Budget 2001: a Brownian odyssey

Mohammed Amin of PricewaterhouseCoopers analyses what the Budget means for treasurers and considers some of the complexities they will need to overcome.

Some people have compared Gordon Brown unfavourably with Nigel Lawson, arguing that he does not have a coherent vision for the tax system. However, I believe there is now clear evidence for an overall Brownian vision.

No country is an island unto itself, not even Britain. The recognition that it must compete as a place to do business is the strategic theme, even if the Government sometimes stumbles in the execution, as with the double taxation relief furore last year.

So what do treasurers need to think about?

Interest and royalties

UK interest has been exempt from withholding, by election, when paid within 51% groups of companies. From 1 April 2001, this will apply to all interest (and other annual payments) where the recipient is a UK resident company, or the taxable UK branch of a foreign company. There are few points to watch out for:

- the provision is mandatory, where the payer 'reasonably believes' that the above conditions are satisfied. This kills certain planning ideas involving withholding income tax on payments which could be paid gross by election;
- if, despite reasonable belief, the conditions are not satisfied, then the payer is left to account to the Inland Revenue (IR) for the income tax. Accordingly, paying companies need to be very cautious before agreeing to pay interest gross. While it is easy to check that a business is incorporated in the UK, it is much more difficult to assure yourself that it is UK resident. One approach would be to insist on IR certification that the recipient meets the qualifying conditions.

Double taxation relief (DTR)

The effect of last year's DTR changes is that overseas mixer companies now give a worse DTR outcome than owning overseas subsidiaries directly from the UK. Where companies are owned directly from the UK, 'onshore mixing' allows eligible unrelieved foreign tax (EUFT) on dividends with overseas tax at rates between 30% and 45% to be offset against those qualifying dividends where the foreign tax is less than 30%. Despite last year's controversy, no fundamental changes are made to this new regime, but there are some important changes in the details:

- under last year's legislation, dividends from a mixer company where the 'mixer cap' has applied cannot participate in onshore mixing. The mixer cap bites when some dividends into a mixer have foreign tax at more than 30%, while other dividends into it have foreign tax less than 30%. The high tax dividend is capped at 30% and the dividend paid by the mixer to the UK (which also includes the low tax component) cannot benefit from any EUFT that the UK group may have from other dividends. From 1 April 2001 the group will be able to restrict the foreign tax claimed on the high tax dividend into the mixer, so that the mixer cap is not triggered. This will allow the dividend from the mixer to the UK to benefit from any available EUFT; and
- UK companies are often held by foreign firms which are owned by a UK parent. The UK corporation tax paid by the subsidiary has always been available for DTR, just like foreign tax. The applicable rate has been calculated using DTR principles, which can mean an effective rate of relievable 'foreign' tax on the UK subsidiary's dividend either below or above 30%. In future, the rate will be deemed equivalent to the UK corporation tax rate when the dividend is paid. This simplification kills certain planning ideas using UK companies under foreign chains where the effective tax rate was boosted above 30%.


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Controlled foreign companies (CFCs)

Where a UK company owns a CFC which pays tax at less than 75% of the UK rate, then, unless the CFC qualifies for one of the many exemptions, the UK company must self-assess itself on the CFC's profits.

One exemption is the CFC having an acceptable distribution policy (ADP) which requires 90% of the CFC's profits to be distributed back to the UK within 18 months of each period end. The Budget eliminates an 'artificial tax avoidance scheme' which enabled the CFC to have an ADP without anyone in the UK paying much tax on the dividend. Briefly, a bank would subscribe money for new shares in the CFC, which entitled the bank to receive dividends but allowed the CFC to buy back the shares at a low price. The dividend paid to the bank satisfied the CFC's ADP requirement, while costing the group little since the bank had paid about as much cash into the CFC as it received as a dividend.

While the CFC dividend was taxable in the bank's hands, as a financial trader it received a tax deduction for its loss on CFC's shares, since the selling price was far less than the amount invested. Accordingly, the bank suffered little or no tax on the dividend.

After the Budget, dividends paid by a CFC to UK companies that can deduct losses on shares do not count towards an ADP if a UK tax avoidance scheme is involved. While this blocks the scheme, groups which have a part-owned CFC where a UK financial trader is also a shareholder will need to take care to demonstrate that there is no tax avoidance motive to prevent this new provision impacting upon them.

Foreign exchange, financial instruments and corporate debt

Since the November pre-Budget report, consultation has been underway regarding reform and possible consolidation of the law.

The professional consensus was that more time was required, and legislation has been deferred, probably to 2002. This is expected to finally eliminate the 'bear trap', where debt of an associated company is purchased below face value.

For example, if company A buys the shares of distressed company B and at the same time pays £400,000 for £1m nominal value of company B debt, then company A is taxable on the difference of £600,000, even if the debt is not actually repaid by company B.

While taxpayers must wait another year for relief from this injustice, Finance Bill 2001 is likely to contain targetted anti-avoidance measures to address schemes 'exploiting' the existing legislation. I await the Bill with interest.

Taxation of intellectual property, goodwill and other intangible assets

The Government has been consulting on this. Following the first round of consultations, a new proposal document has been issued, asking for responses by 31 May and aiming at legislation 'at the earliest opportunity'.

Historically, purchased goodwill and many other purchased intangibles (such as trademarks which are perpetual) have attracted no tax relief, being capital nothings. However, gains on their disposal have been taxable. The consultation document proposes:

- such items will be tax-deductible as they are amortised in the purchasing company's accounts, provided the accounts follow UK generally accepted accounting practice;
- regard may be taken of the treatment in the consolidated accounts, to protect the Exchequer against subsidiaries amortising faster than the group (published) accounts;
- sales at a price above the tax written down value will give rise to an income receipt. Where sales proceeds exceed original cost, the excess over cost may be rolled over against the purchase of other intangibles;
- where a company is acquired, it will be possible to roll over against intangibles inside the firm, by reference to their tax written down value; and
- in the longer term, UK law may be extended to include an election equivalent to the US Internal Revenue Code section 338(h)(10), discussion of which is beyond the scope of this article.

Overall, the proposals represent a worthwhile move towards tax neutrality for intangibles.

Gains on substantial holdings

Since June 2000, consultation has been underway regarding proposals to allow companies to roll over capital gains on substantial shareholdings. In part, this recognises that one reason groups have overseas mixers is to defer taxation of capital gains on foreign subsidiaries. The consultation is continuing, but the key points of the current outline are as follows:

- a stake of 20% of the ordinary share capital will be considered substantial;
- the shares sold must be shares of a trading company or the holding company of a trading group, as must the replacement shares; and
- rollover into business assets eligible for rollover relief will also be permitted.

During the consultation process, the concept of a complete exemption for such gains has been considered. But it is recognised by the Inland Revenue and industry that countries which exempt capital gains on substantial foreign shareholdings typically disallow interest relief on loans to finance such acquisitions. Disallowance of interest relief generates many complexities. While the Government does not rule out such a change in the longer term, bringing the UK closer to European systems, the current likelihood is for a roll over system to be introduced in the 2002 Finance Bill.

Limited liability partnerships (LLPs)

One area where the Government has not listened to representations concerns property investment. A property investment company, which pays corporation tax on rental income and on capital gains, is not tax-efficient if the shareholder is a pension fund, since direct investment would be tax-free. This may be one reason that many quoted property companies trade at a discount to net asset value (NAV).

The property industry has been lobbying, without success, for the creation of tax transparent property investment vehicles, such as real estate investment trusts (REITs) in the US. An LLP engaging in property investment would have most of the characteristics of a REIT. To stop them being used in this way, legislation will provide that, where an LLP is engaged in property investment and a pension fund is a partner, the pension fund's share of income and gains will not be tax exempt. The same will apply to the pension business of life insurance companies and the tax-exempt business of friendly societies.

Conclusion

A short article like this inevitably requires selectivity. Many of the other Budget changes, such as 100% first year allowances on energy-efficient capital expenditure will also be relevant to large companies, but were excluded on space grounds.

Overall, the Budget and the further consultations take the Chancellor a long way towards his vision of a tax system that makes the UK a desirable place in which to do business. At the same time, it is disappointing that unfashionable and immobile taxpayers (such as property companies) find that their representations fall on deaf ears. ■

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