TACKLING THE MAIN TAX ISSUES

THE CHANCELLOR'S PRE-BUDGET REPORT IN DECEMBER PROMISES MUCH ACTION ON THE UK TAX FRONT IN 2004, SAYS **MOHAMMED AMIN** OF PRICEWATERHOUSECOOPERS.

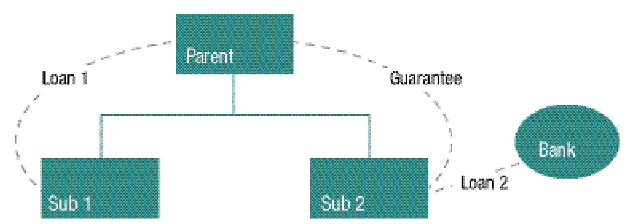
Gordon Brown's Pre-Budget report on 10 December 2003 continued the trend of recent years, where major tax changes are announced away from the traditional spring Budget. Corporate treasurers need to digest the changes rapidly, as the most important ones come into force on 1 April 2004.

TRANSFER PRICING AND THIN CAPITALISATION. The changes announced are best explained in the context of a simple example, as shown in *Figure 1*. All the companies are UK resident. Loan 1 owed by Sub 1 to the Parent is interest free. The terms of Loan 2 owed by Sub 2 to the Bank are, *prima facie*, arms' length but the Bank would only have lent half as much money but for the Parent having guaranteed Sub 2's performance – that is, Sub 2 is thinly capitalised as it has too much debt in relation to its capital.

Historically, with all of the companies being UK resident, the scenario in *Figure 1* would cause the Inland Revenue (IR) no qualms. The transfer pricing rules were expressly aimed at profits being diverted offshore, by UK companies overpaying or undercharging foreign affiliates. Similarly, the thin capitalisation rules were aimed at the UK tax base being eroded by excessive interest payments to foreigners. The *status quo* was, however, thrown into turmoil by a recent European Court of Justice decision in the case of Lankhorst-Hohorst GmbH. This held that the German thin capitalisation rules (similar to those of the UK) breached one of the fundamental freedoms of the European Union (EU), namely freedom of establishment. Accordingly, they were unlawful. The IR realised that the UK's transfer pricing rules and thin capitalisation rules would most probably also fail such a challenge under the EU treaties, since the UK rules apply to cross-border transactions only.

FIGURE 1

TRANSFER PRICING LOAN PATTERN



As allowing the UK rules to be struck down would risk the tax base, the alternative solution is being adopted, of making the rules apply to UK-UK transactions just as much as UK-foreign. The change takes effect from 1 April 2004. There are some noteworthy points, as follows:

- **Transfer pricing corresponding adjustments.** On Loan 1, the Parent will become taxable on deemed interest income at the commercial rate of interest which should have been charged on this interest-free loan. To avoid a one-sided tax cost, Sub 2 will be able to claim tax relief for a deemed interest expense of the same amount. The draft legislation published with the Pre-Budget Report recognises that groups may wish to move cash to correct their non-arms' length arrangements. Accordingly, any cash payment by Sub 1 to the Parent (to make up for the interest it should have been charged) will be ignored for tax purposes for both companies.
- **Thin capitalisation.** As we have assumed Sub 2 has borrowed twice as much money (with the benefit of the guarantee) as it could have borrowed without the guarantee, half of its interest expense will be disallowed for tax purposes. That does not stop the Bank from being taxable on the full amount of the interest received.

When the changes were first mooted, there appeared to be a real risk of double taxation, with Sub 2 suffering a disallowance, but no corresponding relief anywhere else. The IR has responded to representations on this point. Under the draft legislation, the guarantor, the Parent, will receive a tax deduction for Sub 2's disallowed interest, as if Parent had been a party to a notional loan from the Bank. Accordingly, being found to be thinly capitalised, in an entirely UK situation, should not cause an absolute loss of tax relief.

Of course, with both transfer pricing and thin capitalisation, the new rules could mean income and deductions arising in unexpected places. If the group was not tax paying overall, the effect could be to create stranded tax losses carried forward. The impact of the rules could also be to jeopardise other tax planning.

Finally, if the guarantee has been provided without charge, the Parent will be taxed on the fee it should have charged, while Sub 2 can claim relief for the corresponding notional expense.

- **Documentation requirements.** One of the most onerous aspects of the present cross-border transfer pricing rules is the requirement to maintain contemporaneous documentation. In the absence of acceptable documentation, transfer pricing adjustments give rise to penalties additional to the tax payable on the adjustment. These documentation requirements will now apply for UK-UK transactions.

FIGURE 2
EU INTEREST MATTERS

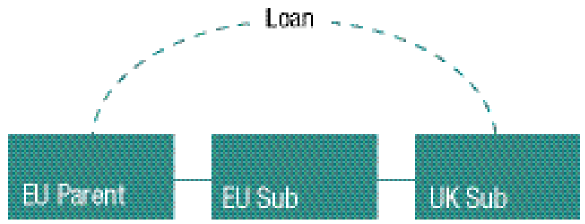


FIGURE 3
DOUBLE TAXATION IN PROPERTY

	Property income	Property gains
Corporate income/gain	100.0	100.0
Corporate tax	(30.0)	(30.0)
Available for dividend/growth in value	70.0	70.0
Individual dividend/capital gain	70.0	70.0
Personal income tax/CGT	(17.5)	(28.0)
Cash left to shareholders	52.5	42.0

To ease the transition, the penalty regime is being relaxed for two years running to 31 March 2006 – to avoid EU discrimination claims, the easing applies to cross-border and UK-UK transactions. The draft legislation provides that where a person delivers an incorrect return, he or she shall not be regarded as doing so negligently for the purposes of the penalty provisions by reason only of their failure to keep records relating to transfer pricing documentation. This test, unfortunately, leaves the IR much scope to argue that, irrespective of the documentation issues, the company knew the transaction was not at arms-length prices and has therefore knowingly filed an incorrect return.

EU INTEREST AND ROYALTIES DIRECTIVE. Withholding tax on dividends paid to substantial EU shareholders was abolished a decade ago. However, for many years, progress on a similar provision for interest and royalties was stalled. While many of the UK's double tax treaties reduce the withholding tax rate to zero, some (for example, interest paid under the UK/Italy Treaty) do not.

The EU Interest and Royalties Directive was finally adopted on 3 June 2003, and legislation will be included in the Finance Act 2004, applicable to interest and royalty payments made on or after 1 January 2004. They will be exempt from UK withholding tax, provided the recipient is an EU company which is a '25% associate' – that is, one company holds 25% or more of the capital or voting rights in the other, or a third company holds directly 25% or more of the capital or voting rights in both. The ownership interest needs to be direct or the interest will not be eligible for the relief, as seen in *Figure 2*.

For interest, advance IR clearance will be needed that the new provisions are applicable. However, for royalties, the payer can self-assess whether the qualifying condition for zero withholding are met.

CONSULTATION ON THE MEANING OF 'UK SOURCE' FOR PAYMENTS OF INTEREST AND ROYALTIES. While legislating to implement the EU interest and Royalties Directive, the government proposes to simplify one of the more arcane aspects of UK tax law. Income tax only needs to be withheld from payments of 'UK source' interest and royalties, but there is no definition of UK source. Instead, one looks to extensive and old case law, with a number of factors to take into account, which can lead to some difficult distinctions. Veteran treasurers may have fond memories of the 'Swiss roundabout' and similar structures used to pay interest on bonds without withholding tax prior to the introduction of the quoted Eurobond rules.

It is proposed to sweep all this complexity aside and specify that if interest or royalties are paid by a UK resident company, then they automatically have a UK source. However, comments are requested by 10 February 2004, so if anyone still has a Swiss roundabout, now is the time to speak up or restructure.

REAL ESTATE INVESTMENT TRUSTS (REITS). For many years, property companies and other property investors have lobbied the government about the double taxation of property income and gains. Illustrated in *Figure 3* is a comparison of a property company either paying dividends or retaining profit as growth.

If, instead, the 100 of income or gains had arisen directly to a UK top-rate taxpayer, he or she would have been left with 60. The problem is far worse with a tax-exempt investor, such as a pension fund or charity, where the retained proceeds for such an investor of 70 (in a property company) contrasts with 100 (with direct ownership.)

In the US, REITs are quoted vehicles which are themselves tax free, provided they distribute their income and capital gains to shareholders. REITs have led to a dramatic increase in US interest in quoted property investment. France has also recently introduced the same concept. The government announced that next Budget Day it will publish a formal consultation document on REITs. While the first UK quoted REIT may be some time away, I predict that, if introduced, their impact in the UK will be as dramatic as it has been in the US.

PROPERTY AND SHARE DERIVATIVES. For many years, an investor with a large share portfolio who wishes to reduce his or her exposure to the stock market has been able to do so using derivatives, for example, by selling FTSE 100 futures or by purchasing a put option. This is often quicker and entails lower transaction costs than selling the share portfolio itself. There has been nothing equivalent in the property market, where the need is, arguably, greater since buying or selling properties entails far higher transaction costs than share transactions. One reason for the dearth of property derivatives has been uncertainty of tax treatment.

It is proposed to include property derivatives within the 'derivative contracts' tax regime set out in FA 2002. This contains a coherent set of rules for the tax treatment, governing such matters as accruals or mark-to-market accounting. Where the derivative is held for trading purposes (for example, an investment bank dealing in derivatives), then the profits and losses would be part of trading income. However, for a non-trader, such as a property investment company, a derivative based on the value of property would give rise to capital gains or losses. There are, however, a few undesirable aspects.

A timing difference can arise between the derivative and the underlying property, for example, a gain on the derivative that is accrued in the accounts will give rise to a taxable capital gain for that year. If the property being hedged is still owned at the year end, any fall in value will not be recognised until it is disposed of. These timing mismatches may become much more serious under International Financial Reporting Standards (IFRS), which requires all derivatives to be marked to market.

No indexation allowance will be given. This will no doubt facilitate the derivative calculations, but it does present a disadvantage to taxpayers.

The capital gain/loss treatment will only apply to derivatives linked to the value of the property. Derivatives linked to the income from property will give rise to income gains/losses.

The IR is also floating the idea of extending these rules to equity derivatives. At present, equity derivatives, if not held by a trader, are outside the derivative contracts rules and give rise to capital gains or losses when disposed of, and are eligible for indexation allowance. Under the IR proposals, equity derivatives would have the same treatment as property derivatives described above.

The deadline for responses to this consultation is 10 February 2004.

PREPARING CONSOLIDATED ACCOUNTS UNDER IFRS. For all accounting periods starting on or after 1 January 2005, EU-listed companies must prepare their consolidated accounts under IFRS. From the same date, all UK companies, listed or not, will be permitted to use IFRS for their entity (unconsolidated) accounts, instead of being required to use UK GAAP, as at present. The Chancellor announced that the UK tax law will be amended so that IFRS accounts will be an acceptable starting point for tax purposes. The challenge with IFRS is that simply following the accounts will, in many cases, lead to radically different tax outcomes from those arising under UK GAAP. The IR has been busy consulting with corporates, professional bodies and professional firms regarding the way forward. It is clear that significant changes to tax law will be required. It was announced that:

- Tax relief will continue for research and development (R&D) expenditure when incurred, even where IFRS requires it to be capitalised.
- The present tax treatment of hedging arrangements using derivative contracts and foreign currency liabilities will be preserved.
- The detailed legislation governing derivatives and corporate debt will be revised to take account of IFRS (in particular IAS 39, which applies to financial instruments) and complementary changes to UK GAAP.

This remains a difficult area, with much scope for problems to arise when the detailed legislation is drafted. Overall, given the pace of change in the UK tax environment, treasurers need have no fear of too much time on their hands.

Mohammed Amin MA FCA CTA(Fellow) AMCT is a tax partner in PricewaterhouseCoopers LLP and heads its Finance & Treasury Network in the UK.
mohammed.amin@uk.pwc.com
www.pwcglobal.com