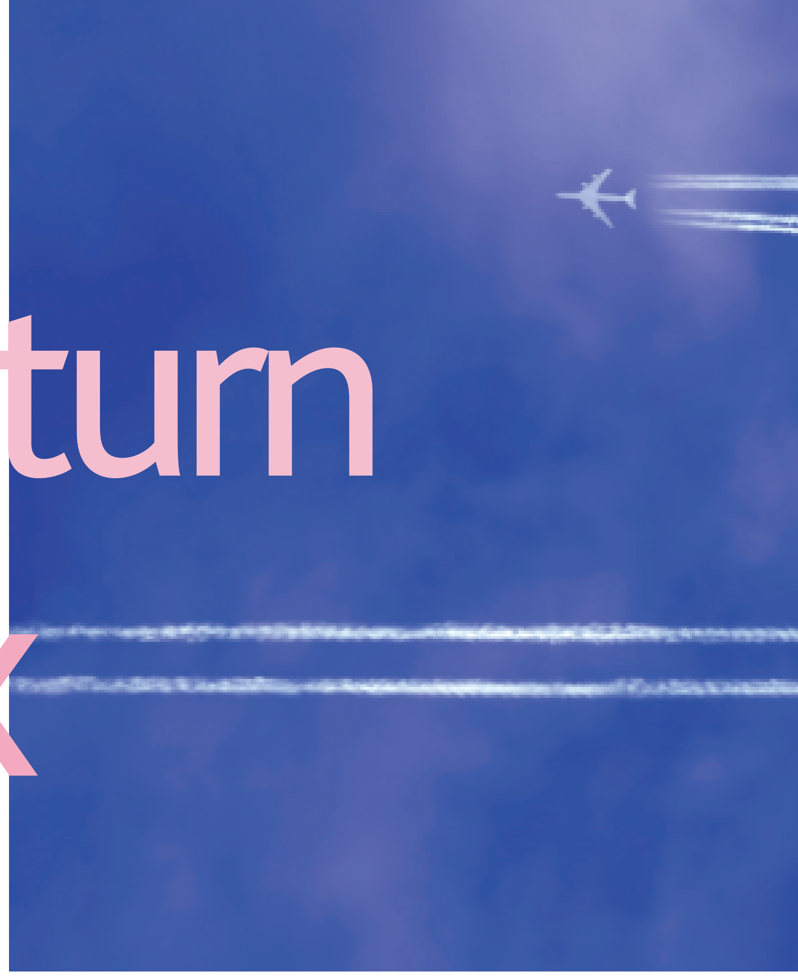
About-turn on tax



Executive summary

■ The UK is moving away from taxing companies on foreign dividends (but offering double-tax relief) in favour of a continental-style exemption regime, taking a new approach to disguised interest, and removing the tax hurdles to Islamic financial instruments.

In the April Budget, chancellor Alistair Darling announced a major change in the UK's tax regime for foreign dividends. Instead of offering double tax relief for the foreign tax paid on a corporate's foreign dividends, the UK is moving towards the exemption regime that prevails in many continental European countries, which contains the following three key elements:

▪ **Dividend exemption** Paradoxically, the UK is introducing an exemption for foreign dividends by first making all dividends (both UK and foreign) taxable, and then creating five specified exemptions that are subject to anti-avoidance provisions. This approach allows the legislation to exempt most foreign and UK dividends while taxing those arising from certain types of income (such as foreign interest income) that many countries with an exemption system also tax. This change comes into force for dividends received on or after 1 July 2009 and is intended to be consistent with the UK's obligations under EU treaties.

A key point is that UK-UK dividends no longer receive a blanket tax exemption, but need to fall within one of the specified exemptions.

▪ **Debt cap** The government has been consulting on a debt cap to prevent groups locating excessive amounts of related party debt in UK borrowing companies. The cap will come into force for periods of account of the worldwide group beginning on or after 1 January 2010.

UK group companies with net finance expense will be required to compare their combined net finance deductions (the "tested amount") with the worldwide group's gross external finance expense (the "available amount") taken from consolidated accounts prepared under International Accounting Standards (IAS) or other acceptable standards (including UK and US GAAP). UK group companies with net finance income or no finance income or expense are excluded when calculating the tested amount.

Impairment losses, profits or losses on the disposal of a loan (capital gain/loss), foreign exchange, external debt factoring, external hedging arrangements and certain short-term debt are specifically excluded from the definition of finance expense. All finance leases are included.

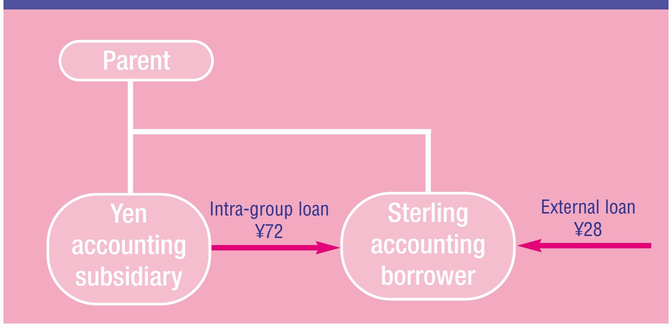
To the extent the tested amount exceeds the available amount, the UK group must restrict its finance deductions for tax purposes. Corresponding adjustments may be made to reduce UK group finance income to the amount of the disallowance.

A gateway test will be introduced and, if met, a group need take no further action on the debt cap measure. The gateway test will operate by comparing the net debt of UK group companies with the worldwide group's gross debt based on consolidated accounts. If the total net debt of all relevant companies is less than 75% of gross debt from the worldwide consolidated accounts, then the group passes the test.

If the group cannot meet the gateway test, it may still avoid the detailed application of the rules if a certifying statement is made confirming that the available amount exceeds the tested amount. However, given the complexity of the rules, significant work is likely to be required to obtain a sufficient level of comfort to self-assess that this is the case.

The key point for treasurers is that the rules will require a significant amount of additional record keeping and review to ensure

Figure 1: Structured FX arrangements



THE CHANGES IN THIS YEAR'S BUDGET, ESPECIALLY IN THE TAXATION OF FOREIGN PROFITS, ARE SOME OF THE MOST IMPORTANT FOR MANY YEARS, AND MERIT DETAILED ATTENTION BY TREASURERS. **MOHAMMED AMIN** EXPLAINS.

they are not infringed. While complex in some respects, the UK regime for deducting interest expense will remain more generous than some competitor locations. For example, the UK will continue to allow an interest deduction where the money borrowed is used to purchase a foreign subsidiary, dividends from which will be exempt.

- **Treasury consent** ICTA 1988 section 765, which dates from the immediate post-war period, is notorious among tax practitioners as the only tax provision with criminal penalties for failure to comply. It is being repealed, with a new transaction reporting regime. Reports will be due within six months of the transaction. However, exclusions from the new reporting requirement are narrower than the existing general consents under section 765, so certain transactions which do not currently need consent will have to be reported in future.

DISGUISED INTEREST Since December 2007, Her Majesty's Revenue and Customs (HMRC) has been consulting about tax avoidance involving disguised interest. The original consultation set out a new approach for taxing company transactions that are loans in substance but, due to their legal form, are taxed more favourably than loans or not taxed at all. HMRC proposed an over-arching principle that the rules should tax a return that is "economically equivalent to interest", and deliberately contained few detailed rules as to how the law should operate in practice. This led to concerns that HMRC would have significant discretion over how the law would operate in practice.

As a result of the consultation, the legislation in the Finance Bill 2009 retains the original concept of taxing a return which is economically equivalent to interest, but sets out a set of exclusive criteria. All of the following must be met:

- It is reasonable to assume that the return is by reference to the time value of an 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 rules will not apply to an arrangement unless it is reasonable to assume that the main purpose, or one of the main purposes, of the arrangement is tax avoidance. Straightforward intra-group share investments are excluded. This should prevent double taxation in a chain of companies.

There is also a specific rule 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 shares treated as debt rules in the Finance Act 1996. Broadly, if such shares (whether redeemable or not) give rise to an interest-like return and are held for an "unallowable purpose", they are taxed on all accounting debits or credits in the same way a loan receivable would be. Again, shareholdings in group companies are outside the scope of the rules.

The new rules apply from 22 April 2009 but arrangements entered into before that date are excluded from them.

STRUCTURED FOREIGN EXCHANGE ARRANGEMENTS The government is considering the issues and potential approaches to structured financial arrangements which involve the overhedging or underhedging of certain economic risks, and will issue a paper in the summer. The issue is illustrated by the structure in Figure 1. It enables a taxpaying group to borrow in yen with no post-tax foreign exchange risk, and is attractive if sterling borrowing rates are much higher than yen borrowing rates.

Although such arrangements are not motivated by tax avoidance, they pass on to the taxman, through tax relief, foreign exchange risks that would otherwise be borne by the business.

REMOVING THE TAX IMPEDIMENTS TO SUKUK Alternative finance investment bonds were defined in the Finance Act 2007 and correspond to the Islamic financial instruments known as sukuk.

For religious reasons, many Islamic investors are not prepared to invest in interest-paying bonds or to allow their companies to borrow funds by issuing bonds. Over the last decade, sukuk have been approved by Islamic religious scholars as a way for companies to issue tradable certificates (sukuk) which give investors a steady payment stream.

One common way to structure a sukuk is for the sponsoring company to sell one or more assets to a special purpose vehicle (SPV) company, which pays for the assets by issuing sukuk to investors. The SPV then generates income by renting the assets back to the sponsoring company and pays that income to the investors. After a specified period, the sponsor repurchases the assets from the SPV, which passes the sale proceeds to the investors to redeem the sukuk.

While the original legislation created a basic framework, it did not address the associated transactions involving the underlying assets.

The transfer of real estate assets to an SPV can trigger charges to stamp duty land tax. The sale can also crystallise capital gains and a claw-back of capital allowances. None of these tax penalties would arise if a company simply issued conventional interest-bearing debt secured on the assets. Tax changes now included in the Finance Bill 2009 will eliminate these tax obstacles, making it feasible for UK companies to raise funds in this manner. Treasurers should consider whether this might be suitable for their company.

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