Brown goes a shade green

Since 1984, the UK has countered UK-parented groups accumulating profits in low-tax overseas subsidiaries by taxing parent companies on the profits of such subsidiaries. Controlled foreign companies (CFCs) are taxed unless they are carrying on 'exempt' business activities, pay tax locally at 75% of the UK corporation tax rate, or distribute 90% of their profits back to the UK where they can be taxed.

The UK legislation has been challenged as a breach of European Union treaty rights. In September 2006, the European Court of Justice (ECJ) ruled that the UK's CFC rules did not automatically breach the EU treaties, but could only be applied to "wholly artificial arrangements" that did not reflect economic reality. Companies conducting genuine economic activities within the European Economic Area (the EEA: the EU plus Iceland, Liechtenstein, Norway and Switzerland) should not be affected by the UK rules. The ECJ sent the case back to the UK courts for a decision in light of its judgment.

The Pre-Budget Report relaxed the UK's CFC rules, as of 6 December 2006. The relaxation includes exempting from tax that part of the CFC's profits that represent the net economic value added by the CFC, and its parent, from work carried out by individuals working for the CFC in businesses within the EEA. The two key points are:

- Profits from the CFC's capital or intellectual property are not exempt; and
- Although the exemption applies to economic value to the group, profits earned by the CFC from transactions with other group companies can also benefit from it (see *Figure 1*). Although the CFC's revenues are received entirely from the parent company, its staff create value for the group by contributing to its business.

The proposals appear much narrower than warranted by the ECJ's decision. As the issues affect some very large UK groups, the proposed CFC rules will probably be challenged by further litigation before the ECJ.

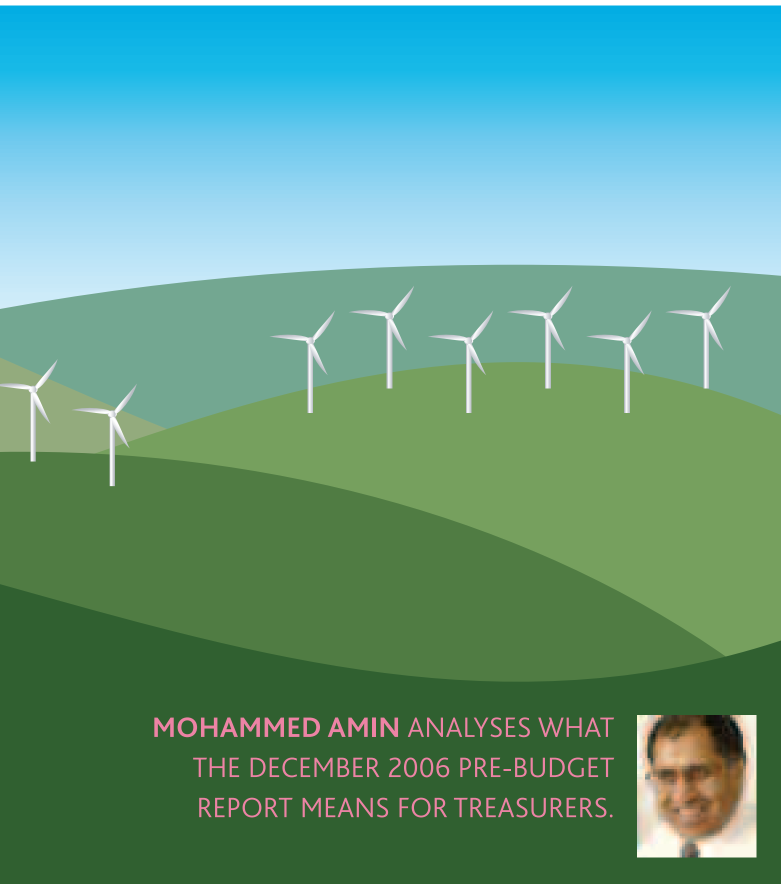
RETROSPECTIVE REDUCTION IN TIME LIMITS FOR MISTAKE OF LAW CLAIMS In the case of Deutsche Morgan Grenfell v Commissioners of Inland Revenue, decided on 25 October 2006, the House of Lords ruled that where a taxpayer claimed repayment of tax paid under a mistake of law (in that case, not appreciating that a UK statutory provision was inconsistent with EU law), the time limit for challenging the decision was six years from the date of the ECJ's decision. Normally the time limit for a repayment would be six years from the date the tax was paid. The case was of narrow impact because it did not apply to taxes which could be collected under an assessment, and so was primarily limited to cases about advance corporation tax (ACT), and because the law has already been changed so that it does not apply to cases started on or after 8 September 2003.

Executive summary

- For many years, the Pre-Budget Report (PBR) has been almost as significant as the Budget itself when it comes to announcing tax changes affecting business, and this year's was no exception regarding the environment. But how green was Gordon's PBR?

In the Pre-Budget Report, the government limited the impact of the case still further. It will now not even apply to cases started before 8 September 2003, unless the judgment is given before 6 December 2006. Deutsche Morgan Grenfell was the test case for a group litigation order, so only Deutsche Morgan Grenfell itself, plus other taxpaying members of the order, will benefit from the decision. As the ECJ has established that a taxpayer's treaty rights cannot be taken away without adequate notice being given, more litigation seems likely here.

A TAX RULINGS SYSTEM FOR THE UK Groups with subsidiaries in certain overseas countries, such as the Netherlands, appreciate the benefits of obtaining binding advance rulings from the tax administration to clarify how those subsidiaries will be taxed. By comparison, the UK has a very limited set of tax provisions (certain anti-avoidance provisions) where there has been a binding system of formal advance clearances. In addition, binding advance guidance has been given by HMRC on certain aspects of new tax legislation, under the Code of Practice 10 (COP 10) procedure although there is no



MOHAMMED AMIN ANALYSES WHAT THE DECEMBER 2006 PRE-BUDGET REPORT MEANS FOR TREASURERS.

assurance that such guidance will always be granted.

This inability to obtain binding guidance in all circumstances has increased the uncertainty of the UK as an operating environment for multinational groups, compared with countries like the Netherlands. The HMRC document *2006 Review of Links with Large Business* reports the results of the Varney Review. A key Varney proposal is that HMRC should give pre- or post-transaction rulings on all legislation, not just legislation enacted within the last four years under the COP 10 procedure. The advance rulings will apply to "significant investments and corporate reconstructions" and will be available to "businesses that provide clear plans for investment". HMRC should also provide businesses with "their view of tax consequences of significant commercial issues whenever there is uncertainty". The government has announced it will implement the recommendations of the Varney Review in full.

So by the time of the 2008 Budget, businesses that seek a binding view from HMRC of a proposed transaction, or a view post-transaction but pre-filing a return, will receive a binding view within 28 days. The business will have to make a full and transparent disclosure of the supporting facts and the commercial intent.

Given the scope for obtaining a binding view, it may become the norm for companies to seek such binding guidance for all major proposed transactions, as is often the case in other countries which have a wide-ranging rulings regime. This could be one of the most significant changes in recent years for the actual practices of corporate tax departments.

REITS The first real-estate investment trusts (REITs) became operational on 1 January 2007. They are widely expected to transform the UK's quoted property company sector. As no corporation tax will be payable at the corporate level, they should appeal to a wider class of investors than quoted property companies have done historically.

Some detailed changes were announced in the Pre-Budget Report that will make REITs more attractive:

- Charities will be exempt from tax on REIT dividends, just as they are from tax on rental and dividend income;
- A company will be able to give notice to become a REIT and specify the date it will become one provided it has reasonable grounds for believing it will be listed by that date; and
- HMRC will require the REIT to be 75% in exempt property at the end of the year in which it lists, rather than immediately.

The changes should make it much easier for a property-rich group to transfer its properties to a subsidiary and float it off as a REIT.

ACCOUNTS AND HEDGING Changes are being made to the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004.

Existing regulation 9A applies to interest rate contracts which are a hedge, if the company makes an election. Broadly speaking, the effect of the election is that the company is taxed/relieved in respect of debits and credits arising from the contract which are recognised in the company's profit and loss account, but is not taxed/relieved in respect of fair value movements that are taken to equity.

Regulation 9A will be extended to apply to currency, commodity and debt contracts, as well as interest rate contracts. The change applies to periods of account beginning on or after 1 January 2006 and ending on or after 27 December 2006. Companies will need to consider whether to make the election.

GREEN TAXES Despite many rumours of extra green taxes, the Chancellor announced only a few changes. All rates of air passenger duty have been doubled with effect from 1 February 2007. Road fuel duties will rise by 1.25p per litre, although there is no return to an automatic annual escalation in duty. There is also an implicit tax increase for rebated fuel oil ('red diesel') so that it will no longer be available to construction vehicles from 1 April 2008.

Whether these and other minor changes are significant enough to mark this as a 'green' Pre-Budget Report is debatable.

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Figure 1. Tax exemptions on intergroup CFC deals