

REGULATORY IMPACT ASSESSMENT

Introduction

This regulatory impact assessment (RIA) considers the costs and benefits of the measures relating to double taxation relief in the Finance Act 2000 taking into account refinements brought in by the Finance Act 2001. The original measures stemmed from the review of the system of double taxation relief for companies conducted by the Inland Revenue during 1999, and have been amended in the light of consultations with business and representations received since then.

This RIA considers the corporation tax implications.

1. Purpose and intended effect of the measures

- 1.1 Double taxation arises when a company pays tax on its income or gains both in the country where they arise and in the country where it is resident (and perhaps also in a third country, where it has a permanent establishment). The United Kingdom relieves double taxation by the credit method, whereby the income and gains are taxed in the United Kingdom but the foreign tax is credited against the United Kingdom tax payable. As an alternative, the income and gains may be reduced by the amount of the foreign tax paid in respect of them. For 1999/00 the total amount of double taxation relief claimed by companies totaled £6bn.
- 1.2 In March 1998 the Government announced a review of double taxation relief for companies. The review considered the functioning and the fairness of the existing system, its effectiveness in meeting the objectives of the relief and business' compliance costs, while having regard to the overall cost of the relief. In March 1999 a discussion paper (" Double Taxation Relief for Companies") was published. Comments were invited by 30 September 1999 on whether to retain the credit method or switch to an exemption system for relieving double taxation and on a number of other issues concerning the credit method that were identified in the paper.
- 1.3 The measures introduced in the 2000 and 2001 Finance Acts improve the financing of the system for direct investment and provide additional flexibility for companies in the utilisation of the relief, while capping the rates of foreign tax for which credit is given. The main features are:
 - The relief available for underlying tax attributable to a dividend paid from one company to another will be capped at a rate equal to the United Kingdom corporation tax rate;

- Dividends from foreign subsidiaries can normally be pooled for the purposes of crediting foreign tax ('onshore pooling').
- Excess foreign tax up to 45% that has been capped as above may be credited against pooled dividends, or surrendered to other group companies
- Companies will be able to carry back three years, or to carry forward indefinitely, foreign tax on dividends and on the profits of foreign branches which can not be relieved immediately;
- Dividends paid to satisfy an acceptable distribution policy for a Controlled Foreign Company are ring-fenced so that excess foreign tax arising on any other dividend cannot be credited against them;
- And relief will be allowed to all non-residents for foreign tax paid on the income of their United Kingdom branches or agencies.

Details of other measures being introduced are set out in annex 1.

2. Options

- 2.1 Various options were discussed in the review, including making no changes, switching from the credit method of relief to an exemption system, and using non-legislative solutions.
- 2.2 In some cases representations had been made for certain practices that have grown up over the years to be put in statutory form, as this would bring the benefit of greater certainty and transparency.
- 2.3 New legislation was necessary to implement the changes fully.

3 Benefits of the changes

- 3.1 New outbound investment from the UK will be simpler to structure while retaining the full benefits of the system of relief. UK companies that hold their subsidiaries directly will no longer be disadvantaged by the system. Following the changes, they have the potential to obtain more relief than was previously available for foreign tax suffered that is attributable to dividends from those subsidiaries. The creditable foreign tax was previously capped at the UK corporation tax rate (now 30%) and the new rules raise that limit to 45%.

- 3.2 United Kingdom companies with foreign subsidiaries will benefit from the greater flexibility in the utilisation of relief that is introduced by the changes. They will be able to use otherwise unrelieved foreign tax to reduce the UK tax that would be payable on other foreign dividends by the company. They will also be able to carry it backwards or forwards to maximise the relief or surrender it to another company in the group that can use it.
- 3.3 Companies with overseas subsidiaries held through offshore holding companies will potentially benefit from the greater flexibility, but within the new capping arrangements that exclude from relief underlying tax in excess of 45%.
- 3.4 United Kingdom companies that operate overseas through branches will benefit from the introduction of a system to carry unrelieved foreign tax backwards or forwards as do foreign companies or individuals that operate in the United Kingdom through branches. In addition, these persons are able to claim credit relief for foreign tax on a broader basis than hitherto.
- 3.5 Changes relating to underlying tax will bring greater transparency and certainty to the system. The changes give statutory authority to practices that have been developed administratively particularly in relation to profits transferred otherwise than by a dividend and companies taxed overseas as a single entity.
- 3.6 The effect of the cap is to limit the extent to which the UK system gives relief to companies for rates of tax in excess of 45% suffered on overseas operation. Within the capping arrangements, companies will also be expected to take reasonable steps to minimise their foreign tax (e.g. through claiming available reliefs). The abolition of dividend specification rules will ensure that dividends are identified more closely with the accounting profits of the overseas source. Together with the exclusion from the onshore pooling arrangements of dividends paid up by a controlled foreign company to meet the acceptable distribution test, these measures contribute to reducing the Exchequer cost of the substantially greater flexibility that is being provided through the other changes.

4. Consultation and guidance

- 4.1 Twenty-five responses were received to the discussion paper mentioned at 1.2 above. There was a more substantial response to the Budget announcement in March 2000 and, in the course of further consultation, a wide range of comments and suggestions were made.

As a result of the consultation, changes relating to relief for underlying tax were brought forward and incorporated as part of Finance Act 2000. In order to assist companies with complex group arrangements, the start date for the more significant proposals was deferred until 31 March 2001.

- 4.2 The estimated compliance costs/savings, based on consultations with four tax managers, are set out in annex 3. To give an opportunity for further consultation, business was invited to comment again when the updated draft was published in March 2001. No further comments on the estimated compliance costs/savings in the light of the changes made to the provisions have been received.
- 4.4 Consultation on complex issues relating to 'in county' mixing and the surrender, between UK companies, of eligible unrelieved foreign tax started in October 2000 with comments invited by 30th November. The detailed provisions on these two aspects were to be set by HM Treasury and the Board of the Inland Revenue. The regulations have now been published and came into force for dividends paid to the UK on or after 31st March 2001.
- 4.4 Since the Finance Act 2000 received Royal Assent there has been an on-going process of consultation with representative business groups.
- 4.5 The Inland Revenue website has been used to provide guidance on the detailed interpretation of the legislation as quickly as possible. Guidance on interpretation of the capping and on-shore pooling provisions was placed on this in October and December 2000.

5. Revenue effects

In a full year the cost to the exchequer will be £25 million. The extension of double taxation relief to non-residents trading here through a branch or agency, effective from 21st March 2000, account for around £10 million of this and the remaining £15 million relates to the on-shore pooling regime, effective from 31st March 2001.

6. Compliance costs and savings to business: Business sectors affected

- 6.1 Around 5,200 companies claim relief for foreign tax each year. They are all potentially affected by one or more of the changes mentioned above (plus an additional small number of foreign companies who are able to claim credit relief for the first time). Annex 2 shows double taxation relief allowed by industrial sector, for the latest year for which figures are available.

- 6.2 The chemicals, other manufacturing and construction sectors together have in the past accounted for over 80% of the tax savings that companies obtain by the use of mixer companies. The figures in the table include all types of foreign tax, including withholding tax on e.g. interest and dividends. The most significant changes in the package of measures concern underlying tax in respect of dividends from overseas subsidiary companies.
- 6.3 Large multinational groups with complex legal structures and many overseas interests have needed to consider how the changes affect them, particularly if they have companies in the group that fall within the Controlled Foreign Companies legislation. It has been estimated that around 200 United Kingdom companies make use of intermediate holding companies that act as mixer companies and are affected by the changes.
- 6.4 Several thousand companies hold their subsidiaries directly from the UK and these will derive most benefit from the new pooling provisions.

Non-recurrent costs

- 6.5 Companies will incur some one-off costs in familiarizing themselves with the new legislation. They will need to take specialist advice about its application to them, train their staff and amend the software (where this is used) that performs the calculations of double taxation relief and prints out computations for internal use and for forwarding to the Inland Revenue. Companies consulted said they would normally expect to do this type of familiarization with new rules on a regular basis and could not quantify the additional cost of new measures. Although this consultation took place before Budget 2000, and does not therefore take into account the extensive changes made to the provisions in the final Finance Act and Finance Act 2001, no further comments have been received.
- 6.6 In some circumstances groups whose subsidiaries are owned directly by UK companies will obtain the most benefit from the new provisions. On the other hand for many groups there will be little or no difference, and in the majority of cases all or virtually all their subsidiaries are owned from the UK. A decision to reorganize will always be a complex one dependant on many factors. Some groups will consider a major reorganization of their overseas operations is justified, others a limited reorganization. Others will not feel any reorganization is required at all, and for a fourth group reorganization after an acquisition will be avoided. Some groups who considered they would have

to reorganize to gain maximum benefit from the provisions volunteered rough estimates in the summer of 2000. The amendments brought in by the Finance Act 2001 will reduce the extent of reorganization that some groups previously felt necessary and for others may obviate it entirely.

- 6.7 The restriction of relief for underlying tax and credit elsewhere of eligible unrelieved foreign tax will not require the capture of additional data or the performance of additional or different types of calculation. The existing calculations that are already carried out will continue to be made; but some of the figures that are used will be modified, in that the rate of tax attributable to dividends paid between companies will not be able to exceed 30%, or 45% for eligible unrelieved foreign tax, in place of a possibly higher rate that has entered into the calculations in the past. This will not result in any ongoing costs and one-off costs are expected to be around £50 per group. Again however consultation took place before Budget 2000, and does not therefore take into account the extensive changes made to the provisions in the final Finance Act and Finance Act 2001.

Recurrent costs

- 6.8 The changes will not, for most companies, involve the capturing of additional data, although some data that is already held will be used in a different way. If a company wishes to take advantage of any of the ways in which eligible unrelieved foreign tax can be used, it will already know the amounts involved (foreign tax paid less the amount allowed in the original period). But it will also now have to keep a record of the amount of the unrelieved tax and make sure that it adds it to the tax (if any) paid in the other period concerned. Estimates of these costs varied between £100 and £300 per group/company per year.
- 6.9 Some non-resident companies operating in the United Kingdom through a branch or agency will for the first time be able to claim relief for foreign tax paid on the income of their United Kingdom branches or agencies. They will already have the information about the foreign tax that they have paid but they will have to incorporate that information in a claim to the Inland Revenue. The non-recurring cost of setting up such a system of information is estimated to be around £50 per company and the recurring costs of formulating a claim at around £125 per company per year.
- 6.10 In those cases where tax relief has been extended, companies will only incur the compliance costs if they think that the outcome will be reduced United

Kingdom tax bills as a result of additional relief for foreign tax that exceeds the costs of putting them in a position to make the claim.

- 6.11 The requirement that a company claiming relief for foreign tax should take reasonable steps to keep its foreign tax payments down may mean multinational groups incurring costs in other countries in taking those steps. The extent of these will depend on what procedures the groups have currently in place to ensure that this is the case.
- 6.12 On the other hand, UK companies will see a reduction in their recurrent tax planning costs as a result of other changes concerning relief for underlying tax (as set out in annex 1). Sources of compliance cost savings are listed in annex 3, each of which leads to savings of between £200 and £1000 per company/group. Companies should find it easier to make double taxation relief claims where foreign companies make group tax returns; the abolition of the specification of profits out of which dividends have been paid should involve some compliance savings; and there ought to be some benefits from certain practices that have grown up over the years are being put into statutory form. The definition of relevant profits is now clearer, as are the rules for relief where a company distributes another company's profits (currently legal costs are often incurred which will no longer be necessary). Groups have indicated that removal of uncertainty will enable them reach decisions more quickly and effectively.
- 6.13 Taken together these measures are expected to result in reductions in recurring costs of approximately £2 million per year. Even when the costs relating to the provision of the new reliefs for carry forward/back of foreign tax, and for branches of foreign companies, are taken into account, the measures are expected to result in an overall reduction in costs in the region of £1 million per year.

7. Impact on small businesses.

- 7.1 There will be a beneficial effect on small and medium-sized enterprises (SMEs). These typically have not employed mixer companies and will benefit from the on-shore pooling provisions and the ability to utilize EUFT. For this purpose we have used the European Commission State aids definition of small and medium-sized enterprises¹. Broadly speaking, a company is an SME if it, together with any company that it controls by holding 25% of its capital or voting rights, has:

¹ " *The Commission Recommendation of 3 April 1996 concerning the recognition of the definition of Small and Medium sized Enterprises*" OJ L107

- fewer than 250 employees, and either (or both of),
 - an annual turnover of not more than Euro 40 Million (about £25 million)
 - an annual balance sheet total not more than Euro 27 million (about £17 million)

8. Other costs

8.1 The changes will lead to new costs for the Inland Revenue, in the form of the time required for familiarization with the new legislation, additional training requirements and more submissions to Head Office, especially in the early days.

9. Enforcement and monitoring

9.1 The Inland Revenue will monitor how the changes operate in practice. In particular, International will continue to monitor the effectiveness of the legislation concerning relief for underlying tax, in conjunction with the Large Business Office. The case for further changes to the legislation will be kept under review on an annual basis.

10. Summary

10.1 The package of measures has improved the way in which the UK's system of allowing double taxation relief fulfils its objectives.

10.2 Businesses that were consulted before the 2000 Budget were unable to quantify some of the non-recurrent costs associated with these measures since they considered that they would be dealt with in their normal cyclical compliance reviews. The scope of the current changes may go beyond what would be covered in such reviews. The total non-recurrent costs that so far have been quantified would be in the region of £0.3 million. The package includes some measures that are expected to increase recurrent costs and others that will reduce such costs. Overall there is expected to be a saving in compliance costs of around £1 million. The measures will have some effect on the costs of small and medium-sized enterprises if they wish to claim the benefit of on-shore pooling. Most compliance costs relate to the reliefs claimed by the major multinational groups of companies and it is these who are expected to benefit from reductions in these costs.

11. Contact Point

Susan New
International (External Relations Group)
Victory House

30-34 Kingsway
LONDON
WC2B 6ES

TEL NO 020 7438 7250
FAX 020 7438 7511
E-MAIL Susan.New@ir.gsi.gov.uk
!

ANNEX 1
OTHER MEASURES

In respect of underlying tax relief the following measures not referred to elsewhere in this RIA have been introduced

1. If relief from, or for, foreign tax can be claimed under a double taxation agreement, credit for it cannot be claimed under domestic law; and credit relief for foreign tax cannot be claimed under domestic law if a double taxation agreement expressly denies relief for it under the agreement.
2. The time limits for claiming relief for foreign tax have been extended where the tax is not paid until after the current time limits have expired.
3. The royalties article of some double taxation agreements will deny relief from source state taxation. Legislation has now made clear that in cases where there is a special relationship between the payer and the recipient of royalties, this may be overruled not only where the royalty rate is excessive, but also where the agreement under which the royalties are paid would not have been made in the absence of the special relationship.
4. The operation of the mutual agreement procedure has been improved by legislation that clarifies how effect may be given to an agreement reached under the procedure and what time limits apply..

ANNEX 2**DOUBLE TAXATION RELIEF CLAIMED IN ACCOUNTING PERIODS ENDING IN 1998-99**

<u>SECTOR</u>	<u>Number of Companies</u>	<u>CT Liability Before DTR £mn</u>	<u>DTR Claimed £mn</u>
OIL AND GAS	120	1,820	1,640
MINING AND QUARRYING	10	190	150
CHEMICALS (INCLUDING PHARMACEUTICALS)	160	840	410
OTHER MANUF AND CONSTRUCTION	1,180	2,810	1,320
DISTRIBUTION, HOTELS AND CATERING	490	990	130
TRANSPORT AND COMMUNICATION	160	1,320	100
UK AND FOREIGN BANKS	70	1,930	340
LIFE/GENERAL INSURANCE	180	2,520	370
OTHER FINANCIAL ACTIVITIES	1,070	2,830	1,550
BUSINESS SERVICES	440	360	140
OTHER SERVICES	230	90	20
REMAINING SECTORS	1,110	1,630	900
ALL COMPANIES WITH DTR	5,220	17,330	7,070
REMAINING COMPANIES WITH CT LIABILITY	474,780	23,170	0
ALL COMPANIES WITH CT LIABILITY	480,000	40,500	7,070

ANNEX 3

RECURRENT COSTS/(SAVINGS)

	Small/Medium groups (<i>groups with less than 25 overseas subsidiaries</i>)			Large groups (<i>groups with 25 or more overseas subsidiaries</i>)			All groups
	Per company / group	No. of companies	Total £000s	Per company/ group	No of companies	Total £000s	Total (rounded to £m)
Cap on underlying tax and EUFT		2000	Nil	Nil	200	Nil	
Carry forward/back of foreign tax	175	2000	350	300	1000	300	0.6
Relief for UK branches of foreign companies	125	300	38	125	200	25	0.1
Repeal of specification of profits	(400)	1000	(400)	(600)	1000	(600)	(1.0)
Distribution of profits of another company		None	Nil	(1000)	250	(250)	(0.3)
Group returns	(400)	100	(40)	(800)	200	(160)	(0.2)
Definition for relevant profits	(100)	1000	(100)	(200)	1000	(200)	(0.3)
Minimum foreign tax	50	1000	50	100	1000	100	0.2
Treaty claims	Nil		Nil	Nil		Nil	Nil
Time Limits	Nil		Nil	Nil		Nil	Nil
Royalties	Nil		Nil	Nil		Nil	Nil
Mutual agreement procedure	Nil		Nil	Nil		Nil	Nil
Sub-total costs			440			425	0.8
Sub-total (savings)			(540)			(1200)	(1.7)
TOTAL SAVINGS			(100)			(775)	(0.9)