single item of foreign income with a single tax payment. Royalties originating from different assets should be considered separately for the purpose of calculating the maximum credit available for tax paid on the royalties, unless it is reasonable to suppose that further aggregation does not materially alter the outcome of the calculation of maximum credit.

Example

A company holds patent rights that are licensed to three countries that impose withholding taxes on royalty payments of 20%, 10% and 5%. Royalties of 100 are received from each country and in each case expenses attributable to the payment are 70.

The total royalty income is 300 and foreign tax paid is 35. The total profit is $300 - 210 = 90$, so UK tax at 30% is 27, which determines the amount of credit relief that may be given.

Comments on this Guidance

30. The Inland Revenue would welcome comments on this draft guidance including areas where additional guidance would help.