TAXREP 26/99

DOUBLE TAXATION RELIEF FOR COMPANIES

Comments from the Tax Faculty of the Institute of Chartered Accountants in England and Wales on a Discussion Paper issued on 12 March 1999 by the Inland Revenue on Double Taxation Relief for Companies

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DOUBLE TAXATION RELIEF FOR COMPANIES:

A DISCUSSION PAPER

1 We welcome the opportunity to comment on the above Discussion Paper which was issued on 12 March 1999.

GENERAL COMMENTS

2 We found the commentary, together with the background notes on the UK system of double taxation relief ('DTR'), a helpful summary of the issues. The introduction states that the discussion paper focuses on policy issues in a relatively high level manner. We accept that this is a helpful approach, but in our response we have also considered specific problems that arise in this area and how they might be resolved.

3 We have divided our response into two: firstly the major points that arise and secondly other less fundamental points that still need to be addressed.

MAJOR POINTS

Retention of the credit system

4 The discussion document proposes retention of the credit system of relieving double taxation rather than the adoption of an exemption method. In our response to the previous consultation, issued as TAX 26/98 (a copy of which is attached), we suggested that the Revenue should carefully consider the possibility of the introduction of an exemption system and its ramifications. The discussion paper sets out in Chapter 4 the arguments for and against the possible introduction of an exemption system, and concludes (in paragraph 4.18) that an exemption system should not be introduced.

5 We have considered these arguments again in the light of the comments made in the document. We support the conclusion that the existing credit system should be retained, subject to the following points.

6 Firstly, the more glaring inefficiencies of the current system, in particular the probable loss of DTR on legal mergers or conversion and the inability to trace DTR via non corporate entities, must be addressed as a matter of urgency (see paragraphs 27 to 29 and 42 to 45 below).

7 Secondly, there are circumstances, for example in the area of the exploitation of natural resources, where because of high capital investment, local tax depreciation and long lead (or head) times, the credit system may operate unfairly. In these circumstances, some type of exemption method may be preferable to a credit system. On the assumption that a general exemption system will not be introduced, this could be achieved by way of exemptions under specific treaties, thus targeting the relief to those countries where this problem arises.

8 Thirdly, as a deregulatory measure, the Government may wish to introduce an option for a company to use an exemption system where dividends from an overseas subsidiary do not exceed £50,000 in the financial year and derive from activities where the CFC rules do not apply.

Onshore v offshore pooling

9 The document reviews the idea of onshore pooling (adding together foreign tax credits and crediting against UK tax payable on total foreign income), as an alternative to offshore mixing. As noted in the document, there are a number of ways that this could be organised – a single pool for all types of foreign income from all countries, or alternatively separate pools by type of income or country or tax rate.

10 The document notes that as a result of the existing, inflexible, system of granting double tax relief on a source by source basis, it is usual for UK multinational companies to establish an offshore ‘mixer’ subsidiary company, typically in the Netherlands, to receive dividends which are then paid up as a dividend to the UK parent. We understand that the majority of UK multinationals adopt this structure, which is well-known and (as made clear in the document) accepted by the Revenue.

11 We note the comments in paragraph 6.14 on the costs of running an offshore mixer structure, although we suspect that majority of these costs will have to be incurred in any event in order to comply with DTR rules.

12 Subject to the comments below, onshore pooling would achieve a similar result as an offshore mixer arrangement, and should at least avoid the need for the extra costs of running an intermediate mixer company. We think that onshore pooling would be a valuable additional method to enable UK companies to obtain effective DTR. We therefore welcome the proposal to introduce onshore pooling.

13 If onshore pooling is introduced, it should not be at the price of a denial of foreign tax losses against the domestic tax base. Further, UK groups should not be precluded from using an offshore mixer structure, should they wish to do so. If offshore mixer structures were replaced in favour of onshore mixers, then many if not most UK multinationals would need to restructure entirely their overseas ownership structures. Regardless of the possible tax charges that might arise, the time and costs of undertaking a restructuring of this sort could be very expensive.

14 We therefore recommend that if any onshore pooling arrangements are introduced they are introduced as an additional method of providing DTR, and that taxpayers are able to operate whichever system of relief they wish to apply to their particular circumstances.

15 In the event that the Government decided to offer both offshore pooling and onshore pooling, we recommend that special rules should be introduced to allow offshore mixer companies in groups to be restructured into the UK without suffering any tax charges.

16 The document recognises (in paragraphs 6.18 and again at 6.28) that the offshore mixer structure also provides a shelter from UK corporation tax on capital gains (‘CGT’) on the disposal of investments held by the offshore mixer company. If an onshore system is introduced, we think that the Revenue should examine whether it might be possible to introduce some form of share roll-over relief. Such a relief might improve the attraction of the UK as a base to locate international holding companies.

This proposal could be undertaken as part of any further review of CGT for companies.

EU tax issues

17 We are concerned that the document does not address in detail the EU implications of double taxation issues, and what changes may be required in order to ensure that the UK rules are not vulnerable to a challenge in the European Court of Justice ('ECJ'). The ECJ has become increasingly involved in direct taxation issues in recent years, and more and more cases are being brought by taxpayers in member states that domestic laws infringe the Treaty of Rome. Moreover, in addition to overriding legislation in members states, the ECJ's rulings can override existing double tax treaties between Member States.

18 A typical recent example of this process was the Safir case [1998] STC 1043 where the ECJ held that Swedish tax rules were unlawful even though the taxpayer, who had received insurance services from the UK, was probably subject to a lower tax rate than a taxpayer receiving domestic services.

19 A further difficulty arises from the conflict between the OECD concepts as used in the UK's double taxation agreements and the relevant EU rules. For example, the concept of non-discrimination as against the ECJ's interpretations of the EU concepts of 'equality' and 'freedom of establishment'.

20 The interaction of the Treaty of Rome with national laws and also with established OECD concepts used in tax treaties is of concern to taxpayers. It has created much uncertainty, both for taxpayers and we suspect the Revenue, whilst the appeal process to resolve any uncertainty is long and expensive.

21 These problem areas should be addressed on a multilateral basis with the other EU member states.

Inherent problems with UK DTR rules

22 The basic problem with the UK's DTR rules (and also we suspect other EU Member States) is that they do not go far enough in extending benefits to non-residents. The

scale of these problems has been brought to the fore in the recent case of Compagnie de Saint-Gobain v Finanzamt Aachen-Innenstad (Case C-307/97). Whilst the precise scope of the judgement it is not entirely clear, the UK DTR rules appear vulnerable in the following areas:

- any instance where double taxation arises between Member States, and
- the application of UK legislation and treaty provisions of an anti-avoidance nature, including the controlled foreign companies and thin capitalisation rules, and
- possible higher tax rates on permanent establishments than on domestic businesses, and
- the denial of benefits available under treaties and domestic rules to residents, etc, and
- treaty withholding taxes on the gross amount of interest etc, which may be discriminatory if deductions are denied which would be allowed to a resident taxpayer against similar income.

23 It is clear that even from this initial list that the potential areas were UK law is vulnerable are wide-ranging and we suspect that there are many more examples.

24 Apart from the Parent/Subsidiary and the draft Interest and Royalties Directives, the EU Commission has had little cause to date to become involved in DTR issues and has generally left them to the OECD and to individual Member States. However, in view of the developments referred to above, this appears unlikely to continue. It would be beneficial if the UK pressed for greater certainty in these areas.

What should be done?

25 We think that it is vital that a thorough review is undertaken of the UK DTR rules (including treaties) to ensure that they comply, as far as appears reasonably certain, with EU law. For example, as highlighted at Paragraph 8.5 of the discussion document, the possible extension of double tax relief to UK branches or agencies of a non-UK or EU (or indeed any non UK resident) company is considered, we suspect for the reasons already mentioned above. If the review identifies that certain UK rules do not comply with EU law, or that the precise application is unclear, then UK laws

should be amended rather than wait for the ECJ to consider them and possibly pronounce them invalid.

26 We appreciate that this exercise is not straightforward, but we think it is in the interests of all that it is undertaken, and we would be happy to discuss this further.

OTHER POINTS

Underlying tax and company mergers

27 One long-standing anomaly in the UK legislation is caused by the requirement that the underlying tax for which relief is claimed must have been paid by the same company as that paying the dividend. The consequence is that, when foreign subsidiaries are merged in a way which involves the old subsidiary disappearing, the new merged subsidiary contains pre-merger profits which if remitted up to the parent receive no credit for the tax originally paid on them by the former subsidiary. Moreover, it is not always obvious whether the merger is made in the right or the wrong way for claiming relief, as this depends on the exact wording of the applicable company law. Further there is little consistency of approach on how such mergers etc are dealt with for company law purposes across the EU, let alone in the US where company law varies from state to state.

28 Aside from the clear case of double taxation, this problem also causes additional compliance costs and/or delay in cases where relief is available, due to the need to first confirm the legal position of the merger.

29 This is a point which causes genuine practical problems and has been the subject of representations by business and professional organisations for many years. We welcome the Revenue's clarification via Tax Bulletin that various US State company mergers allow continuity of DTR history. Nonetheless, it is disappointing that the discussion document makes no mention of it, although we understand that the Revenue accepts this is an anomaly and that this issue will be looked at as part of this review. We believe that the time is right for the Revenue to reconsider the availability of tax credits where underlying companies 'merge'.

Double taxation relief and timing mismatches

30 The basic DTR rule is that relief is only given in respect of the accounting period when the double taxation arose. Thus, where a taxpayer may have excessive double tax relief, this cannot be carried forward or back.

31 Problems arise where there are mismatches in the timing. There can be a mismatch of accounting period because of different year ends of subsidiary and parent, or long-term contracts spanning several accounting periods. This is generally resolved in the UK by the matching of the dividend with the relevant profits irrespective of the accounting period(s) in which they arose.

32 In contrast to many other countries which give credit relief, there is no further provision for carry forward or back of unrelieved foreign tax. Such a facility would be useful, although it would only be effective if the foreign tax rate was lower than the UK rate in the earlier or later year. It would effectively enable onshore mixing as between accounting periods even if only on a source by source basis.

33 We think it would be reasonable to allow unused DTR credits to be carried forward for offset against future profits subject to DTR. In addition, we think it would be reasonable to allow unused DTR credits to be carried back.

34 In addition to the general problem described above, there are also a number of other examples where mismatches arise, as follows:

- Branch profits calculated under UK tax principles for UK tax purposes differ from the profits which were subject to foreign tax, or, under the principle of the Bowater case, relevant profits for purposes of calculating the underlying tax rate differ from the profits subject to foreign tax. This can be advantageous or not, and it may be mitigated where there is an overseas branch by deferring claiming capital allowances.

- Foreign exchange gains and losses where the exchange rate moves between the date the foreign tax is paid and the date the credit is received. Again, this can be advantageous or not, and in any event the taxpayer could hedge any possible exposure.

- Divergent characterisation e.g. of payments for software (as royalties or sales proceeds). The tax treatment of software payments is a difficult area in various respects, not just for double taxation relief, and is being addressed by the OECD as part of its work on E-commerce. The aim must be to arrive at a solution that avoids the mismatches that may arise under present national practices.

- Mismatch of both the nature of the income and of the persons paying the tax and claiming relief. International artistes and sportsmen do not fit readily into the normal tax system and so special rules for them are likely to be necessary under treaties and/or domestic legislation. Rules may be needed both to overcome problems of mismatches and to leave the main taxing power with the source country.

- Problems can result from differences in company law and tax law between the UK and the foreign country in relation to consolidated groups that the UK treats as separate companies. Likewise, changes to foreign subsidiaries including not only mergers (discussed at paragraphs 27 – 29 above) but also conversions and dissolutions which may cause the loss of or trap part of the underlying tax in the subsidiary or dilute its value.

- The difficulties for minority shareholders in obtaining information and documents to support double taxation relief claims.

35 The above list of potential problem areas is not exhaustive, and we suspect that many more examples can be identified. In many cases the difficulties can be worked around and are more of an irritant than an outright obstacle. Nevertheless, we think that steps could be taken to remove such impediments wherever possible.

Credit relief for non-admissible taxes

36 There are still some cases where problems occur with the interaction of DTR where a country may not levy a direct tax on profits but instead tax businesses in other ways.

For most countries this is not a problem, because company profits are taxed in a similar way to corporation tax and are an admissible tax for the purposes of credit relief. However, if this is not the case, the UK rules may not allow for DTR, and the only relief will then be by way of an expense, which is much less favourable than full credit relief.

37 Where it is a problem, the level of double taxation can be considerable. The typical example where the problem arises is in relation to technical and professional fees, where the other country seeks to levy gross or near-gross withholding taxes rather than taxing a figure which reasonably relates to the accounting profit earned in the country. This was the situation in Yates v GCA International Ltd [1991] STC 157, where Venezuela levied at source a tax on 90% of technical fees remitted, of which only 23% related to work done in Venezuela.

38 It was held that the tax was an admissible tax on the facts as performing a similar function to corporation tax, but credit relief was only available for 23% of the underlying tax, a clearly harsh outcome so far as the company was concerned. The hardship is even more acute in such cases if the tax is not announced until after the contract has been signed and there is no tax variation clause in the contract.

39 Where the other country is deliberately violating international norms in discriminatory fashion, there seems to be no alternative but to exert diplomatic and commercial pressure on the country to conform and for businesses to take care in wording contracts. Thus the US has managed in its treaties to negotiate clauses preventing high withholding taxes on technical fees. The UK should adopt this position in its negotiations with other countries.

40 There is, however, a more borderline situation where the foreign country would like to comply with international norms but cannot. In developing countries there are often valid reasons for levying taxes on various kinds of gross bases instead of anything resembling accounting profits, given the difficulties they face in obtaining taxpayer information and enforcing liabilities domestically, let alone internationally. There is a case for the UK taking a sympathetic view, where those reasons appear genuine, and taking perhaps temporarily a broader view of what taxes can be considered admissible

(in part or in whole), subject to appropriate anti-shopping safeguards and possible time limitation of any such benefits.

41 The negotiation of a treaty is an opportunity to persuade the other country to come into line with normal taxing principles, but the other country may have sufficiently strong other bargaining counters that a treaty is agreed which does not remove all the problems.

Credit relief: Partnerships and other entities

42 Another case which resulted in double taxation was Memec plc v IRC [1998] STC 754. In that case, the interposition of a German silent partnership into the structure resulted in greater tax overall than under a conventional structure. However, it is not only German silent partnerships that can result in credit relief being denied where it should otherwise be available. For example, in the US there are various increasingly used types of hybrid entity, including limited partnerships. As mentioned previously, the US position is complicated by the fact that each state is responsible for its own partnerships and company law.

43 There is, therefore, a general problem of adapting domestic legislation and treaties to new and unusual kinds of entity so as to avoid double taxation (and also double exemption). Whilst we appreciate that the OECD has a major role in these areas, the UK should take a lead in addressing these issues and resolving them so as to ensure that international trade is not inhibited.

44 As a general principle the structure of the chain should make no difference to the availability of relief. The amount of relief should not depend on what lies between (in terms of time or group structure) the relevant profits and the tax paid thereon or between either of those and the UK parent. The UK DTR rules should be designed to ensure that this result is achieved.

45 More time should be spent during bilateral treaty negotiations, especially with the current re-negotiation with the US, on issues such as this which will have an impact for many years to come, rather than simply fine-tuning a 'balance' in the treaty which may quickly become out-of-date.

Mutual agreement procedure and dispute resolution: arbitration

46 Tax treaties on the OECD model are deliberately couched in general terms, which do not provide specific answers for all eventualities. Heavy reliance is, therefore, placed on the mutual agreement procedure between the competent authorities as the mechanism for resolving problems on which the treaty is silent, uncertain or inconsistent and for resolving disputes in a manner which achieves compatible treatment in both countries. It is, therefore, important for the relief of double taxation that the procedures operate fairly and effectively.

47 If there is no treaty, a taxpayer in dispute over the foreign tax must rely on remedies available under the law of the foreign country. If there is a treaty and the foreign government fails to apply it correctly, the UK company can ask the Revenue to raise the matter with the other fiscal authority under the competent authority procedure provided in treaties on the OECD model. This is an unsatisfactory procedure for business, as the taxpayer is not involved in the process and there is no time limit to bring it to an end. Further, with the introduction of Advance Price Agreements, the use of the competent authority procedure to resolve bi-lateral transfer pricing problems is likely to increase.

48 This situation could be improved by the inclusion in future UK treaties of arbitration procedures. We understand that the US now includes such provisions in its treaties, starting with the US/Germany treaty in 1996. Businesses are increasingly familiar and comfortable with arbitration in commercial matters. There are precedents for such procedures, namely the multilateral Arbitration Convention for the resolution of transfer pricing disputes within the EU. However, until there is experience of actual arbitration cases under these treaties, it remains to be seen whether arbitration proves as satisfactory in the tax sphere.

49 We believe it would be helpful to include an Arbitration Article in future UK treaties. It provides an additional remedy available for use if wanted in future. It is recommended that this should be a standard request in all UK treaty negotiations. There would, of course, have to be the necessary enabling domestic legislation.

De minimis exemption

50 There are significant compliance costs in complying with the DTR rules. It is, for example, necessary to submit details of the accounts of the underlying company and also the overseas tax suffered. We believe that it should be possible to ease the compliance burden if a de minimis figure could be set for small dividend payments. We have seen one suggestion for a limit of £50,000, although it was not clear whether this was for the total dividends paid or for each and every dividend. We suggest a limit of £10,000 for each claim, up to a maximum limit of £50,000.

Publication of FICO practices

51 Double taxation relief is a complicated subject, both in theory and in practice. It is important that taxpayers have certainty as to how the Revenue will treat particular problems. The Revenue has developed many practices to overcome practical problems, and we appreciate the UK Revenue's pragmatic approach. We are aware that FICO have many unpublished practices. It is particularly important under corporation tax self assessment ('CTSA') that all these practices are made properly available to all taxpayers. We know that the Revenue plans to issue the FICO Manuals shortly and we believe that this will be helpful. It is also important that the manuals are updated regularly. It would also be helpful if some of the more important information (and perhaps forms etc) were made available on the Revenue's web-site.

Treaty negotiation: input from interested parties

52 We recommend that the negotiation process should be reviewed to see whether more effective means can be found of obtaining input from interested taxpayers in the course of treaty negotiations, and whether there ought to be more involvement by Treasury and/or DTI officials.

Inconsistency between FICO and International Division

53 We are also aware that in some instances FICO and International Division may not be consistent in their approach to certain double tax relief issues. It is important that their approaches are consistent. This should be improved if the relevant FICO manuals are published shortly.

Tax Sparing

54 We would be grateful for confirmation as to the UK Revenue's policy on the inclusion of tax sparing clauses in future UK treaties. We understand that the UK's policy is to resist or time limit such arrangements in future agreements.

Double tax relief for Insurance Premium Tax ('IPT')

55. We believe the UK should take domestic tax law powers to grant double tax relief under treaty for a treaty partner country's taxes equivalent to IPT.

Future developments: E-commerce

56. E-commerce is perhaps the single subject currently of most concern to tax authorities around the world. There are very complex issues involved with applying the normal tax principles in this area. The questions of who does what, where and when and in what capacity and in what jurisdiction are more difficult to determine in relation to E-commerce, both for direct taxes on income and for indirect taxes like VAT, by comparison with existing businesses.

57. The present general view is that existing principles can still be applied with appropriate clarification and that new taxes or new criteria of residence etc are unnecessary. However, there is great concern about enforcement, especially given the impossibility of controlling the use of unbreakable encryption and anonymous payment mechanisms.

58. Any serious leakage of tax in this area has the potential to cause severe damage, both by creating unfair competition between electronic and conventional commerce and by reducing Government's revenues. However, the risks should be seen in perspective. The problems are not so acute in the area of business to business transactions, which so far accounts for the great bulk of e-commerce, as in retail transactions. Also, there are many economic activities where the Internet cannot substitute for traceable physical activity. We nonetheless believe that, following the Ottawa Conference, OECD member states should explicitly consider e-commerce in their treaty negotiations. We suspect that the UK may need to extend domestic law powers to ensure that effective double tax relief is obtained for any new taxes levied on e-commerce.

Completion of this review

59. The ongoing review creates a lot of uncertainty in deciding how to structure commercial transactions and it is important that the review is completed as quickly as possible. We understand that any legislative changes should be included in next year's Finance Bill. It is important that Government adhere to this timetable.

Working parties

60. The document and our response identify several technical and industry specific issues which require further investigation, and we suspect that there may need to be some working parties established to consider these aspects. We would be happy to be involved in any working parties.

61. We would be delighted to discuss these matters further, if that would be helpful

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