

Technical Note: DTR Avoidance

1. The FST has announced that the Government plans to introduce legislation in the 2010 Finance Bill to tackle avoidance of corporation tax involving double taxation relief (DTR). The legislation will in each case take effect from 21 October 2009. This note provides an explanatory commentary and sets out the background to the changes. Draft legislation will be published shortly.
2. Two statutory instruments have also been made today amending regulations relating to manufactured overseas dividends and repealing regulations dealing with manufactured interest. The statutory instruments in each case take effect from 21 October 2009.

1: Unit Trusts

3. Unit trusts are collective investment schemes created by deed where the scheme property is held on trust for the investors. Investors pool their money into a common fund which is then invested by the trustees in a managed pool of assets such as equities or debt securities.
4. Unauthorised unit trusts (UUTs) are broadly any unit trust schemes that are not authorised in terms of the Financial Services and Markets Act 2000 provided that the trustees are UK resident.

The schemes

5. The schemes seek to take advantage of the tax rules applicable to UUTs by using them to convert foreign income subject to withholding tax into receipts of UK income with a UK tax credit attached. The aim is either to generate repayment of this credit (though no or only minimal UK tax has actually been paid) or get around the restrictions for claiming double

taxation relief (DTR) that would have applied had the overseas income been received directly by the investors.

6. The scheme investors typically first create a UUT and then subscribe cash in return for units (similar to shares) issued by the trust. The cash subscribed for the units is used by the UUT to acquire overseas assets such as shares¹ that the investors might have acquired directly. Alternatively, overseas shares already held by the investors may be contributed to the UUT in exchange for units. These shares will pay dividends but overseas tax is deducted from the dividends so only a net amount of dividend is actually received by the UUT.
7. The units entitle the investors to a share of the UUT's profits. Under the terms of the trust agreement all income arising to the UUT is distributed to the unit holders but in a later tax year than that in which the income is received.
8. The UUT trustees are charged to income tax at the basic rate (20%) on the overseas dividends they receive, but are able under normal DTR rules to offset the overseas tax to reduce that tax liability. If the overseas tax withheld from the dividends is equal to or greater than the basic rate of tax there will be no UK tax payable by the trustees. If it is less UK tax will be paid equal to the difference between the basic rate liability and the overseas tax withheld.
9. If, for instance, gross income of the UUT is 100 from overseas dividends from which overseas tax of 20 is withheld then the UUT's tax computation will show gross taxable income of 100 and income tax liability of 20. However, this liability will be wholly covered by the overseas tax of 20 withheld from the overseas dividend so no UK tax will be paid.

¹ In what follows references are to "shares" and "dividends" but should be seen as encompassing other types of overseas assets and income.

10. In the tax year immediately following the year in which the overseas dividends were received, the UUT is treated under section 941(2) of Income Tax Act 2007 (ITA 2007) as distributing that income to the unit holders². Although funded out of the overseas dividends, that distributed income is treated in the unit holders' hands as UK source income³, and as having been paid after deduction of basic rate UK tax. However, the UUT will not account for any tax on making the distribution and, as a result of the DTR claim in the previous tax year, will not have paid UK tax on the income from which the distribution is funded (or will have paid it only to the extent that its liability exceeded available DTR).
11. If the recipient of the distribution is tax exempt or is a loss-making entity then it may seek to claim payment of all of the UK tax treated as deducted from the distribution. If the recipient of the income is a financial trader then it may claim credit relief for the tax against other income without certain restrictions that would have applied had it received the overseas income directly.
12. For instance, in the example at paragraph 9 above, the recipient of the distribution from the UUT (if a loss-making entity or exempt from UK tax) would be able to claim "repayment" of tax of 20 even though no UK tax had actually been paid.
13. The avoidance results from the fact that although the UUT is effectively just a conduit by which the overseas income is received by the unit holders, its interposition changes the tax character of the income from overseas dividends with overseas tax into UK source income with a UK tax credit.

The remedy

² The mischief arises only where the distribution is made in a later tax year than that in which the trustees receive income. Where the tax years are the same, tax is collected under section 942(3) of ITA 2007.

³ For individuals, by section 550 of Income Tax (Trading and Other Income Act) 2005; for companies by section 971 of Corporation Tax Act 2009.

14. Changes will be made to the legislation relating to the taxation of unit holders in UUTs so as to treat them as receiving overseas income in certain circumstances.
15. The new rule will apply where:
 - the trustees of a UUT as treated under section 941(2) of ITA2007 as making a distribution in a tax year, and
 - there is a reduction in the income pool in that a tax year by Step 1 in section 942(5) of ITA2007.
16. In any such case then part of the distribution the trustees are treated as making may be treated in the unit holders' hands as overseas income. The amount of the deemed overseas income will be the lower of the reduction in the income pool in the year or the amount of foreign tax relief claimed in previous years under section 788 or 790(1) of the Income and Corporation Taxes Act 1988 (ICTA 1988) grossed up at the basic rate⁴. This will prevent repayment of the tax, and ensure that the rules restricting relief for DTR on foreign income apply properly to distributions from UUTs sourced from overseas income.
17. For those receiving the income in the course of a trade this deemed foreign income will be taxed as trading income with double taxation relief for the overseas tax subject to section 798A and 798B of ICTA 1988. For others it will be taxable under Chapter 10 of Part 4 of ITTOIA 2005 (income tax) or Chapter 5 of Part 10 of Corporation Tax Act 2009 (corporation tax) from which overseas tax has been deducted.
18. This change will have effect at unit holder level only. There will be no change to the amount of tax paid by the trustees.

Commencement

⁴ That is, divided by the basic rate of income tax expressed as a percentage.

19. The new legislation will apply to distributions treated under section 941(2) of ITA 2007 as made by the trustees on or after 21 October 2009. The legislation will have no effect if either:
- The UUT⁵ has no income pool as at 5 April 2009 (calculated in accordance with section 943 ITA 2007), or
 - The UUT has not claimed credit relief for foreign tax under section 788 or 790(1) of ICTA 1988 in either of the two years to 5 April 2009.
20. In any other case, the amount of distribution treated as foreign income can be calculated by carrying out the following steps:
- Will the deemed distribution reduce the income pool as at 5 April 2009 (see Step 1 in section 942(5) of ITA 2007)?
 - If the answer is no, then the proposed legislation can have no effect in the tax year ended 5 April 2010.
 - If the answer is yes, then the deemed foreign income is the lesser of the amount of the reduction in the pool and the amount of the foreign tax for which relief has been claimed divided by the basic rate of income tax expressed as a percentage (20%).
21. The deemed foreign tax is then the amount of foreign income multiplied by the basic rate of UK income tax

Example

22. UUT is deemed under section 941(2) of ITA 2007 to distribute 100 of income on 23 October 2009
23. Under section 1025 of ITA 2007, its modified net income for the year to 5 April 2010 will be nil.
24. It has an income pool b/f at 6 April 2009 of 100.

⁵ Strictly, the tax charge falls on the trustees, but for convenience in what follows the UUT is referred to as the taxable entity.

25. It claimed DTR of 5 under section 788 or 790(1) of ICTA 1988 in the year to 5 April 2008 and in the year to 5 April 2009.
26. The foreign income treated as distributed on 23 October 2009 is the lesser of 100 and $10/20\%=50$. Therefore, the unit holders are treated as receiving foreign income of gross 50 from which overseas tax of 10 is deemed to be deducted. If the unit holder receives the deemed distribution in the course of a financial trade it will be taken into account as an item of trading income, and in any other case, it will remain taxable under the same provisions as at present. The balance of the distribution will be treated as under current rules.

2: Deemed overseas tax.

27. Provision in the DTR legislation at section 804ZA of ICTA 1988 aims to prevent a person receiving relief in the UK for overseas tax where that person is party to a prescribed scheme or arrangement that has as a main purpose the reduction of UK tax by means of that credit being taken into account.
28. In the disclosed schemes, an entity arranges to receive manufactured overseas dividends (MODs) instead of real dividends with the intention of preventing section 804ZA from applying. MODs arise where, under an arrangement for the transfer of overseas shares, one party is required to pay to the other an amount that is representative of dividends on those securities.
29. Legislation will be introduced to ensure that section 804ZA applies to the deemed overseas tax deducted from MODs in the same way that it applies to real overseas dividends. This does not affect the legislation that applies to MODs, but prevents a MOD tax credit

from being treated more favourably than a tax credit on a real dividend.

30. This will be achieved by amending paragraph 3 of Schedule 28AB to ICTA 1988 to ensure that the “foreign tax total” calculated under paragraph 3(3) of that Schedule does not include amounts of deemed foreign tax referable to MODs. These amendments will also ensure that the foreign tax total does not include amounts of deemed overseas tax that arise in other circumstances, for instance under section 807 of ICTA 1988 or as a result of the amendments to the tax treatment of holders in UUTs described above.
31. This will result in the disallowance of deemed overseas tax in DTR claims in avoidance cases only, since it will still be necessary for that tax to arise as part of a scheme or arrangement, one of the main purposes of which is to cause that tax to be taken into account for DTR purposes. This will not be the case where the claimant bears the full economic effects of the tax and is not taxed more favourably than it would be if it had received the real foreign income under deduction of tax.
32. The legislation will apply in relation to amounts treated as if they were foreign tax payable on or after 21 October 2009.

3: Manufactured interest

33. Manufactured interest arises where, under an arrangement for the transfer of UK debt securities, one party is required to pay to the other an amount that is representative of the real interest on those securities.
34. In certain circumstances, provisions of the Manufactured Interest (Tax) Regulations 2007 (S.I. 2007/2488) treat a recipient of

manufactured interest as having received that amount under deduction of UK tax. The recipient of the manufactured interest can then offset this deemed UK tax against any UK tax liability that would otherwise arise on the interest (or against tax liability unrelated to that interest).

35. Schemes have been notified to HMRC that exploit these tax rules to create multiple claims within the UK for a single payment of tax or otherwise to give rise to relief inappropriately.
36. To block these schemes the Manufactured Interest (Tax) Regulations 2007 have been repealed. The repeal has effect in relation to manufactured interest paid or treated as paid on or after 21 October 2009. Instead, the recipient of manufactured interest will simply be taxed on the amount of manufactured interest it receives with no relief for any notional tax credit.
37. Corresponding changes have been to the regulations relating to MODs (the Income Tax (Manufactured Overseas Dividends) Regulations 1993 (S.I. 1993/2004 as amended)), with the result that where a recipient of a MOD receives that amount from an overseas payer and no reverse charge arises under section 923 of ITA 2007, the recipient will be taxed on the actual amount of MOD with no relief for any notional overseas tax. These changes have effect in relation to MOD payments made or treated as made on or after 21 October 2009.

Comments

38. As noted, draft legislation will be published shortly. In the meantime any questions on the content of this Technical Note should be addressed to:

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