The Offshore Tax Planning Review

A USEFUL HOME FOR EUROPEAN INTERMEDIARY HOLDING COMPANIES

Patrick Hurd[1]

The New FID Rules

After much lobbying, the Government has decided to change rules affecting international holding companies. The objective has been to ensure that surplus ACT does not represent a real tax cost to international companies generating their profits overseas. The Finance Act 1994 adds a substantial number of new sections to the Taxes Act 1988; the references that follow are to these new sections of the 1988 Act (except where otherwise indicated).

The UK imputation system of tax for companies and their shareholders differs from the classic system in that shareholders obtain a tax credit at 20% for tax to be paid in due course by the company on its profits. As foreigners lose the benefit of the tax credit, in whole or in part, there is no need for the system to employ withholding taxes. On paying the dividend the company accounts to the Inland Revenue for advance corporation tax ("ACT") at 20% on the dividend, which is, as the name indicates, on account of the company's mainstream tax liability ("MCT").

No withholding taxes? So a UK company can pay a dividend to any person in any territory and not suffer withholding tax? The answer is, Yes.

The new FID rules are designed in a way that ACT which is paid or payable on a qualifying distribution to a shareholder is repaid to the company where that company has no MCT against which to offset it. The stimulating ("exciting" would be too strong!) effect of this is that a UK holding company can receive income on which it has no liability to UK tax and can distribute it up to its foreign shareholders without suffering any tax on the way out. These shareholders can be resident in a tax haven.

---

1 Patrick Hurd, Principal of Wycombe Hurd & Co, 8-9 Rose & Crown Yard, London SW1Y 6RE. Tel: (071) 839 7044 Fax: (071) 839 7356 a specialist offshore practice.

The advantage over the Netherlands, Luxembourg, Austria and France, etc, may now be apparent to the reader (though capital gains cannot be ignored).

I have taken an example to illustrate the points and to serve for working through certain of the new rules.

An Illustration

An Italian manufacturing company ("Nuts SrL") is wholly owned by a Dutch BV ("BV") and ultimate ownership is hoped to be placed into a Jersey trust for the benefit of the client and his family who have become expatriate Italians.

It is intended that dividends will be paid up from Nuts SrL to BV (which will be effective from an Italian tax point of view) and from BV they need to pass to the trust. In the future, it is also anticipated that surplus profits will be withdrawn by way of dividends to the owning trust. (This will enable the owner to benefit from favourable Italian and UK treatment of this income.)

Some of the tax implications:

For Italian anti-tax abuse reasons the owners of the BV cannot directly be Jersey trustees. Similarly, if the payment goes directly from BV to the trustees there will be withholding tax on the dividends.It would be possible to structure part of the payments out of BV as interest (reflecting the financing arrangements) but this would neither be entire (because of debt equity restrictions) nor indefinite. Withholding tax in the Netherlands on payments to a Jersey trust would be 25%. By using the Antilles as an alternative to a UK company the overall cost could be reduced to around 10% (7.5% withholding and 3% Antilles tax).

For the purposes of this illustration, I have taken the company out of the new international headquarters code (such a company being termed an IHC) introduced in the same Act. To come within this code at least one of the conditions (a), (b) or (c) must be satisfied and, unless (b) is satisfied, (d) must also be satisfied:

(a) Throughout the accounting period the company must be wholly owned by another company which is a foreign held company in that period.

(b) Throughout the accounting period the company must be wholly owned by another company which is not resident in the UK at any time in that period. In addition, throughout the accounting period and the previous 12 months the company's shares must be quoted on a recognised stock exchange outside the UK and not quoted on such an exchange in the UK, and there must have been dealings in its shares on an overseas exchange.

(c) At any given time in the accounting period each shareholder must own at least 5% of the company's share capital and at least 80% of that capital must be foreign held; this means held by either -

(i) persons other than companies who are non-UK resident throughout the accounting period; or

(ii) companies which are foreign held companies in the accounting period; or

(iii) a combination of (i) and (ii).

(d) At any given time in the accounting period, the proportion of the company's ordinary share capital ultimately owned by persons (other than companies) resident in the UK must not exceed 20% Ultimate ownership may be traced on any reasonable basis through corporate owners to persons who are not companies.

The UK solution:

A UK holding company ("TaxfreeCo") should be interposed between BV and the trust, holding 100% of the equity in BV. The shares will all comprise one class.

Conditions set out in the FID rules are extensive, so that it is necessary to analyse each step to ensure that each condition is met. It is easier in my view to look at it chronologically, from the source of the income, rather than section by section in the new legislation introduced by the Finance Act 1994.

1. The essential elements of the new rules are:

(a) that a company ultimately has foreign source profits which benefit in the UK from double tax relief, and

(b) that the company can now pay dividends over which it can make elections that they be treated as foreign income dividends, where the ACT payable on those dividends (which will not be capable of being set against its MCT in the ordinary way) will be refunded to the company by the Inland Revenue.

2. To be able to have anything to match against a foreign income dividend ("FID"), and so be able to benefit from the new rules, there must be:

(a) a matching FID received by TaxfreeCo, or

(b) distributable foreign profit ("DFP") earned by TaxfreeCo.

To have DFPs there must be foreign source of profit ("FSP") (s.246I):

(a) If in an accounting period there is income covered by double tax relief, so much of the income as forms part of TaxfreeeCo's chargeable profit is "foreign source profit" for that period ("FSP").

(b) Double tax relief ("DTR") will be available in respect of dividends paid by BV where BV's income has come from dividends paid by Nuts SrL from commercial profits which have been subject to tax in Italy. Care needs to be taken concerning the detail of the relief to ensure that "relevant" profits benefit from the relief (s.799 ICTA 1988). "Relevant profits" are the profits for the specified period for which or the specified profits out of which the dividend is paid or, if not specified, for the last accounting period. Dividends can in certain circumstances be attributed to earlier periods.

(c) Where there is FSP which exceeds the "relevant amount of tax", the excess is "distributable foreign profit" ("DFP").

(d) "Relevant amount of tax" means firstly (under sub-section (5)) the amount of foreign tax payable in respect of FSP (where foreign tax payable exceeds corporation tax payable before double tax relief).

This requires some analysis. The foreign source profit of TaxfreeCo is the dividends from BV. These dividends will not have suffered tax in the Netherlands, but nevertheless as "foreign tax" is **any** tax imposed outside the UK for which double tax relief is afforded, it will include Italian tax suffered. Italian tax suffered will exceed UK corporation tax and therefore sub-section (5) applies.

As double tax relief will be given in respect of the underlying profits of Nuts SrL, the relevant amount of tax will be the amount of the underlying tax paid by Nuts SrL.

(e) The distributable foreign profits will therefore be equal to the net amounts of the dividends received by TaxfreeCo.

It is interesting to consider the position where the foreign tax is less than UK corporation tax. Subsection (6) of s.246I will apply rather than subsection (5), so that it will be the aggregate of the foreign tax and the UK tax which equals the "relevant amount of tax".

The process will still work efficiently where the underlying tax on profits is not significantly less than the UK rate (if it were, clients would not be interested in the structure anyway as they would have been making profits in a tax haven!). The threshold to consider is the additional rate of UK tax payable as against the withholding tax payable if the dividends were paid directly to a tax haven (or through a similar route using a Netherlands company).

3. Having calculated that TaxfreeCo has distributable foreign profits equal to net dividends received, TaxFreeCo must now elect that dividends paid by it become FIDs (s.246A). There are restrictions on the type of shares over which FIDs can be elected but, provided that there are no commercial constraints on having one class of share issued to the trustees, there should be no difficult hurdles to overcome.

The process for matching is as follows:

(a) TaxfreeCo elects that FIDs are matched with its DFPs under s.246J;

FIDs cannot exceed DFPs but DFPs of the preceding year remain eligible profits and FIDs can effectively be carried forward;

(b) TaxfreeCo (not being an IHC) pays FIDs and ACT in an accounting period in respect of qualifying distributions (s.246N); payments of dividends to non-resident corporate shareholders will be qualifying distributions;

(c) it is necessary for s.246N(2) to determine the notional foreign source ACT; it is the lesser of the available ACT and notional foreign source ACT which can be repaid;

(d) notional foreign source ACT is calculated under s.246P as being the amount of ACT which TaxfreeCo would have paid in respect of distributions in the relevant period and which would not have been set off against its MCT for that period using various assumptions.

4. Section 246Q provides the way in which the relief is given, either by repayment or set off.

Payment occurs 9 months after the end of the financial period in question, so that there will be a cash-flow disadvantage.

Anti-avoidance provisions

A glance at the anti-avoidance provisions will demonstrate that it will be difficult for the Inland Revenue to attack the structure in such a way as to defeat it. The controlled foreign company rules (CFCs) are unlikely to be applicable, as the underlying profits will have been taxed in a high tax jurisdiction, and if not there will be (or can be) a full distribution policy. As a bona fide trading concern the Revenue are unlikely to use the argument over control and management of the subsidiary being in the UK. This would not help them in any event, and begs the question of whether a dual resident company might take advantage of the matching provisions.

Conclusions

The opportunities are now available to the UK to seize an advantage over other holding company jurisdictions, even though we do not operate a "participation" exemption.

Capital gains tax could still be a problem. However, in general terms it appears that the problem can be overcome in either of two ways. First, if the shares of the UK holding company are held by non-UK residents, then a disposal of the underlying assets can be achieved through the sale of the shares in the holding company. Second, if there is an intermediate holding company, which enjoys a participation exemption between the UK company and the foreign business (as in the example set out in this article) the profit can be made in that intermediate company and distributed up as a dividend as previously outlined.

It is a dry topic and one which the writer recognises will not easily generate enthusiasm. However, for those of us in practice in the arena of creating suitable international structures for clients, the UK holding company will (or should) become an extremely effective tool.