Yet more change

Executive summary

■ The chancellor of the exchequer gave his Pre-Budget Report to parliament on 24 November 2008. Some of the tax changes announced in the PBR and related documents are the most far-reaching for years, and will have a major impact on treasury management decisions.

The UK taxes profits earned by overseas branches of UK companies but gives a credit for foreign income taxes suffered. Similarly, when a foreign subsidiary pays a dividend to its UK parent, that dividend receipt is taxable, but a credit is given for foreign withholding taxes and for corporate income taxes paid by the foreign subsidiary on the underlying income that has been used to pay the dividend. Accordingly, the UK tax system is classified as a credit system.

Conversely, most continental countries operate a territorial corporate tax system. Under this approach, Dutch companies, for example, do not pay Dutch corporate income tax on the profits of their foreign branches, although they will pay any local corporate income taxes. Similarly, when a foreign subsidiary pays a dividend to its Dutch parent, the parent is exempt from Dutch corporate income tax on that dividend. Such systems are classified as exemption systems.

There has been increasing concern that a credit system is no longer appropriate for the UK given the growing globalisation of business, particularly with most of the large European Union countries operating an exemption system.

After nearly two years of consultation, in its Pre-Budget Report (PBR) the government announced its final proposals for changes to the taxation of foreign profits, which will appear in the Finance Bill 2009. They include:

- a dividend exemption for large and medium groups; and
- an interest cap based on net external finance costs.

The other significant tax measure in the PBR that treasurers must consider are the new rules on disguised interest.

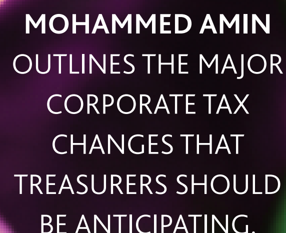
DIVIDEND EXEMPTION Foreign dividends received by large and medium-sized groups on ordinary and most non-ordinary shares will be exempt from UK tax. Small companies are excluded, in part because they are not subject to the same fiscal protection measures as large businesses and because of boundary issues with the taxation of individuals. The government is continuing to consider what changes are best suited to small groups.

A targeted anti-avoidance rule will be introduced to counter perceived potential exploitation of the exemption. This is consistent with the approach in other exemption countries. If foreign dividends are to be tax-exempt, the tax system needs protection against the artificial diversion of profits that would otherwise arise domestically (and be subject to tax) into foreign subsidiaries in low-tax jurisdictions that can then pay tax-free dividends.

INTEREST CAP As part of the package of foreign profits measures proposed to offset the cost of the new dividend exemption, further restrictions are to be introduced on the deductibility of interest. An interest cap will restrict UK interest deductions based on the group's worldwide net interest expense. This is intended to counter the risk that groups with little or no external debt may nevertheless leverage their UK operations to reduce UK corporate taxes.

At its simplest, if the group overall pays no external interest, then UK companies will not be able to deduct interest paid on loans from other group companies. To avoid falling foul of EU non-discrimination provisions, the rules will apply to UK-UK loans and not just to loans into the UK from overseas group companies. In the case of UK-UK loans, if the borrowing company is denied a deduction for interest expense, the UK lender will be able to exclude the corresponding interest income from its taxable income.

These provisions will require all groups to review their intra-group loans. Otherwise, there is a risk that interest deductions on intra-group loans could be denied in the UK, while the corresponding receipt remains taxable in a foreign country. Even with UK-UK loans, there is a risk that the operation of the new rules may leave groups with losses trapped in group companies that may not be able to use them in the future.



MOHAMMED AMIN OUTLINES THE MAJOR CORPORATE TAX CHANGES THAT TREASURERS SHOULD BE ANTICIPATING.

DISGUISED INTEREST Just over a year ago, HMRC issued a consultation document containing its proposals to deal with tax avoidance using financial products. The document dealt with two types of avoidance: disguised interest and transfers of income streams (not covered in this article). Following a period of consultation, including meetings with interested parties, HMRC has issued a revised consultation document, with amended draft legislation and explanatory notes.

The original consultation document set out a new approach for taxing company transactions, which are loans in substance but, due to their legal form, taxed more favourably than loans or not taxed at all. HMRC's previous approach to such avoidance was to enact legislation on a piecemeal basis to target particular schemes, including legislation such as the rules about shares treated as debt in the Finance Act 1996, sections 91A-91G. The aim of the disguised interest rules is to replace these piecemeal responses with a comprehensive set of rules which ensure that an interest-like return is charged to corporation tax in all circumstances where an arrangement is structured with the intention that the return is not taxed as income.

The original proposed legislation stated an over-arching principle that the rules should tax a return which is "economically equivalent to interest", and deliberately contained relatively few detailed rules as to how the law would operate in practice. This led to concerns that HMRC would have significant discretion over how the law would operate in practice.

The revised proposals retain the original concept of taxing a return which is economically equivalent to interest, but now set out a series of criteria to determine whether the rules apply. These criteria are:

- the return must be by reference to a time value of that amount of money;
- the return must be at a rate reasonably comparable to a commercial rate of interest; and
- there must be no practical likelihood of the return not arising as expected.

The revised rules attempt to deal with some of the concerns and uncertainties raised during the consultation process. The key points are summarised here:

- The rules will not apply to an arrangement unless the main purpose, or one of the main purposes, of the arrangement is tax avoidance.

- The rules are intended to catch returns denominated in a foreign currency, including foreign exchange movements.

- Straightforward intra-group share investments are excluded. In straightforward situations this should prevent double taxation in a tier of companies and should also remove controlled foreign companies from the scope of the rules.

- The rules catch an overall interest-like return which is split between different companies, although doubts remain over the extent to which the rules will disaggregate an interest-like return that forms part of a larger (non interest-like) return.

- The revised document also carves out a new proposal for preference shares, which are accounted for as a financial liability rather than equity. It is proposed that such shares will be dealt with by what is effectively a revised version of the Finance Act 1996's rules on shares treated as debt. Broadly, if such shares (redeemable or not) are held for an "unallowable purpose", the fair value movements will be taxable as interest. No deduction will be allowed to the issuer, for whom payments on the shares will still be treated as non-deductible dividends. Again, shareholdings in group companies are outside the scope of the rules.

HMRC's intention is to enact the legislation as part of the Finance Bill 2009, so that it is in force from 1 April 2009. Arrangements entered into before that date may be outside the scope of the rules.

RELEASE OF TRADE DEBTS BETWEEN CONNECTED COMPANIES There was at least one piece of unreservedly good news in all the changes. The Finance Bill 2009 will include legislation to ensure that where a trade debt between connected companies is formally released, the debtor will not be taxed on the consequential credit. Currently the creditor company is denied a tax deduction on a release, but the debtor may be taxed. The existing law can cause problems especially if the waiver takes place when the borrower has been dormant for many years and the group may have forgotten that the liability arose as a trading debt.

It will be effective for releases made in accounting periods beginning on or after 1 April 2009. It will apply to companies which, in the relevant period, are under common control, or where one company controls the other.

This change will apply only to formal releases, which are usually written under deed. It will not protect a simple informal waiver of a debt (whether a trading or non-trading liability) which HMRC regards as creating taxable income for the debtor company.

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