

Budget 2009

Taxing Foreign Profits: How the new UK rules could affect your company

1. Introduction

Major changes to the UK tax treatment of foreign profits of UK corporates are proposed. These relate to:

- the taxation of dividends/received;
- interest deductions for UK members of multi-national groups (the "**worldwide debt cap**");
- controlled foreign companies; and
- movements of foreign capital (Treasury consents).

The changes, including the draft legislation, have been subject to extensive consultation.

2. Dividends

One of the core elements of the changes is the introduction of a new regime for the taxation of dividends received by UK companies. The starting point is that dividends received by companies are taxable, but there will be a broad range of exemptions. The effect will be that the majority of dividends received by UK companies (from overseas companies and UK companies) will fall within one of the exceptions and therefore not be subject to UK tax unless the arrangements under which they are paid fall within anti-avoidance rules.

Exemption will apply to dividends and other distributions paid:

- by a company controlled by the recipient/company;
- in respect of non-redeemable ordinary shares;
- on portfolio holdings (shareholdings of less than 10% of that class of share);
- out of profits from transactions whose purpose is not to achieve a UK tax advantage; or
- which fall within the rules applying to "disguised interest" (shares accounted for as debt).

It was originally proposed that "participating dividends" paid by overseas companies to "small" companies (essentially, those which employ fewer than 50 persons and have an annual turnover and/or a balance sheet value of €10 million or less) would not be exempt, but would continue to be subject to the current rules i.e. taxable in the UK with a credit for overseas tax; "participating dividends" being dividends where the recipient company controls (directly or indirectly) 10% or more of the voting power of the paying company. However, this exclusion for small companies has been dropped.

The above changes will clearly be beneficial to international groups repatriating their profits from overseas subsidiaries, both in terms of tax payable and compliance.

The changes will apply to dividends and other distributions received on or after 1 July 2009.

3. The worldwide debt cap

The introduction of the worldwide debt cap ("**WDC**") is to some extent seen as the quid pro quo for the dividend exemption.

This change will limit the amount that UK members of a multi-national group can deduct for tax purposes by way of interest expense. The general intent of the WDC is to prevent the UK member obtaining a deduction which is disproportionate compared with the finance costs of the group as a whole.

The latest recommendations exclude from the scope of WDC financial services groups (whose activities meet certain conditions), short-term debt (repayable within 12 months) and de minimis levels of interest costs. Groups who pass a "gateway" test will not need to apply the new rules at all.

The WDC regime is to apply to finance expenses payable in accounting periods beginning on or after 1 January 2010. This should at least allow some time for companies and their advisers to understand the regime much of the detail of which will continue to remain uncertain until the Finance Bill is published.

4. Controlled foreign companies

The CFC rules are designed to prevent avoidance of UK tax by diverting profits to offshore entities which would otherwise be taxable in the UK. However, the compatibility of the UK rules with European law has been called into question. Various proposals have been put forward including the replacement of the current CFC regime with an income-based CFC regime. The process and consultation relating to the reform of the CFC regime generally continues.

However certain changes are to be introduced in the short term so that the CFC rules operate consistently with the new dividend exemption regime. These changes essentially comprise the removal of the exemption for superior and non-local holding companies (subject to a two year transitional period) and the removal of the Acceptable Distribution Policy ("**ADP**") exemption. This is an exemption for CFCs that distribute at least 90% of their profits within 18 months of the end of the relevant accounting period - given the new exemption for dividends it would clearly be inappropriate for this exemption to continue.

These changes will come into effect for accounting periods commencing on or after 1 July 2009 (subject to transitional rules applying until 1 July 2011 in relation to the non-local and superior holding companies exceptions).

5. International movement of capital

The government is at last taking the opportunity to remove a long-standing anachronism within the UK tax code, namely the rules which require UK companies to obtain Treasury consent (on pain of criminal sanction) to the issue of shares or debentures by, or the transfer of shares or debentures of, a foreign subsidiary. They will be replaced by a new requirement to report (within six months after the transaction) certain specified overseas share transactions whose value exceeds £100 million. There will be exclusions for transactions carried out in the ordinary course of trade, between parties resident in the same territory, giving certain securities to banking or insurance companies or which are otherwise specified in the new rules.

This is a welcome move and long overdue. The new regime will come into effect for transactions undertaken on or after 1 July 2009.

The information contained in this update is intended as a general review of the subjects featured and detailed specialist advice should always be taken before taking or refraining from taking any action.