Double Taxation Relief

INLAND REVENUE

DECEMBER 2004

In his Pre Budget Report, the Chancellor announced two measures that amend the rules giving relief against Corporation Tax in respect of foreign taxes.

- A draft Finance Bill clause setting out changes with immediate effect to close down known avoidance schemes.

- A technical note on proposals for further Finance Bill legislation to clarify the way that relief is given for foreign tax paid on trade receipts.

The Government is also making changes to close down loopholes in CFC taxation rules with immediate effect. Details of a change to the way that underlying tax is calculated on dividends paid by CFCs are included in a separate note, which also includes a draft clause, on CFC taxation

Comments are invited on the detail of changes set out in the technical note. Please write to:

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Comments should reach him by 31 January 2005.

1 Tax avoidance involving annual payments and double taxation relief

(1) ICTA is amended as follows.

(2) In section 125 (annual payments for non-taxable consideration) in subsection (2) (payments to which the section applies) for paragraph (b) substitute—

“(b) is made under a liability incurred for consideration in money or money’s worth all or any of which—

(i) consists of, or of the right to receive, a dividend, or

(ii) is not required to be brought into account in computing for the purposes of income tax or corporation tax the income of the person making the payment.”.

(3) As from 2nd December 2004, the title of that section accordingly becomes “Annual payments for dividends or non-taxable consideration”.

(4) Section 801 (dividends paid between related companies: relief for UK and third country taxes) is amended as follows.

(5) In subsection (2) (case where overseas company has received a dividend from a third company) for “subject to subsections (4) to (4D)” substitute “subject to subsection (4)”.

(6) Subsections (4A) to (4D) (which relate to cases where the amount given by the formula in section 799(1) exceeds U in that formula) shall cease to have effect.

(7) The amendment made by subsection (2) has effect in relation to any annual payment made on or after 2nd December 2004 (whether the contract or other arrangement is one made before, on or after that date).

(8) The amendments made by subsections (4) to (6) have effect in relation to dividends paid on or after 2nd December 2004.

EXPLANATORY NOTE

Tax avoidance involving annual payments and double taxation relief

Introduction

1. This clause amends the operation of section 125 ICTA 1988, which sets out circumstances in which tax deductions may not be given for annual payments. It extends its scope to include any annual payment made in consideration for the receipt of a dividend, or a right for any person to receive a dividend.

2. The clause also removes subsections (4A) to (4D) of section 801. Where they apply, these subsections deem underlying tax to have been paid in a specified amount.

3. The purpose of both sets of amendment is to prevent avoidance schemes that aim to create tax deductions from contrived arrangements whereby annual payments are given in return for a right to receive foreign dividends.

Detail

4. **Subsection (1)** introduces the clause.

5. **Subsection (2)** amends section 125 to extend the scope of paragraph 125(2)(b). At present it refers to an annual payment made in return for non-taxable consideration, with the result that the section denies a tax deduction for such a payment.

6. This rule is retained in paragraph 125(2)(b)(ii), but is supplemented by paragraph 125(2)(b)(i), which similarly denies a tax deduction for an annual payment made in return for consideration in the form of any dividend, or a right to receive any dividend.

7. **Subsection (3)** amends the heading given to section 125 in the Act, so as to properly describe the amended scope of the section.

8. **Subsection (4)** introduces the second part of the clause, which amends section 801 ICTA 1988.

9. **Subsections (5) and (6)** repeal subsections (4A) to (4D) of section 801, and make a consequential change to subsection (2).

10. Subsections (4A) to (4D) are concerned with the calculation of underlying tax on a dividend paid by a UK resident company. This is relevant to the calculation of underlying tax if a UK dividend is paid to a foreign company, which then pays a dividend back to the UK.

11. In this circumstance, differences between the UK company's taxable profit and its distributable profit mean that the underlying tax might not always be sufficient to cover the tax due on the foreign dividend.

12. The tax due on the foreign dividend is given by the formula in section 799(1A). If (or to the extent that) a foreign dividend is paid out of profits included in a UK dividend, but the underlying tax is less than the amount given by the formula, subsections (4A) to (4D) deem it to be increased by the amount of the difference.

13. This rule has been exploited by some artificial and extremely aggressive planned avoidance schemes, which have been notified to the Inland Revenue under the rules for disclosure of marketable tax avoidance arrangements. The repeal is necessary to ensure that these damaging schemes are rendered ineffective.

14. **Subsection (7)** gives the commencement rule for the change to section 125. It is effective for determining the tax deduction for any annual payment made on or after 2 December 2004.

15. **Subsection (8)** gives the commencement rule for the repeal of section 801(4A) to (4D). It is effective for the calculation of DTR for any dividend paid on or after 2 December 2004. In accordance with section 834(3), a dividend is treated as paid on the date on which it becomes due and payable.

CORPORATION TAX - CREDIT FOR FOREIGN TAX PAID ON TRADE RECEIPTS

INLAND REVENUE TECHNICAL NOTE

Introduction

1. UK residents are taxed on their worldwide income, but where income is received from abroad, any foreign tax paid is often available as a credit against UK tax, in accordance with treaties or unilaterally.

2. Credit given for foreign tax should be limited to the tax due on the foreign income, and should not reduce tax payable on other income. However, some uncertainty has arisen over the implementation of this principle, and so the Government is persuaded that it should act to clarify in law exactly how this limitation on foreign tax credit will apply.

3. Difficulties can arise when an item of foreign income is received in the course of a trade, and the foreign income has been subject to tax in another jurisdiction. This note sets out some questions to be considered in the design of this legislation, and comments are invited from interested parties.

Scope

4. It is intended that the legislation will apply to credit relief given for tax withheld from income that is taxed as a receipt of a trade. Therefore, the rules will mainly apply to interest and dividends received by financial traders and royalties received in circumstances where they represent trade income.

Net Basis of Credit Relief

5. An item of foreign income must be aggregated with related transactions to record the net profit or loss from the activity that gave rise to the foreign tax. This is necessary because the subject of taxation is the profits of the trade, but it requires a judgement to be made as to what transactions should be related to the payment of foreign tax. In broad terms, everything that is relevant to the question of the profitability of the foreign activity or asset is relevant, including:

Asset value

6. Where income derives from an asset, and the asset value is taken into account in calculating trade profits, it should also be taken into account in determining the net foreign income.

7. For example, any movement in the share price between the purchase and sale of shares should be included in calculating the net foreign income to the same extent that it is taken into account in calculating overall trade profits.

Interest expense

8. Where foreign income arises from an activity or asset that requires funding, and the calculation of trade profits includes a deduction for interest, a reasonable allocation of the interest expense should be made in the calculation of net profit arising out of the receipt of foreign income.

Other overheads

9. Similarly, a fair and reasonable allocation of other overheads should be taken into account in calculating the net profit from the foreign income.

Example 1

10. A financial trader acquires a shareholding at a cost of 1000. A dividend of 85 is received after deduction of tax at source of 15, and subsequently the shareholding is sold for 950. Interest and other expenses attributable to the whole period of the shareholding were 10, and it is assumed that all of these transactions took place in a single accounting period.

11. As the trade is a financial one, all of these transactions are taken into account in the calculation of the profits of the trade. The overall result of the series of transactions related to this shareholding is a profit, calculated as follows:

Sale of shares	950
Gross dividend	100
Purchase of shares	-1000
Interest	-20
Other overheads	-10
Net profit	20

At 30%, the tax on this profit is 6. Tax withheld from the dividend was 15, so there is no further corporation tax to be paid, but the remaining 9 withheld tax cannot be relieved.

Allocation of Funding Costs and other Overheads

12. The above example raises the question of how overheads should be allocated to a shareholding. The factors that might affect the interest properly attributable to the shareholding might include:

- The cost of the shareholding
- The period for which it is retained
- The cost of debt for the company, either specific to the acquisition of the shareholding, or the average cost of debt.
- The regulatory capital requirement for the shareholding

For other overheads, perhaps just cost and period of retention are relevant.

Questions

13. Section 798B already provides rules for the allocation of financial overheads, which apply in some but not all circumstances in which the proposed rule applies. Do these rules produce satisfactory results? Could the same approach be used for the allocation of overheads in circumstances not within the scope of sections 798 to 798B?

14. Companies that trade in financial markets have means of determining which business is profitable and which is not. Do these process provide for a means of allocating overheads to holdings of shares and other assets, for the purpose of determining the amount of credit relief available?

15. If this is impractical, might some other allocation basis provide a reasonable approximation? For example overheads including interest might be allocated in proportion to gross profit from shareholdings. If so, how should shareholdings that result in a loss be dealt with?

16. Royalties sometimes represent trade receipts, and so the same issues may arise in that context. Can similar methods of allocation be used? In what other contexts might similar issues arise?

Example 2

17. The facts are as in example 1, except that the shares are sold for only 890, so the result before allocation of overhead expenses is a loss. In this situation, there cannot be any credit relief, because there is no profit and hence no UK tax in respect of the shareholding.

18. In this case the foreign tax may be claimed as a deduction instead of a credit, so the loss would be calculated as follows:

Sale of shares	890
Gross dividend	100
Purchase of shares	-1000
Overheads	-
Foreign tax	-15
Net loss	-25

Nothing has been included here for overheads. In this situation, the precise amount to be allocated is irrelevant, since there is no credit relief.

Retained Shares

19. If a shareholding is retained at the year end, the calculation might proceed as above using the mark to market valuation, with a separate calculation of net profit for each accounting period. This ensures consistency between the basis of taxation for the trade and the method by which DTR is determined. However, comments are invited as to whether this might produce anomalous results in some cases where a shareholding is acquired in one period, and a dividend received in the next.

Example 3

20. A shareholding is acquired for 1000, and at the year end is worth 1020, no dividend having been received. In the following year, a dividend of 100 is received with tax withheld of 15, and at the end of the year, the shareholding is worth 1030.

21. For each period, overheads including interest total 10,000 and the overall profit before overheads is 4,000. For the purpose of this example, it is assumed that overheads are allocated in proportion to profits.

Period 1

The gross profit attributable to the shareholding is 20, and so the allocation of overheads is $\frac{20}{4000}\times 10000 = 8$. Hence the net profit is 12. However, since there is no foreign tax to consider, this calculation is not actually necessary.

Period 2

The gross profit is 1030 – 1020 + 100 = 110.

Overheads are $\frac{110}{4000}\times 10000 = 44$, so net profit is 66.

The maximum credit relief is 30% of 66 = 19.8, which exceeds the tax withheld of 15, so there is no restriction.

Legislation

22. The Government is satisfied that legislation is needed to clarify the operation of the above principles. Comments are invited as to the detailed application of the rules, but the proposed form is:

- The rules will be limited to the situation where foreign tax is paid on income that represents a trade receipt.

- Where the income is derived from an asset, changes in asset value should be aggregated with the foreign income in determining net profit to the same extent that the asset value is taken into account in determining net profit. This would include purchase cost, sale proceeds, and valuations. The basis of valuation (for example mark to market or accrual) should be consistent with the basis used in the calculation of profit for the period.

- Overheads including interest should be allocated to the foreign income on a fair and reasonable basis. Comments are especially invited as to whether this or any similar phrase might need to be expanded upon in legislation, and if so how.