Building pressure

PHILIP GILLETT URGES TREASURERS TO WATCH CLOSELY DEVELOPMENTS IN THE UK'S CONTROLLED FOREIGN COMPANIES TAX REGIME.

The pressures for change in how foreign profits are taxed in the UK have been building for some time. Some of the pressure arises from the need to improve the international competitiveness of the UK tax regime, especially the controlled foreign companies (CFC) rules, which have come under attack for being too complex and far-reaching. The CFC regime has been in existence for more than 20 years and has been amended almost every year since its creation, which has obscured its original stated purpose. However, the most significant pressure on the government in this area has come from recent decisions of the European Court of Justice (ECJ).

Following extensive private consultations with various representative bodies and individuals from business in mid-2006, the government issued a discussion document in June 2007.

Executive summary

- Pressure has been mounting on the UK government over its controlled foreign companies regime, especially following recent decisions by the European Court of Justice. The UK government needs to decide whether to tax all dividends, both UK and foreign, or to exempt all dividends. The latter is more common in the EU and would be popular with corporates, but the UK government has concerns over such a move.

TAXATION OF FOREIGN DIVIDENDS The starting point for these discussions has been the taxation of foreign dividends. At present, foreign dividends are subject to tax when received in the UK but benefit from a credit which is given for foreign tax already paid. This is sometimes limited to any withholding tax suffered but, more frequently, for dividends from foreign subsidiaries, includes any foreign tax paid on the underlying profits.

The current legislation covering this area is extremely complex, not least because of the way in which it was introduced in 2000, when initially some comparatively draconian legislation was put forward which was heavily modified prior to enactment. The net result, however, is that for most UK corporates, subject to sensible planning of foreign dividend flows, very little additional UK tax is payable on the remittance of dividends from overseas subsidiaries.

The problem from an EU perspective is that the UK system taxes dividends received by a company from non-resident subsidiaries but does not tax dividends from UK subsidiaries. This is clearly discriminatory treatment on the basis of residence and likely to be considered incompatible with EU treaties.

This issue was considered in the Franked Investment Income case, which was the subject of an ECJ decision given in December 2006. The ECJ found that the UK system for taxing portfolio dividends –

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that is, those from holdings of less than 10% of a company's share capital, on which a credit can only be claimed for foreign withholding tax – was incompatible with EU treaties. The court's opinion on non-portfolio dividends was slightly more Delphic, in that it looked at the amount of additional UK tax that was likely to be payable – in other words, it looked at the effect of the UK tax system rather than its basic structure. It therefore outlined a broad principle and referred the issue back to the UK courts to consider in more detail. This case has recently been heard in the High Court and a decision is expected later this year.

NEED TO ACT The upshot of all this is that the UK government is required to do something about portfolio dividends and may well also be required to do something about non-portfolio dividends, not least because a different treatment of portfolio and non-portfolio dividends would not sit easily in UK legislation.

The UK government needs to decide whether to tax all dividends, both UK and foreign, or to exempt all dividends. The idea of subjecting dividends from UK companies to tax when received by other UK companies could clearly lead to multiple taxation of company profits and a considerable administrative burden, even within purely UK groups, which would be very unattractive. There is therefore broad enthusiasm for an exemption system but the government have two key concerns:

- The UK has a relatively relaxed system for giving relief for interest and the government is concerned that under an exemption regime companies would be tempted to gear up the UK more highly than normal and to overcapitalise overseas subsidiaries in lower tax jurisdictions so those subsidiaries would make higher profits which could then be distributed back to the UK as tax-free dividends.
- Companies might also be tempted to put even more emphasis on their tax haven operations unless the existing CFC legislation was made fully effective.

A number of ideas have been put forward with the aim of limiting perceived excessive interest deductions, but the CFC issue is also under pressure from the ECJ.

A SIMPLE TEST The proposal contained in the discussion document issued in 2007 is that a company's deduction for interest in the UK would be limited to the total interest paid by the worldwide group. But this very simple test could have unintended effects in some cases. The most obvious effects would be:

- It would affect non-UK based groups that geared up their UK operations more highly than the group as a whole, possibly to take advantage of our favourable interest regime.
- It would limit interest deductions on upstream loans within UK-based groups, with the intention of deterring groups from remitting profits to the UK through loans rather than through the dividend.

There have been extensive discussions on this proposal and the government seems to accept there will be a number of non-abusive, fully commercial arrangements which would fall foul of this test and which should therefore be exempted. Examples might include the UK subsidiary of a non-UK multinational group which is heavily involved in PFI (private finance initiative) work. Its gearing might be expected to be significantly higher than the group as a whole. As regards upstream loans, there are a number of countries that only permit one dividend to be paid each year, but treasurers might want to bring back the cash on a monthly or even daily basis until a dividend could be formally declared.

Both these scenarios would face problems in the absence of relieving legislation. A sensible approach might be a general commercial override but the government has not so far put this forward.

CADBURY SCHWEPPES RULING Two recent UK CFC cases are highly relevant. The decision in the Cadbury Schweppes case was given by the ECJ in late 2006. This concerned the potential application of the UK CFC legislation to a group treasury company based in Dublin. The problem with the current UK CFC legislation is that it only applies to non-UK subsidiaries and is therefore potentially discriminatory on the basis of residence, and so possibly in conflict with EU treaties.

In the Cadbury Schweppes case, the ECJ decided that UK CFC legislation was incompatible with EU treaties except where it was applied to "wholly artificial" arrangements. Given that most group treasury and other financing operations are not wholly artificial arrangements, the existing CFC legislation no longer gives the government the protection from abuse it requires.

VODAFONE 2 RULING This concern has been emphasised by a more recent decision of the UK High Court, referred to as Vodafone 2. In this case the court looked at the application of the CFC legislation to a Luxembourg financing company. It held that on the basis of the Cadbury Schweppes decision, since the Vodafone arrangement was not wholly artificial, it had no choice but not to apply the UK CFC legislation. This clearly leaves the UK very exposed in this area.

The government introduced legislation immediately following the Cadbury Schweppes decision, with the aim of limiting the potential damage, but most commentators believe this legislation could also face an ECJ challenge. Its only effect has been to create an element of uncertainty, although it may have deterred other groups from setting up similar structures. While possibly successful as a short-term holding measure pending the development of a long-term solution, it does not appear to be a long-term solution itself.

US MODEL To avoid potentially discriminating on the basis of residence, last year's discussion document put forward the idea of targeting the foreign income subject to UK tax on the basis of defining a specific type of income. This approach would avoid trying to subject to UK tax an entire foreign corporate entity on the basis of a series of mechanical tests, as is currently the case. It is a similar approach to the US sub-part F legislation.

Such a regime would probably be more effective than the current one, and would prevent some avoidance techniques such as "swamping", where "bad" income in a company can be swamped by "good" income. As such it might not be attractive to all taxpayers. However, it would be better targeted, taxing the income at which it was aimed and not taxing the income of otherwise innocent subsidiaries caught by the interaction of the current collection of mechanical tests, which is a not uncommon problem. Most importantly, however, a debate on an income-based regime would require the government to state clearly the policy behind its CFC legislation, enabling a proper debate on what the appropriate policy should be.

INTELLECTUAL PROPERTY The discussion document set out a number of different types of foreign income that could be subject to UK tax but the proposal that arouses most concern is the suggested approach to taxing offshore intellectual property. The document suggested subjecting to the CFC regime any international group income derived in any way from the ownership of intellectual property, wherever that intellectual property was owned, even if had no connection whatsoever with the UK or was an intrinsic part of normal trading income in a non-UK company.

THE REMOVAL OF THE CFC CHANGES FROM THE PACKAGE IS VERY ATTRACTIVE TO A NUMBER OF UK GROUPS, ESPECIALLY THOSE WITH SUBSTANTIAL VALUE IN INTELLECTUAL PROPERTY, BUT THE IMPLICATIONS FOR TREASURERS MIGHT BE LESS ATTRACTIVE.

This was considered by many to be a totally unacceptable extension of UK taxing rights. It would push the UK to the bottom of any international tax competitiveness league and may have formed part of the thinking of companies that are considering emigrating from the UK.

Given the complexity and difficulty of many of these issues progress has been slow. This was a particular problem because the government wanted to look at the three issues of dividend taxation, interest deductibility and CFC as a package, and to maintain revenue-neutrality across those issues.

Following the first meeting of the new Business-Government Forum on Tax and Globalisation in June, both the CBI and The Hundred Group wrote to ministers to encourage them to make progress on the dividend and interest issues, while deferring the CFC changes for more extensive discussion.

The financial secretary to HM Treasury, Jane Kennedy, replied to the letters in July, saying that the new CFC rules would be deferred pending further consultation but that work would proceed on the dividend and interest proposals.

DELINKED This delinking of the three issues presents a real opportunity to pursue the dividend and interest issues in isolation and might have offered the possibility of legislation in next year's Budget. However, in her letter, Kennedy said the potential fiscal risks were too great to legislate on dividend exemption in next year's Finance Bill. Given that 2010 may see a general election, which often means a truncated Finance Bill, this could mean no changes until 2011 at the earliest. This would be very disappointing from the business perspective.

The removal of the CFC changes from the package is very attractive to a number of UK groups, especially those with substantial value in intellectual property such as international branded goods or pharmaceutical businesses, which had serious concerns about their impact, but the implications for treasurers might be less attractive.

The government believes there is significant fiscal risk in the introduction of a dividend exemption regime and has seen interest restrictions and better CFC legislation as vital components of the necessary fiscal protection. With the removal of the enhanced protection offered by a more effective CFC regime from the package, it will be looking to tighten the proposed interest restrictions, perhaps to an unacceptable degree, before introducing a dividend exemption regime. Treasurers should watch developments closely.

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