Tax Representation

ICAEW TAX FACULTY

# TAXREP 4/09

# TAXATION OF THE FOREIGN PROFITS OF COMPANIES

***Memorandum submitted in February 2009 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales as a further response to a consultation document published on 9 December 2008 by HM Treasury and HM Revenue & Customs. The first response submitted in January 2009 has been published as TAXREP 1/09.***

**Contents** **Paragraph**




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## TAXATION OF THE FOREIGN PROFITS OF COMPANIES

### INTRODUCTION

1. We welcome the opportunity to comment further on the proposals published by HM Treasury and HM Revenue & Customs on 9 December 2008 at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_029074

2. Our initial response, TAXREP 1/09, was submitted in January 2009 and is available on our website at http://www.icaew.com/index.cfm/route/163364/icaew_ga/Faculties/Tax/Publications_and_technical_guidance/TAXREP_01_09/TAXREP_01_09/pdf

3. We have attended the Open Days organised by HM Treasury and HM Revenue & Customs on 12 and 27 January and on 3 February 2009.

4. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

### GENERAL COMMENTS

5. We continue to welcome the decision of the Government to introduce a participation exemption and have set out below our comments on the detailed proposals. To the extent that comments in our first response are still of relevance we have repeated them in the current paper.

6. We are not in favour of the debt cap in principle and we are concerned by the very complicated provisions that are now emerging. Nevertheless if this is the price that has to be paid for the introduction of the participation exemption then, on balance, that is a burden that we will have to reluctantly accept.

7. In the light of the problems drafting the detailed provisions and the work that still has to be done we do not believe it is realistic to seek to introduce the package before 1 July 2009.

8. If the participation exemption is introduced from 1 July 2009, we recommend there is a 3 month delay before the debt cap provisions come into play, i.e. not before 1 October 2009, to allow blocked upstream loans to be unwound in that ‘interregnum’ period. Alternatively, and perhaps preferably, we recommend that the interest cap be introduced for accounting periods beginning on, or after, the date of Royal Assent.

9. There is also the need to fix the current problem with section 801(4)(a) ICTA 1988 which was discussed at the second Open Day on 27 January 2009. The current provision technically disallows DTR in relation to foreign dividends where they pass through more than one UK company in a chain. HMRC sought to

belittle the danger of this happening but the strong feeling from everyone else at that meeting was that this is a real problem.

## SCHEDULE 1 PART 1

### New section 930C

10. We repeat below the points that we made in paragraphs 7 and 8 of TAXREP 1/09 even though you have told us it is just a repeat of what is currently in the DTR rules.

11. The original point is reproduced below:

> ‘7. The blanket exclusion from the dividend exemption under 1 ( c) seems to be too harsh.
>
> 8. It could be that a preference dividend would rank for a deduction in the overseas territory and would as a result not qualify for the dividend exemption: it seems that this was the policy intention, but there may be other cases where the exclusion is unwarranted.’

### New section 930D

12. We understand this provision is intended to cover all CFCs on the basis that when the CFC rules are in play that should be the primary defence. We do not believe that the current drafting achieves this objective as it does not bring in dividends from companies which meet the 40% test. We believe that new section 930D(1) needs to apply where there is control, and also in cases where ‘the company is a controlled foreign company as a result of section 747(1A) ICTA 1988’.

### New section 930E

13. We continue to believe that the definition in sub-section (5) of ‘qualifying redemption amounts’ is too widely drawn and we repeat what we put in our earlier representation.

> ‘10. We believe that the definition in sub-section (5) of ‘qualifying redemption amounts’ is too widely drawn and that, as a consequence, many shares will be treated as redeemable and the dividend exemption will not apply to them.
>
> 11. For example, under Irish law any share is redeemable and we believe that ‘arrangements’ as envisaged for the purposes of Condition A could, therefore, extend to the law of a foreign jurisdiction and mean that no Irish company dividends would be covered by the proposed exemption. We recommend that specific wording be included to make it clear that this is not the case.
>
> 12. In addition, in any case where there are arrangements in place to sell a share, or otherwise realise value from it (for example, in the form

of a share buy-back), it would seem that conditions B and/or C would be met – meaning that in effect a dividend in anticipation of a sale could never qualify for exemption under this heading. As this is the provision which joint venture shareholdings will primarily rely on, we do not believe that it should be restricted in this way, and would recommend that conditions B and C be amended so that only shares which are truly "redeemable" are within their scope.'

14. Finally, there does not appear to be an exemption, here or elsewhere, for a non-controlling equity interest in a company which does not have a share capital, for example a US LLC. We should be grateful for confirmation as to whether this exclusion is the consequence of a specific policy decision.

**New section 930F**

15. In our earlier representation, at paragraph 14, we made note of what we believed to be a drafting error. We understand from comments made at the second Open Day meeting that our point has now been taken on board. We reproduce below, paragraph 14 from the earlier representation.

> '14. There appears to be a drafting error i.e. section 930F should, in our view, refer to holdings of strictly less than 10%, rather than to holdings of 10% or less. Otherwise the cut-off between the portfolio and participation exemption is not the same in the ECJ's FII GLO judgment, reflecting the fact that underlying double tax relief is available only for holdings of 10% or more.

16. We understand that the phrase 'amounts paid up are different' is meant to refer only to stated capital but we believe there may still be confusion and we have repeated below the point we made in our earlier representation.

> 15. We believe that the intention of sub-section (3) was to treat partly paid and fully paid shares of the same class as different classes of shares for the purposes of these provisions. However, the drafting appears to be wider than that and could be deemed to apply to rights issues shares and even to shares issued at different times at different prices, which would exclude a very large number of shares from its scope. We suggest that the wording be amended to make it clear that it only applies where the amount of the nominal value of the share which is paid up is different.'

**New section 930G**

17. If a company has once failed this exemption then there is currently no mechanism to allow it to come back within the exemption e.g. by paying out taxable dividends up to the amount of the 'bad' reserves.

18. We are concerned about the complexities of the exclusions. We understand that HMRC believe that the fact that the distribution has to be made as part of a scheme which has a main purpose of obtaining a tax advantage as narrowing it down (930I(2)(a). However, recent experience has shown that HMRC spend a lot of time claiming things are parts of schemes when they are only at best tangentially related. In order for that to be a proper, narrowing, filter we suggest

that it needs to be limited to cases where the purpose of the scheme is to obtain a tax advantage as a direct result of the receipt of the tax-free dividend. Given that proposed section 930G is already a 'motive test' in essence, we suggest that the exclusions should not apply to dividends which are exempt as a result of section 930G (in this way you avoid the absurd situation that a quasi-preference dividend can never be exempt, whereas a preference dividend can in the right circumstances).

19. We also repeat below the points we made in our earlier representation:

> ‘16. Unlike the other exemption headings, this applies only to “dividends” and not “other distributions”: as this is effectively the exemption of last resort, we do not believe that it should be limited in this way.
>
> 17. A reduction in UK tax does not prejudice the application of the dividend exemption if that reduction is ‘minimal’ – (3)(a).
>
> 18. This contrasts with the equivalent test under new section 930I(2)(a) where the test is a ‘negligible tax advantage’.
>
> 19. If these are effectively the same test then the same terminology needs to be used: if they are not, then at the very least clear guidance needs to be given on the distinction which is intended, and if at all possible it should be incorporated into the statute.’

**New section 930L**

20. We believe this is a provision that will cause unnecessary uncertainty. We suggest that it should be narrowed down so that it can only apply where the scheme involves non-arm’s length transactions, which have not been subject to a Schedule 28AA adjustment (or the equivalent in other territories) and that scheme was undertaken in order for the related profits to be remitted tax-free to the UK by way of dividend.

**New section 930M**

21. We understand that the government is sympathetic to the points we made re this section in our earlier representation and it is repeated below.

> ‘20. This anti-avoidance provision is targeting situations when a company is not a CFC when the profit is earned and then through a change in control becomes a CFC before the dividend is paid.
>
> 21. We believe that the wording in (2)(a) should be amended by adding ‘a control of’ between ‘of’ and ‘a’ so that it reads ‘subsection (1)(b) is satisfied by reason of the acquisition of control of a company’.’

22. We repeat below the representations we made in our earlier representation in relation to new sections 930Q, 930R and 930U

> **‘New section 930Q**

22. We are unclear why the definition of ordinary share in section 832(1) has not been used which defines ordinary shares as any share ‘other than capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the profit of the company’. While this is a wider definition than that proposed here, it has the advantage of being familiar to UK tax practitioners – and we believe that the scope of the anti-avoidance provisions is such that retaining the familiar definition should not result in increased risk of abuse.

**New section 930R**

23. This defines the ‘participation distribution’ by reference to a holding of at least 10% and contrasts with the provision in 930F which is by reference to a portfolio holding of 10% or less: as noted above, we consider that 930F should be amended to refer to a holding of less than 10%.[1]

**New section 930U**

24. The effect of retaining the ADP provisions in this way is to effectively require groups which do not want the ADP treatment to apply (i.e. those which wish to accept an apportionment in relation to a pre-commencement period) to retain profits offshore until the ADP deadline has been met – which appears to run contrary to the general intention behind the exemption, which encourages repatriation of profits. We recommend there should be the right to elect to opt out of the ADP regime for the transitional period (this could be achieved by making the election a condition for the exemption in paragraph 2(1) Schedule 25 ICTA 1988, and then only excluding dividends in relation to which the election has been made from the exemption under this section).’

23. In relation to the last paragraph we understand that there is consideration of allowing the opt out to be more widely available so that companies can benefit from lower withholding taxes under the relevant UK Double Tax Agreement. The issue would be whether the UK charge under this procedure would be treated as a voluntary payment rather than a tax with, as a consequence, the lower Treaty withholding not being available. We believe that this needs careful consideration and is a similar issue to the £30,000 payment that can be required of non domicile individuals to continue to benefit from the non remittance basis and the query whether such a payment would rank for double tax relief for US citizens against their US tax liabilities.

**SCHEDULE 2**

24. We have obviously not seen the EC treaty advice that the government has sought from a leading QC so it is difficult to comment. It is clear that a significant quantity of the complication in the current proposals is caused by the need to keep the measures EC Treaty compliant.

[1] This is a similar point to the one made at paragraph 15 of the current representation and we understand this point will also be addressed.

25. There is a need to distinguish net versus gross from UK sub-consolidated versus aggregated individual amounts. In our view the latter is clearly contrary to the EC Treaty in the light of the Judgment in the Thin Cap GLO which has recently been heard in the High Court. We are also not clear that the former would be any more compliant as after aggregation it differentiates foreign to UK inter-group loans (recognised) and UK to UK inter-group loans (not recognised).

**Gateway test**

26. We repeat below the general points we made in our earlier representation, as still being valid:

> '25. At the very least the schedule as a whole should be disapplied (other than possibly a requirement to return the calculation proving it) in any case where the available amount is the same or more than the tested amount, less related party interest income which would be taken into account under paragraphs 44 and 45.
>
> 26. As an alternative there should be an accounts based gateway test under which if the UK tax group net finance expense is less than, or equal to, the global consolidated net finance expense then there should be no need to do the formal legislative calculation.'

27. We understand the government is looking at not requiring any reallocation or deduction in a case where there would be no overall restriction which we support.

**General comments**

28. We support the view that FOREX adjustments should be excluded from the debt cap calculations.

29. We continue to believe that if there are unrelieved borrowing costs then there should be a facility to carry these forward to ensure that amounts can be matched.

30. The reallocation of interest income which can result from the way in which these rules operate can have the effect of converting trade debits into non-trade debit carry forwards. We understand that the government is looking at ways to resolve this and we strongly support those efforts.

31. We welcome the proposal outlined in the presentation given at the 27 January open day to adjust the 'available amount' to strip out cash balances resulting from disposals which are being held for future acquisitions. However, given the time limit and the need to demonstrate a purpose for holding the particular cash balance we believe that it is important that this should be optional, so that groups can choose not to take on the additional compliance burden which would inevitably be associated with identifying and documenting such balances.

32. We understand that there is to be an exclusion for short-term debts, based on a new definition which will probably be limited to 3 month debt excluding any rolled over debts, as a means of addressing most of the cash-pooling concerns. We are

not sure that this will fully address the issue as many companies will have the balances for longer than the 3 months.

33. We understand it is under consideration to allow a longer period than 12 months for the separate debt cap returns to be made, provided this had no effect on the tax payment date. We believe that this might be helpful to some groups.

34. We believe that the adjustment provisions should apply where the recipient of the interest is a CFC suffering an apportionment, in the same way as it does where the recipient is a UK company.

Iky
6 February 2009

**ANNEX A**

## ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 130,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

**ANNEX B**

## THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**; see http://www.icaew.co.uk/index.cfm?route=128518.