Taxation of foreign profits on companies: the current uk tax system

Parts of the World, European Union

Taxation of foreign profits on companies Introduction In June 2007, HMRC released a discussion document titled ‘ Taxation of foreign profits of companies'. The proposal covers widespread changes by the government to make the UK more competitive and attract capital investment to boost the economy. The changes to the taxation of foreign profits have been driven by pressure from business concerning the complexity of the UK tax system. The other main reason of the reform is the uncertainty as to whether the UK's current regime is consistent with EU law, owing to the recent rulings of the European Court of Justice (ECJ) in current cases (Anon 2007). Current UK Tax System Currently, UK companies receiving dividends from other UK companies suffer no tax. Dividends from foreign companies on the other hand are currently subject to tax. The UK maintains a firm distinction between foreign direct investment (FDI) and portfolio investment. FDI (active) occurs when shareholdings greater than 10% are held, whilst, portfolio (passive) income is the term used when shareholdings are less than 10%. The UK allows double tax relief (DTR) for both underlying tax (foreign corporation tax) and withholding tax (WHT) on FDI dividends, however, passive income only gains WHT relief not underlying tax (ULT) (Miller & Oats 2006). Until the Finance Act 2000 the UK operated a credit system with no onshore pooling, known as the ‘ strict source by source' method. The Act was intended to modernise the UK method and make it a more attractive location for holding companies. However, the changes were met with fierce criticism as advantages of offshore pooling were removed without new provisions for onshore pooling being introduced. Eventually, UK government bowed to pressure and reluctantly introduced a limited onshore pooling system (Miller

& Oats 2006). Limited Onshore Pooling Normal onshore pooling allows high foreign tax credits to be used against tax liability from other sources of foreign income. The UK's method of limited onshore pooling rules that tax relief cannot exceed 45% of the gross foreign income (before WHT and ULT, thus, protecting the UK from having to give DTR for unreasonably high effective rates of foreign tax. (Miller & Oats 2006) The UK's tax regime interacts with controlled foreign companies (CFC) legislation to discourage UK groups having intermediate holding companies in other countries. Controlled Foreign Company Legislation The UK's existing CFC (anti-haven) legislation prevents companies from avoiding tax by accumulating funds in subsidiaries with low tax rates (tax havens) (Anon 2007). It uses an all-or-nothing approach, where profits are either exempt or taxed in their entirety. According to the HMRC (2006) a company is defined as a CFC if it matches any of the following criteria: • Resident outside the United Kingdom, • Controlled by persons resident in the United Kingdom • Subject to a level of taxation less than 75 per cent of the level that it would have paid had it been resident in the UK The UK mostly targets portfolio income as it is easier to switch to tax havens often requiring only paper transactions. Examples of these include interest, dividends and royalties (easy to sell patent to subsidiary in low tax country), otherwise known as mobile income. The reason for this is that if a company has gone to the trouble of purchasing a factory, assembling a workforce and establishing trade it is unlikely it has done so purely for tax avoidance reasons (Miller & Oats 2006). What has influenced the proposals? ECJ Rulings Although downplayed in the report, major influences of the reform are the rulings by the European Court of

Justice (ECJ) on two cases in 2006. The Cadbury Schweppes case (13 September 2006) occurred when the UK sought to apply CFC rules (Ireland CT of 10% less than 75% of UK tax (30%)) against two subsidiaries of Cadbury Schweppes located in Ireland. Cadbury Schweppes argued that they had a permanent establishment with fully trading subsidiaries and their profits were not derived from a wholly artificial arrangement. The ECJ ruled that UK's CFC rules breached the right to freedom establishment in the European Court (EC) treaty (Bond 2007). The ECJ held this decision in order to comply with EU law; the CFC rules can only apply to wholly artificial arrangements that are designed to avoid tax. The existing rules were considered to be hindering companies obtaining a lower tax rate for genuine activity income (Anon 2007). In response to this ruling the UK Finance Act 2007 made amendments addressing CFC legislation. It is unsure whether these now achieve compliance with EU law; however, they are not of concern to the Groniter Group due to new legalisation that will follow the discussion document. During the Franked Investment Income (FII) Group Litigation case (12 December 2006); the ECJ addressed the legality of the credit method operated in the UK (Bond 2007). Under the credit method (UK) a firm that invests in Ireland pays corporation tax (CT) at 12. 5%. A dividend paid from this Irish subsidiary would then be subject to UK CT at 30%, with credit given for the underlying tax already paid in Ireland. However, in Germany (exemption method) a firm that invests in Ireland will again pay CT at 12. 5% on profits of the Irish subsidiary, but any dividend paid to the German parent company will be exempt from CT in Germany. As a result, a UK firm investing in Ireland may face a higher overall CT charge than a German firm would,

yet, this tax treatment in itself is not inconsistent with EU law. As mentioned earlier, UK CT only applies the credit method to dividends received from overseas subsidiaries not domestic, and it was the legality of this discriminatory tax treatment that was questioned by the ECJ (Bond 2007). The ECJ gave a qualified ruling from which it is unclear whether the current UK rules are consistent with EU law (Anon 2007). The review has also come, to a certain extent, in response to pressure from business for taxes on foreign dividends to be eased in order to improve the competitiveness of the UK tax system (Maybrey 2007). The UK system has often been criticised for its complexity and the large administrative costs caused by this. The credit system requires a computation of tax on foreign income so that the amount of foreign tax liability is known with certainty (rather than just the headline rate), before DTR can be granted (Miller & Oats 2006). New trade regulations and ECJ rulings have left CFC rules complex and outdated. The all or nothing approach leaves businesses at risk, depending on whether they meet certain criteria in a particular accounting period. CFC rule changes in other countries (France, Germany, US) suggests there is a common major issue to be addressed (HMRC 2007). Proposed Changes and My Response Exemption with participation One of the main areas of change the document proposes is moving away from the current UK credit method to an exemption system for FDI dividends paid to large and medium sized UK business. Known as exemption with participation, the system would be accompanied by a new income-based system for controlled companies (CC), replacing the old CFC legislation. Participation dividends (> 10% shareholdings) from foreign subsidiaries that have already being subjected to foreign taxes will be

exempt from domestic tax when repatriated to the UK. The exemption system will bring us in to line with most of mainland Europe. The proposed participation regime would enhance the attractiveness of the UK as a centre for business investment and result in increased flow of profit in to the UK (Sanger 2007). I believe that the move to exemption is a positive one and the revenue-neutral proposal would assist in the tax concept of neutrality. It removes the application of the credit regime through complicated multinational structures, and thoroughly reduces costs. UK companies will no longer have to leave profits offshore in lowly taxed countries. Companies can reduce their UK borrowing costs as a result of this (Dodwell 2007). Commercial decisions will no longer be dictated by the tax system, the participation regime allows businesses to decide the best way to operate (Sanger 2007). Controlled Company Legislation The new CC rules will target income that CFC rules already aim to capture, but will be much more precisely targeted. The new income-based scheme will " distinguish between mobile passive income and active income and will enable the UK to tax artificially located profits that are effectively within the control of the UK parent" (Maybrey 2007). CC rules will focus on mobile income (mainly passive income) with a full set of exemptions to ensure genuine commercial activity remains exempt from a tax charge. As in CFC legislation, passive income covers dividends, interest, annuities, royalties, rents and other income of a similar nature (HMRC 2007). Moving away from the existing all or nothing approach, the new CC rules would provide the revenue protection business requires whilst not overcomplicating the prevention of artificial tax avoidance. The new CC system will now apply to subsidiaries in the UK as

well as abroad (to ensure that the new rules are not seen as discriminatory from an EU law perspective) (Frame 2007). Also, without the complications of the old system the CC rules now include tax on capital gains. I think the new CC regime seems a more clear and straightforward approach. Under the all or nothing approach a foreign subsidiary might classify as a CFC one year and not the next, the proposal looks to remove this uncertainty. To form a stronger opinion I feel I would need to know the criteria for exemptions to know whether the proposal have moved the CC rules in the right direction and achieved the clarity and transparency it set out to. Until the policies objectives are made fully available I am wary that the proposal may " impose significant administrative burden on businesses" (Self 2007). Portfolio Dividends With regards to portfolio dividends (