Tax Representation

TAX FACULTY

TAXREP 1/09

TAXATION OF THE FOREIGN PROFITS OF COMPANIES

Memorandum submitted in January 2009 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document published on 9 December 2008 by HM Treasury and HM Revenue & Customs

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TAXATION OF THE FOREIGN PROFITS OF COMPANIES

INTRODUCTION

1. We welcome the opportunity to comment 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. 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

3. We welcome the decision of the Government to introduce a participation exemption and have set out below our comments on the detailed proposals.

4. We hope that our comments will be taken into account at the two Open Days on 12 and 27 January which are intended to provide more details about the proposals, as well as the opportunity for debate and discussion before the formal consultation period comes to an end on 3 March.

5. We intend to make further detailed comments in the light of the discussions at the two Open Days and also taking into account any further comments from our members in relation to the original proposals.

SCHEDULE 1 PART 1

New section 930C

6. It seems incongruous to exclude from the dividend exemption distributions similar to (d) or (e) of section 209(2) ICTA when 209 has the completely opposite purpose of making sure that equity instruments that have the appearance of debt are treated as equity. This could potentially end up disqualifying a significant number of distributions from the current exemption or at the very least causing a considerable amount of confusion and uncertainty.

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.

9. We query whether the exclusion of small companies from the participation (>/= 10%) dividend exemption ((2)(a)) is consistent with the EC Treaty as interpreted by Henderson J in the recent High Court decision in the FII GLO case. We also question the suggestion that “boundary issues” with individual taxation mean that it is inappropriate to extend the exemption to small companies: we believe that

existing anti-avoidance measures would, or could be made to, deal with those concerns even if the exemption were to apply.

New section 930E

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.

13. 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

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.

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

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 930M

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’.

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%.

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).

SCHEDULE 2

Gateway test

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.

General comments

27. We are concerned, in general terms, that the basic comparison is between an amount, the 'tested amount', taken from the CT computations, the total intra-group finance expenses in the UK, and an amount, the 'available amount', taken from the consolidated accounts, the net external finance costs of the world-wide group.

28. More specifically the "tested amount", per Part 2, is a tax adjusted amount based on entity (non-consolidated) accounts.

29. The "available amount", per Part 5, is the difference between two amounts disclosed in the consolidated accounts of the group.

30. Any comparison between the "tested" and "available" amounts will therefore in principle give rise to a mismatch in respect of

    (a) any tax adjustments in arriving at the "tested amount"

    (b) any consolidation adjustments in arriving at the "available amount"

31. This could be considered to be comparing apples and pears and there are inevitably going to be mismatches and amounts of interest may be disallowed because of the mismatch rather than because the amount reflects the mischief at which these provisions are targeted.

32. In particular, as the comparison is not of like with like there is a significant risk of timing differences arising between the two bases. As a consequence if there are unrelieved borrowing costs we believe there should be the facility to carry these forward, to ensure that amounts can be matched despite the two different definitions.

33. Moreover, we consider that external interest received by relevant group companies should be deducted in arriving the tested amount, otherwise the comparison with the available amount is not comparing like with like.

34. There should be a list of overseas country GAAPs that are acceptable. The EC published such a list on 12 December 2008, agreeing that US, Japanese, Chinese, Indian and Korean GAAPs are equivalent to IAS.

Paragraph 22

35. We note HMRC's intention to consider the different ways in which cash-pooling arrangements can operate before proposing Regulations, but would stress that the Regulations need to cover every type of cash pooling arrangements that reflect current methods of good cash management by international group.

Paragraph 26

36. The list in (2) should include Sharia law compliant instruments, at least insofar as these give rise to loan relationship debts.

37. We believe the adjustment at (i) needs to be reconsidered – as it stands it is not clear how the foreign exchange amounts are to be determined, and seeking to identify them all may prove very difficult from a compliance perspective. We suggest that this should be considered in parallel with the point which you note in paragraph 113 of the notes in relation to non-sterling denominated borrowing.

38. The issue that arises there is that, for instance a group may borrow in Japan at 1% interest and lend the borrowing to the UK at 5 or 6%. We acknowledge that the compliance burden needs to be matched with the need to ensure that groups which are in that position are not unduly penalised, and would recommend that approaches are considered which do not in general require the available amount to be adjusted for foreign exchange movements but with an election (either on a global group basis, or on a per company or per loan basis) which would enable taxpayers to choose to compute such adjustments.

Paragraphs 44 and 45

39. These two paragraphs should also be extended so that they apply in situations when the lender is chargeable to UK income tax rather than corporation tax.

40. Moreover, we are concerned that the mechanism of taking interest out of charge to UK tax will deny treaty relief for withholding tax for the, approximately, 30 UK tax treaties that still use the subject to tax test for relief from source withholding tax on interest.

SCHEDULE 3

New section 442B

41. If a parent company guarantees the borrowing of a subsidiary company to enable the subsidiary to get the loan would that be an arrangement caught under (5)? Arguably the interest paid under that loan is a consequence of the actual borrowing. We would welcome clarification.

42. Generally, we query the need for yet another interest anti-avoidance provision, particularly on top of the proposed interest cap, to add to section 786 transfer pricing, thin capitalisation, treaty clearance, current paragraph 13 and anti-arbitrage clearance.

SCHEDULE 4

Paragraph 8

43. The deemed ending of the accounting period has the effect of accelerating the date by which ADP dividends have to be paid in relation to the pre-commencement part of the straddling accounting period – although accounts etc will not be prepared until after the end of the period of account, and in some cases it will not be possible to pay the dividend until this has been done. We therefore believe it would be fairer for the deemed split accounting period to apply for all purposes other than for determining whether the dividend has been paid within 18 months of the end of the accounting period for the purposes of paragraph 2(1)(a) Schedule 25 ICTA 1988.

Paragraph 14

44. In some cases holding companies which would otherwise qualify for the transitional relief will not have received dividends in 'the last accounting period to end before the appointed day' because dividends will not necessarily have been paid up each year to that holding company. This is particularly so in the current economic environment, where both the difficulties in arranging cash transfers, and difficult trading conditions, are limiting the ability to pay dividends within groups.

45. We therefore recommend that, to give proper effect to the transition, the exemption should continue to be available to companies which have been exempt holding companies in any one of the last three pre-commencement periods.

Paragraphs 15 and 16

46. The straddle period rules for qualifying holding companies appear to be duplicated within paragraphs 15 and 16.

SCHEDULE 5

Paragraph 7

47. Sub-paragraph (1)(a) should be extended to apply to a transaction carried out in the ordinary course of a trade or business.

48. Sub-paragraph (1)(b) should be extended to apply to transactions between parties that are resident in the EU and the EEA, even in cases where they are not resident in the same member state, so as not to be in breach of the EC Treaty.

49. The paragraph 7 exclusions should extend to events as well as transactions.

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.