Chapter 6

EC Treaty and bi-lateral tax treaty issues

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EC Treaty issues

Dividend/distribution exemption

Background

6.1 In addition to the desire to modernise the UK corporation tax treatment for foreign dividend income and improve the UK's international competitiveness from a tax perspective, a key driver of the introduction of the dividend/distribution exemption was the UK referral to the European Court of Justice (ECJ) in *Test Claimants in the FII Group Litigation v IRC* ("the FII GLO case") (C-446/04).

6.2 In this case, the test claimants argued, amongst other things, that the UK's taxation of foreign dividends, albeit with credit for any withholding tax and underlying tax but, broadly, capped by reference to the amount of UK corporation tax attributable to such a dividend, as compared with the leaving out of account of UK to UK inter-corporate dividends, was an unjustifiable breach of Article 43 of the EC Treaty (Freedom of Establishment) and/or Article 56 (Free Movement of Capital).

6.3 In their judgment (strictly, preliminary ruling) on 12 December 2006, the ECJ held that, as regards portfolio dividends where the UK corporate shareholder owned less than 10% of the voting power, and given the absence of credit relief for underlying foreign tax suffered, the UK's taxing of such foreign dividends from EU or EEA non-UK companies was indeed an unjustifiable breach of Article 56[1].

6.4 As regards dividends on non-portfolio shareholdings carrying 10% or more of the voting power, the ECJ left it to the national UK court to determine "whether the tax rates are indeed the same and whether the different levels of taxation occur only in certain cases by reason of a change to the tax base as a result of certain exceptional reliefs"[2].

6.5 In his comprehensive judgment handed down on 27 November 2008, Launcelot Henderson J held, at paragraph 65 of his judgment that "it follows that in my judgment the Claimants succeed on this issue, and the UK system of taxation of dividends received from Member States has at all material times infringed Article 43 EC".

Exemption of distributions received by small companies: Targeted Anti-Avoidance Rule ("TAAR")

6.6 In response to representations made by business and representative bodies, the legislation as enacted now encompasses an exemption from UK corporation tax for distributions received by small companies (CTA 2009 s 931B, as introduced by FA 2009 s 34 and Sch 14). The previous confining of the distribution exemption to large and medium-sized companies was considered, rightly, to be a breach of the UK's obligations under the European Communities Act 1972 and Articles 43 and 48 of the EC Treaty, having regard to Henderson J's judgment in favour of the claimants in the FII GLO case on the taxability of cross-border dividends, as compared with the leaving out of account of UK to UK inter-corporate dividends (paragraph 65 of Henderson J's FII GLO High Court judgment, as noted at paragraph **6.5** above).

6.7 Moreover, it is arguable that confining the distribution exemption to large and medium sized companies would have been state aid, which is illegal under Article 87 EC Treaty. It is not considered that this could have been justified as a general feature of the UK tax system. See, for example, the judgment against Austria in the *Adria-Wien Pipeline* case[3], where the confining of a rebate of an energy tax to undertakings manufacturing goods was held to be illegal state aid.

6.8 The s 931B exemption from the charge to UK corporation tax of distributions received by small companies is subject to the requirement that the distribution is not made as part of a tax advantage scheme. "Tax advantage scheme" is defined by s 931V as "a scheme the main purpose, or one of the main purposes, of which is to obtain a tax advantage (other than a negligible tax advantage)".

6.9 "Scheme" is defined to include "any scheme, arrangements or understanding of any kind whatever, whether or not legally enforceable, involving a single transaction or two or more transactions".

6.10 "Tax advantage" is defined as having the meaning given by TA 1988 s 840ZA. Readers may recall that "tax advantage" per s 840ZA is defined as meaning:

"(a) relief from tax or increased relief from tax,

(b) a repayment of tax or increased repayment of tax,

(c) the avoidance or reduction of a charge to tax or assessment of tax, or

(d) the avoidance of a possible assessment of tax."

Section 840ZA(2) then provides that for the purposes of (c) and (d); it does not matter whether the avoidance or reduction is effected:

(a) by receipts accruing in such a way that the recipient does not pay or bear tax on them; or

(b) by a deduction in calculating profits or gains.

6.11 Accordingly, although, therefore, the five distribution exemptions (ss 931E–931I) available to large or medium-sized companies are subject to the eight TAARs set out in ss 931J–931Q (including a new s 931O), it is arguable that the overarching general anti-avoidance rule ("GAAR") to which the exemption of distributions received by small companies is subject is on its own considerably more wide-ranging than the cumulative effect of the eight TAARs to which the five alternative but possibly overlapping dividend exemptions available to large or medium-sized companies are subject. If this is so, then this could result in it being arguable as a matter of application of the EC Treaty freedoms and indeed state aid provisions that the much wider anti-avoidance test which distributions to small companies have to pass to be eligible for the small company version of the distribution exemption is challengeable on EC Treaty grounds.

6.12 This would prima facie have to be by reference to the so-called "equally applicable measures" case law[4]. These cases show that, notwithstanding that a measure, such as the overarching GAAR to which the distribution exemption available to small companies is subject, is equally applicable to distributions received by small UK companies from other UK companies as to distributions received by small UK companies from EU (non-UK) or other foreign companies, such a measure may nonetheless constitute an unjustifiable restriction prohibited by Articles 43, 48 and/or 56 EC Treaty.

6.13 Moreover, the wide definition of "tax advantage scheme" would appear to go way beyond targeting "wholly artificial arrangements" as referred to in the ECJ's judgment in favour of Cadbury Schweppes plc in *Cadbury Schweppes plc v Revenue and Customs Comrs* (C-196/04).

6.14 Section 931C further restricts the availability of the distribution exemption for distributions received by small companies to situations where the payer is resident in and only in either the UK or a "qualifying territory" at the time that the distribution is received, "qualifying territory" basically being defined by s 931C as a territory with which the UK has a double tax agreement under TA 1988 s 788 and which contains a non-discrimination provision.

6.15 Accordingly, even when the recently agreed tax information exchange agreement is ratified between the UK and Liechtenstein, it would appear that distributions from a Liechtenstein subsidiary to a UK small company would not be eligible for a distribution exemption. Liechtenstein is a member of the European Economic Area (EEA). The non-availability of the UK distribution exemption as regards dividends received from

Liechtenstein by UK small companies would appear to be a restriction in breach of Articles 31 and 40 of the EEA agreement (right of establishment and movement of capital respectively). Moreover, as and when a tax information exchange agreement is entered into between the UK and Liechtenstein under FA 2006 s 173, it is arguable that the UK cannot rely on the judgment in favour of Sweden in the ECJ case *Skatterverket v A* (C-101/05), as, contrary to the position in that case as between Sweden and Switzerland, there would then be an operative exchange of information agreement between the UK and Liechtenstein.

Scope of the distribution exemption for dividends received from large or medium-sized companies

6.16 Since the enactment of TA 1988 s 209 as TMA 1970 s 233, there has been debate as to whether or not the s 209 provisions regarding distributions are to be regarded as extending to non-UK resident companies. There have been Counsel's opinions either way. In light of the provisions of s 209(5) and (6) dealing with the situation where both the company and the member receiving a benefit, as referred to in s 209(4), from the company are resident in the UK it is arguable, by inference, that the s 209 concept of distribution is indeed capable of and does extend to non-UK resident companies.

6.17 If this were not, however, to be the case, then the first three exemptions for distributions received by large and medium-sized companies would clearly be discriminatory and ineffective (the s 931J and 931I exemptions are confined to dividends only).

6.18 Equally, the s 931A charge on dividends or other distributions of a company would not then encompass transactions that would otherwise be capable of being regarded as distributions by non-UK resident companies, given that the TA 1988 s 209 definition of a "distribution", per TA 1988 s 209(2) is applied. Section 209(2) reads "In the Corporation Tax Acts 'distribution' in relation to any company means ...".

6.19 HMRC have, however, confirmed that their view is that the s 209 definition of "distribution" does indeed extend to non-UK resident companies. Accordingly, the difficulty and possible discrimination that might otherwise arise should, on this view, which appears reasonable, not trouble us.

Anti-avoidance regarding schemes involving manipulation of controlled company rules

6.20 CTA 2009 931J, the first of the eight TAARs, denies the first and very important exemption for distributions from controlled companies, as defined by reference to TA 1988 s 755D (controlled foreign companies: "CFCs"), but without the UK to UK attribution rules of s 755D(6)(c) and (d).

6.21 Section 931J seeks to deny the s 931E distribution exemption regarding dividends from controlled companies if the dividend is paid in

respect of pre-control profits. "Pre-control profits" are defined as profits available for distribution at the time the dividend is paid that arose at a time when the UK recipient of the dividend neither controlled the payer nor was the 40% potential major participant CFC control definition satisfied (a UK resident shareholder holding 40% but no more than 55% and a non-UK resident shareholder holding 40% or more of a non-UK resident company paying the dividends).

6.22 It is arguable that, in so far as the UK CFC regime is not compliant with the ECJ's *Cadbury Schweppes* judgment, ie it goes beyond applying to wholly artificial arrangements intended to escape the national tax normally payable, the s 931J TAAR would go beyond what is permissible and be unenforceable.

6.23 However, following the judgment of the Court of Appeal against *Vodafone 2*[5] with the implication into the UK CFC legislation at TA 1988 s 748(3) of a sixth exemption for CFCs that are genuinely economically established in the EU/EEA and not wholly artificial arrangements, the UK CFC regime must currently be regarded as EC Treaty compliant by virtue of conforming interpretation or "reading down".

6.24 It is, however, understood that the Court of Appeal's judgment is to be appealed to the Supreme Court and given the reliance in the Court of Appeal's judgment on case law in relation to implementation of Directives, it is possible that the House of Lords may reinstate the disapplication judgment of Evans-Lombe J. This is considered further below in relation to the FA 2009 s 36 and Sch 16 provisions regarding CFCs and the compliance (or otherwise) with the EC Treaty of the transitional CFC regime, after the abolition of the acceptable distribution policy exemption and of superior and international holding companies, albeit with transitional provisions available in respect of the latter.

Debt cap

6.25 FA 2009 s 35 and Sch 15 introduce the debt cap. Whilst both the Part 2 Gateway Test and the Part 3 and Parts 8 and 9 main debt cap disallowance and definition of tested and available amounts with reference to financing expense amounts and financing income amounts do not (other than the tested amounts being confined to UK group companies) differentiate between interest or other financing costs payable as regards the residence of the recipient, the Part 4 exemption from charge to UK corporation tax of certain financing income of UK group companies where there has been a debt cap main test disallowance are only operable in relation to financing income in charge to UK corporation tax, and accordingly do differentiate and arguably discriminate against cross-border intra-EU situations, ie EU or EEA inbound groups, as compared with entirely UK domestic groups which are identically leveraged both externally and internally.

6.26 The diagram below illustrates that where an EU or EEA (non-UK) headed group borrows externally and on-lends more than it has borrowed

to its UK subsidiary with the result that the UK subsidiary pays a higher amount of interest to its, say, Dutch parent than the Dutch parent pays on its external borrowing, so that the main debt cap test operates to disallow the excess interest in the UK subsidiary's corporation tax computations, there can be no Part 4 corresponding exclusion of financing income in charge to UK corporation tax, because there is no such income.

		Tested amount	Available amounts
BV parent	← 100 loan → 5 interest	Nil	5
	interest 7.5 ↑ ↓ 150 loan		
UK subsidiary		7.5	-
		7.5	5
		2.5 disallowance	
No Part 4 exclusion			
UK parent	← 100 loan → 5 interest	Nil	5
	interest 7.5 ↑ ↓ 150 loan	7.5	Nil
UK subsidiary		7.5	5
		2.5 disallowance	
Part 4 exclusion of UK parent interest income		(2.5)	-
Net disallowance		Nil	-

6.27 By contrast, where an identical UK subsidiary borrows from a UK, as opposed to, Dutch parent and pays excess interest to that UK parent, in comparison with that UK parent's interest expense on that external loan, Part 4 provides for the corresponding exclusion in the UK parent of that part of the finance income equal to the disallowance.

6.28 The ECJ judgment against the UK in *Thin Cap Group Litigation (Test Claimants in the) v IRC* (C-524/04) held at paragraph 134 that Article 43 EC Treaty precluded legislation such as this, unless that legislation "provides for consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons only, to be established and allows taxpayers to adduce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question ...".

6.29 It is questionable whether the mechanistic approach of the debt cap provisions and the rigid adherence to the principle that one pound (or one euro) of excess interest in a UK subsidiary of an EU or EEA (non-UK) group is necessarily evidence that the excess interest and underlying loan are non-commercial.

Qualifying financial services group

6.30 Government amendments to the Finance Bill introduced and agreed during the Finance Committee debates on the Finance Bill provide for the exclusion of a qualifying financial services group from the debt cap provisions if, broadly, all or substantially all (understood to be defined as 90% or more) of the UK trading income of the worldwide group for that period, or all or substantially all (again 90% or more) of the worldwide trading income of the worldwide group for the period is derived from "qualifying activities".

6.31 "Qualifying activities" are defined by Sch 15 Part 2 para 8 as:

(a) lending activities and activities that are ancillary to lending activities;

(b) insurance activities and insurance-related activities;

(c) relevant dealings in financial instruments.

6.32 Paragraph 9 provides that "lending activities" includes amongst other things:

(a) acceptance of deposits or other repayable funds; and

(b) lending of money, including consumer credit, mortgage credit, factoring (with or without recourse) and financing of commercial transactions (including forfeiting).

6.33 Fee income from corporate finance activity or, it is understood, from underwriting, would not appear to constitute income from "lending activities" as defined or indeed income from relevant dealing in financial instruments.

6.34 It would therefore appear quite possible for a group to fail the UK trading income test, whereas if its pan-EU operations were taken into account, it might pass it. This could be the case, for example, if fee income was concentrated in London, but outside of the UK, a much higher proportion of the financial services activity comprised "lending activities" as defined. Arguably, this may be discriminatory and contrary to Article 43 of the EC Treaty.

6.35 There is, however, the alternative worldwide trading test, and it may be that the view is being taken that the availability of this test could be a defence to the discrimination apparently inherent in the UK trading income test.

Exemption for certain intra-group financing income where EEA payer denied pay deduction

6.36 FA 2009 Sch 15 Part 5 provides for automatic exclusion from UK corporation tax of financing income received by a UK company (or a company otherwise in charge to UK corporation tax) where the EEA resident payer is a parent of the recipient, or a 75% subsidiary of the recipient, or a 75% subsidiary of a parent of the recipient (paragraph 41) and is liable to a tax or EEA territory charge by reference to profits, income or gains arising to the payer, and no qualifying EEA tax relief is available for the payment to the payer either in the current period, any previous period or any future period.

6.37 In effect, this would appear similar to the concept of "final losses" in the ECJ's judgment in favour of *Marks & Spencer plc*[6].

6.38 Presumably, the Part 5 mandatory UK exemption provisions are considered to be a defence against the EC Treaty breach argument noted at paragraph **6.25** above in relation to the elective Part 4 exemption of certain UK financing income where there is a disallowance under the main debt cap test.

6.39 The difficulty with this is that taking the example given at paragraph **6.25** above of an EU (non-UK) inbound loan to the UK in, say, a Dutch-headed group, that particular UK taxpayer (ie the UK subsidiary) is unable to benefit from any Part 5 UK financing income exemption. Accordingly, the availability of that exemption does not remove the discrimination in the Part 4 provisions in circumstances where there is no countervailing Part 5 exemption available.

Anti-avoidance

6.40 The new Sch 15 Part 6 introduced by Government amendment during the Finance Committee debate on the Finance Bill 2009 sets out the statutory TAAR provisions. Regulations are to be issued under paragraph 53(2) which will set out what schemes are "excluded" for the purposes of the three anti-avoidance provisions (Gateway, main debt cap test and Part 5 UK financing income exemption in relation to disallowed EEA payer finance expense).

6.41 Unless these regulations refine the TAAR to targeting "wholly artificial arrangements" as referred to in the *Cadbury-Schweppes plc* ECJ CFC judgment, it would appear that the TAAR itself will be too wide from an EC Treaty perspective and will therefore have to be either read down to confine it to "wholly artificial arrangements" or disapplied.

Charities, and educational and public bodies

6.42 CTA 2009 Sch 15 para 67 provides for an exclusion from the debt cap provisions for, basically, trading subsidiaries of charities.

6.43 Paragraph 68 provides for a similar exclusion for loans to trading subsidiaries of designated educational establishments, health service bodies, local authorities or persons prescribed in regulations yet to be issued, where the Commissioners are satisfied that the person has functions some or all of which are of a public nature.

6.44 To avoid these exclusions being impermissible state aid under Article 87 of the EC Treaty, it will presumably have to be argued that the aid either facilitates the development of the relevant economic activities (the trading subsidiaries) but does not adversely affect trading conditions to an extent contrary to the common interest (Article 87 para 3(*c*) of the EC Treaty), or it constitutes aid to promote culture and heritage conservation, where, again, such aid does not affect trading conditions and competition in the Community to the extent that it is contrary to the common interest (Article 87 para 3(*d*)) or, alternatively, that these provisions are sufficiently closely linked to the tax exemption for charities, and public sector education, health services and local authorities and such tax exemption is not state aid.

REITs, upstream oil activity and tonnage tax companies

6.45 Paragraphs 58, 59 and 75 broadly provide for real estate investment trusts ("REITs"), upstream oil companies and shipping companies elected into the tonnage tax regime to be outside the debt cap. This is logical, given the exemption from UK corporation tax of companies qualifying as REITs and the disallowance of finance expense for the purpose of the supplementary charge in relation to the ring-fence activities of oil companies, and the different corporation tax base of companies elected into the shipping tonnage tax regime.

6.46 Presumably, as regards fiscal state aid, it is either considered that these activities are, because of existing special tax regimes, not comparable to other companies within the debt cap, or that the absence of or a different corporation tax base means that being taken out of the debt cap does not constitute aid for the purposes of Article 87 of the EC Treaty.

6.47 The latter argument would, however, raise the wider question of the compatibility of the regimes themselves with Article 87; presumably, therefore either advance state aid clearance was sought and obtained for the beneficial regimes, i e REITs/tonnage tax before their introduction, or reliance is being placed on the regimes constituting "aid to facilitate the development of certain economic activities ... where such aid does not adversely affect trading conditions to the extent that is contrary to the common interest" (Article 87 para 3(*c*) of the EC Treaty).

Controlled foreign companies (CFCs)

6.48 A consequence of the Court of Appeal's judgment against *Vodafone 2* is that, whatever the UK CFC provisions actually say, they are to be regarded as complying with Articles 43 and 48 of the EC Treaty because,

further to the *Cadbury-Schweppes plc* ECJ judgment, an additional exemption is to be implied into TA 1988 s 748(3).

6.49 This new implied exemption, which must be taken to have always been there since FA 1984, would read, along the lines of the wording submitted by Counsel for HMRC in *Vodafone 2* (paragraph 39 of the Court of Appeal judgment):

> "The CFC is exempt in that accounting period, if it is actually established in another Member State in the EEA and carries on genuine economic activities there."

6.50 The Chancellor of the High Court, Sir Andrew Morritt, went on to say that it could be that the additional exemption is subject to an exception to exclude CFCs that, whilst actually established in another EEA Member State and carrying on genuine economic activities there, are found to constitute "wholly artificial transactions". In the author's view, this should read "wholly artificial arrangements".

6.51 The Court of Appeal itself acknowledges that this result is only consistent with the case law of "conforming interpretation", ie "reading down", if, first, the resulting meaning "go(es) with the grain of the legislation"[7] and the exercise by the courts of the interpretative obligation cannot require the courts to make decisions for which they are not equipped or give rise to important practical repercussions which the court is not equipped to evaluate[8].

6.52 The consequence of the reading down of a *Cadbury* style exemption into the CFC provisions (whether before or after the abolition of the Acceptable Distribution Policy ("ADP") exemption and superior and international holding company exemptions) is that the new category-based "actively established ... and carrying on genuine economic activities ... in an EEA Member State" additional exemption will frequently be in tension with the unreconstructed motive test[9], and will overlap with, but not coincide with, the exempt activities test in TA 1988 Sch 25 paras 68, having regard to the exclusions for investment business (paragraph 9) and wholesale or distributive, financial or service business (paragraph 11).

6.53 In the author's view, this can only therefore be said to be "going with the grain" of the existing CFC legislation in so far as the implied *Cadbury* exemption is another exemption. In terms of consistency with the structure of the FA 1984 CFC legislation, as amended over the past 25 years, it is in tension if not in conflict with certain aspects, ie the motive test, and overlaps with others, ie the exempt activities test.

6.54 Moreover, the second constraint on reading down requires that the court's exercise of an interpretative obligation does not require the court to make decisions which "give rise to important practical repercussions which the court is not equipped to evaluate"[10]. Admittedly, the ECJ itself in *Cadbury* has enunciated a three objective factors test, by reference to which actual genuine economic establishment is to be tested, namely

premises, staff and equipment. However, this is no substitute for detailed legislative criteria, such as is to be found in the existing 55 pages of CFC legislation[11].

6.55 Suppose, as in the author's view should be the case, that it is possible to qualify treasury activity as benefitting from EC Treaty protection, in so far as it is carried out by a CFC actually established in the EEA but carrying on a genuine economic activity therein. What is the correct answer as to the substance threshold necessary for availability of premises, staff and equipment to manage a loan of, say, £1m? Presumably the premises do not have to be owned, but could be leased, or occupied under license. Do they have to be continuously available? That was not required in relation to holding companies in HMRC's guidance issued in respect of the 1984 CFC legislation (the yellow and grey books). What happens if there is a single loan of £100m? Or £1bn? Does the substance threshold change? Arguably not. These and many other similar questions suggest that the Court of Appeal's judgment in *Vodafone* 2 gives rise to "important practical repercussions which the court is not equipped to evaluate".

6.56 Accordingly, in the author's view, it is quite possible that the amendments to the UK CFC regime contained in Sch 16 do nothing to cure the inherent incompatibility of the UK CFC provisions, even after the FA 2007 enactment of TA 1988 ss 751A751B, given the ECJ's judgment against the UK in the *Cadbury Schweppes plc* case.

International capital movements

6.57 The repeal of the remaining advance special Treasury Consent provisions is of course greatly to be welcomed.

6.58 Also to be welcomed is the introduction via statutory instrument of provisions identical in all material respects to the former General Consents (M03/88). However, there has been no re-enactment of TA 1988 s 765A and accordingly, the question arises as to whether or not the General Consent covering transfer of shares or debentures of foreign subsidiaries controlled by a UK-resident company, to another company in the 51% UK tax group but without replication of s 765A, regarding transactions otherwise reportable between UK nationals, is EC treaty compliant.

6.59 Against this, the exclusion of transactions where all the parties to the transaction are at the time the transaction is carried out resident in the same territory does afford a similar exclusion for transactions carried out wholly within a single EU territory other than the UK.

6.60 However, the real issue here would seem to be that a UK to, for example, the Netherlands transfer ought to be similarly treated to a UK/UK transfer and this is not the case. This is similar to the issue as regards TCGA 1992 s 171 applying only regarding chargeable assets remaining in charge to UK corporation tax.

Bi-lateral tax treaty issues

Introduction

6.61 This section of the chapter discusses the inter-relationship between the reforms of the taxation of foreign profits and the UK's existing network of double taxation conventions. It considers what impact (if any) the reforms will have on the network of tax treaties, and what restrictions (if any) apply to the reforms as a result of the existing network.

6.62 Of the four elements that made up the reforms enacted in FA 2009, neither the amendments to the CFC legislation nor the introduction of the system of reporting international movements of capital are likely to have had any double taxation convention implications. Eventually, when the reform of the CFC legislation is completed, it may be necessary to see whether the legislation will prevail over any provisions in a double taxation convention[12]: in line with existing case law, this may depend on the way in which the charge to tax on the income of the controlled foreign entity is imposed[13].

6.63 So far as the international movement of capital provisions are concerned, it is hard to see that the abolition of the Treasury Consent regime has any double taxation convention implications whatsoever. It might be argued that, with a general move towards more effective exchange of information under double taxation conventions, under tax information exchange agreements and under other administrative arrangements, the system of reporting international movements of capital is unnecessary. The obvious counter-argument is that the UK would not necessarily be aware of a transaction, which might lead them to request information from another revenue authority, unless there was the obligation to report large capital movements.

6.64 The two areas of the reforms that are most likely to have implications for the UK's double taxation convention network are the dividend distribution exemption and the debt cap provisions. These are discussed below.

The dividend/distribution exemption and the UK's tax treaty network

6.65 It is worth reminding oneself what a fundamental change has been made to the UK system of taxing foreign dividends. Prior to 1 July 2009, all dividends received by UK residents from a non-resident company were liable to UK tax, with a right to a foreign tax credit – both a direct tax credit for foreign tax on the dividend itself, and, in some cases, an indirect tax credit for the underlying tax on the profits out of which the dividend was paid. After 1 July 2009, the vast majority of dividends received from non-resident companies will be exempt from UK tax. The entire network of the UK's tax treaties since 1945 has been negotiated on the basis that foreign dividends were taxable, and every tax treaty contains a provision

for the elimination of double taxation through the credit method, equivalent (broadly) to Article 23B of the OECD Model. It will take years for the UK to negotiate changes to the articles of all its double taxation conventions to replace the existing wording that provides for relief by credit[14]. There is a brief discussion below of the possible form that the elimination of double taxation provisions in the UK's future tax treaties may take.

6.66 Up until now, in the case of bilateral foreign tax credit granted under the terms of a double taxation convention, the credit for foreign tax has been granted by domestic law in combination with the "elimination of double taxation" article in the relevant tax treaty[15]. Where no tax treaty applied, credit was granted unilaterally on the basis of domestic legislation which operated as if a notional tax treaty existed with the territory in question[16]. The dividend/distribution exemption is granted under domestic law. It has not been necessary, therefore, to amend the UK's network of tax treaties to grant the exemption. The position is likely to remain for many years, therefore, that tax treaties provide expressly for relief by credit, while UK domestic law provides for relief by exemption in the case of most foreign-source dividends.

"Subject to tax" provisions

6.67 One particular issue that arises from the introduction of the dividend/distribution exemption concerns a limited number of existing tax treaties where the reduced withholding tax on dividends paid from the other country is dependent upon the dividend being "subject to tax" in the UK. **Chapter 1** contains a list of those existing tax treaties, as at 1 July 2009, where there was a restriction on the availability of the reduced foreign withholding tax dependent upon the dividend being subject to tax in the UK.

6.68 Clearly, there were too many of these treaties for the UK to try to renegotiate them before the dividend/distribution exemption came into force. Instead, one of the reasons for introducing the election that a distribution should not be exempt in CTA 2009 s 931R was to ensure that such dividends/distributions might be subject to tax. In principle, this is only a transitional solution, but given the number of double taxation conventions that contain a subject to tax limitation, it may be transitional for some considerable time.

6.69 The election to waive exemption is a pragmatic solution, but may be less than ideal for several reasons. The most important is that it remains to be seen whether the other country is prepared to accept that a dividend is subject to tax where it would have been exempt from tax, but, by exercising an election to waive exemption, the taxpayer has chosen to make the dividend/distribution taxable. It is quite possible that some countries will consider that a tax liability where the taxpayer has chosen to waive exemption is not a true tax liability but a voluntary payment.

6.70 Aside from the fact that these countries may, as a matter of principle, conclude that a voluntary waiver of exemption is not a charge to

tax in principle, these countries have an incentive to refuse to reduce the withholding tax. In principle, these countries will have agreed to reduce their withholding tax on the basis that the dividend would have been taxable in the UK with a foreign tax credit, and they will have agreed to drop their normal withholding tax on dividends in order to share the tax receipts with the UK and to ensure that the amount of their withholding tax did not exceed the UK tax liability so that there was an overspill problem. If the dividend would now be exempt in the UK (but for the election under CTA 2009 s 931R) why should those countries reduce their withholding tax?

6.71 Another difficulty with the election under s 931R concerns the timing of the election. An election must be made on or before the second anniversary of the end of the accounting period in which the distribution is received[17]. In principle, there is nothing to prevent the election being made *before* a distribution is received. If, however, the election is made after the distribution is received, then at the time it is paid the distribution will, in principle, be exempt and not subject to tax: the normal withholding tax in the country of source should apply. On a subsequent election, an application would have to be made for repayment of the excess withholding tax.

6.72 In general, it remains to be seen how the other countries concerned which have treaties with these "subject to tax" provisions will react. It is possible that in some cases the countries will refuse the reduced withholding tax and the overall result of the dividend/distribution exemption will be to shift tax receipts to the country of source.

Future provisions in the UK's double taxation conventions

6.73 It is interesting to speculate what form the UK's future double taxation conventions will take in the light of the dividend exemption. There are two articles that need to be considered: the dividend article and the elimination of double taxation article.

6.74 So far as the dividend article is concerned, the UK's position is that it imposes no tax on outbound dividends, and hence has no withholding tax to reduce or eliminate. So long as the dividend tax credit continues to exist, the UK may be willing to extend that to residents of the other contracting state, but existing treaties then impose a tax charge on the dividend plus tax credit which results in no payment being made in respect of the tax credit to a resident of the other contracting state. The only advantage is that, for residents from states applying the credit method of relief, there is now a UK tax charge in respect of which credit can be claimed. In principle, similar provisions could continue to apply, at least with respect to countries that continue to relieve from double taxation by the credit method.

6.75 So far as the position in the other contracting state is concerned, it will be interesting to see how other countries react to the UK dividend exemption. The traditional approach in the past was for the foreign

country to reduce its normal withholding tax on dividends on the assumption that the dividend would be taxed in the UK, with credit for the foreign tax and the ultimate tax burden on the dividend would be shared between the source country and the UK. Now that the UK exempts the vast majority of dividends it will be interesting to see whether other countries refuse to reduce their domestic withholding tax, or whether they match the UK exemption by dropping completely any withholding tax they would impose on the outbound dividend. The offer to extend to residents of the other country the one-ninth dividend tax credit (subject to a UK withholding tax) is unlikely to be a major bargaining chip in the hands of the UK negotiators. More effective will be the prospect that investment from the UK into that country will be deterred, by comparison with investment into countries which impose no withholding tax, so that profits can be repatriated entirely free of tax. Countries that already offer an attractive environment for investment from the UK (eg China, India, etc) may think that removing a disincentive to repatriate profits is not a good policy option, and may decide to maintain a higher withholding tax on dividends.

6.76 The other provision where new wording will need to be developed is the "elimination of double taxation" article. This article is likely to be more complex in the future than in the past. This is partly because the UK is maintaining its credit system for foreign-source income other than dividends, moving to exemption for the vast majority of dividends, but will still need to relieve by credit those dividends that do not benefit from an exemption or where the election to waive exemption in CTA 2009 s 931R has been chosen by the taxpayer. Thus, relief from credit would still be needed, for example, for: business profits from a permanent establishment; interest; royalties; and capital gains sourced in the other state. The vast majority of dividends would be exempt in the UK, so that any provisions dealing with credit for dividends would only apply if the dividend was taxed in the UK.

6.77 No doubt wording will soon be developed for the new form of elimination of double taxation provision.

The debt cap and the UK's network of double taxation conventions

6.78 One of the most difficult questions about the new debt cap legislation is how it will inter-relate with the UK's network of double taxation conventions. Those conventions reflect – in a number of aspects – the arm's-length principle. This is most clearly seen in provisions relating to associated enterprises and based upon Article 9 of the OECD Model. However, the arm's-length principle is also reflected in Article 7, relating to business profits and the attribution of profits to permanent establishments. It is also reflected in the "special relationship" provisions in, for example, the interest article[18].

6.79 To take Article 9 of the OECD Model as a starting point, this provides as follows:

> "Article 9 – Associated Enterprises
>
> 1. Where
>
>   a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
>
>   b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,
>
> and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

6.80 Article 9(2) contains a provision for a corresponding adjustment where one state adjusts profits to reflect the arm's-length provision, and the other state is then obliged (if it agrees with the basis of the arm's-length adjustment) to make a corresponding adjustment to relieve any international double taxation.

6.81 Article 9 is the basis for transfer pricing adjustments based upon the arm's-length principle. However, the debt cap legislation is not based on the arm's-length principle. An amount of finance expense may be disallowed as a deduction for UK tax purposes under the debt cap provisions, even if the terms of the transactions between members of the worldwide group are on arm's-length terms, so no adjustment would be made under Article 9. The debt cap provisions are not the equivalent of arm's-length thin capitalisation provisions: they make specific provision for the disallowance of an amount of finance expense which is regarded as excessive by the legislation.

6.82 This raises some fundamental issues as to the compatibility of the debt cap provisions with the arm's-length principle enshrined in the UK's existing network of tax treaties.

6.83 On one view, the debt cap provisions adjust the amount of finance expense between associated enterprises in a fashion not consistent with the arm's-length principle. On that view, the debt cap provisions should be overridden by any relevant UK double taxation convention[19].

6.84 On another view, however, the debt cap provisions are not transfer pricing provisions but simply a cap on the amount of deductible interest. They are not within the scope of Article 9, or other arm's-length provisions in tax treaties.

6.85 If one focuses on the wording of Article 9 of the OECD Model, it is hard to say that the debt cap provisions fall within the specific wording of that article: Article 9(1) requires there to be conditions made or imposed between two enterprises which differ from those which would be made

between independent enterprises. The debt cap provisions operate irrespective of whether the amount of debt or the amount of financing charge is the arm's-length amount. It is possible for UK members of a worldwide group to be able to show that their financing arrangements are consistent with the arm's-length principle, and yet they are subject to a restriction in the deduction of financing expenses under the debt cap (which is exactly the reason why there are those who say that the debt cap provisions are inconsistent with the arm's-length principle). However, the issue on the strict wording of Article 9 is whether there are conditions made or imposed which differ from those which would be made between independent enterprises. The answer to that on the strict wording is "no".

6.86 A possible counter-argument to this is to say that the debt cap provisions contain an implicit transfer pricing/thin cap provision. The debt cap provisions work in relation to members of a worldwide group – ie associated enterprises – and on the basis that parties at arm's-length would not agree a higher level of finance expense for the UK members of the group than under the debt cap. The difficulty with this argument is that it is hard to find support for it in the wording of the debt cap provisions.

6.87 The better view seems, therefore, that the debt cap provisions do not fall within the strict wording of Article 9[20]. By contrast, the debt cap provisions are domestic restrictions on the deductibility of interest, and not arm's-length transfer pricing provisions at all[21].

6.88 This has several consequences. First, there is no basis for challenging the debt cap provisions on grounds that they are incompatible with arm's-length provisions in tax treaties. Second, and perhaps more significant, there is no provision for corresponding adjustment under Article 9(2). Where UK members of a worldwide group suffer a restriction in the deduction of their finance expenses, there is no current provision under a double taxation convention which would require the state of the other party to the finance provision to exempt from taxation an amount of non-allowable finance expense. In fact, the recognition that there is no provision for corresponding adjustments under double taxation conventions explains the provisions in FA 2009 Sch 15 Part 5 dealing with the exemption for certain finance income received from EEA countries, which provide a measure of corresponding adjustment but only in the context of EEA countries. For other countries, there is no measure of relief. If the UK disallows part of the finance expense, the result will be a higher charge to UK tax, without any adjustment in any other country in which the worldwide group operates.

6.89 In those circumstances, it is hard to see how an overseas parent of the group, for example, could claim that the group was not being taxed in the UK in accordance with the convention and initiate competent authority procedure under the equivalent of Article 25 of the OECD Model with any prospect of relief from the resulting double taxation. Thus, there is a real prospect that application of the debt cap may lead to an effective double taxation as a result of the disallowance of part of the finance expense of the UK.

6.90 No doubt in years to come the issue of whether the debt cap provisions are compatible with the arm's-length principle enshrined in the UK's double taxation conventions will need to be resolved by litigation. It may also be that the UK will try to seek to include specific provisions in its double taxation conventions for a corresponding adjustment similar to that in FA 2009 Sch 15 Part 5 but concluded with non-EEA countries.

6.91 There are two or three further points to make about the debt cap and double taxation conventions. First, the disallowance of an amount of finance expense under the debt cap does not have as a result that any payment ceases to be interest for purposes of the double taxation convention[22].

6.92 Second, there may be some scope for application of the ownership non-discrimination provision in the equivalent of Article 24(5) of the OECD Model. If, for example, the overseas parent of a group with a UK company can show that it is subject to the debt cap, but there would have been no application of the debt cap had the parent of the group been a UK company, then it may be that the UK subsidiaries to whom the debt cap restriction is applied can raise a valid argument that they are suffering more burdensome taxation by virtue of the fact that they are owned by a resident of another country, as opposed to being owned by a resident of the UK.

6.93 Third, a challenge to the application of the debt cap may have more chance of success in the context of a UK permanent establishment of a non-resident company than in the case of a UK subsidiary. This is because of the specific expenses provision in the current version of Article 7(3) of the OECD Model. The disallowance of part of the finance cost of a UK permanent establishment in accordance with the debt cap provisions may be seen as infringing this specific rule[23]. By contrast, there is no express equivalent provision dealing with the deductibility of interest of a UK-resident subsidiary.

6.94 Again, many of these issues are ones that can be highlighted, but will ultimately need to be resolved by litigation.

Concluding comments

6.95 It is undesirable that the compatibility of the debt cap provisions with the UK's existing network of double taxation conventions remains uncertain. This is likely to require litigation in future years. Unfortunately, there is no other way of coming to a position of certainty on this point, unless the debt cap provisions were expressed to operate notwithstanding anything contained in any arrangements for the relief of double taxation.

Footnotes

1 Paragraphs 74 and 226 of the ECJ judgment.

2 Paragraph 56 of the ECJ judgment, read together with paragraph 226.

3 *Adria-Wien Pipeline GmbH, Wietersdorfer and Peggauer Zementwerke GmbH and Finanzlandesdirektion Fur Karnten* (C-143/99).

4 Ie *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman (C-415/93)*; *Caixa Bank France v Ministère de l'Économie, des Finances et de l'Industrie (C-442/02)*; *Commission of the European Communities v Federal Republic of Germany (C112/05).*

5 *Vodafone 2 v Revenue and Customs Comrs* [2009] EWCA Civ 446.

6 *Marks & Spencer plc v David Halsey (HM Inspector of Taxes)* (C-446/03).

7 Lord Nicholls in *Ghaiden v Godin-Mendoza* [2004] 2 AC 557.

8 Again Lord Nicholls in *Ghaiden* and also Lord Roger in *Ghaiden* and Lady Justice Arden in *Revenue and Customs Comrs v IDT Card Services Ireland Ltd* [2006] STC 1252.

9 TA 1988 Sch 25 Part IV paras 1619.

10 *Ghaiden v Godin-Mendoza* [2004] 2 AC 557.

11 TA 1988 ss 747756 Schs 2426.

12 Which is the current position following the decision of the Court of Appeal in *Bricom Holdings Ltd v IRC* [1997] STC 1179.

13 The distinction now seems to be accepted between provisions which attribute the income of a non-resident to a UK-resident person and tax that UK-resident person accordingly (in which case the protection of the income under a tax treaty also applies) and provisions which tax the UK resident on a notional amount computed by reference to the income of a non-resident (in which case the protection of the treaty does not apply). This distinction has not been challenged above the level of the Court of Appeal.

14 It would be an extremely ambitious taxpayer who tried to argue that they were still entitled to a foreign tax credit – both for direct tax and for underlying foreign tax – on a dividend which is exempt as a result of CTA 2009 Part 9A. Presumably the taxpayer would argue that, in not granting the foreign tax credit (even of the exempt dividend), the UK was not acting in accordance with the double taxation convention. The chances of that argument succeeding are negligible.

15 Under TA 1988 s 788, in combination with the elimination of double taxation article in the treaty and the provisions of the "credit code" in s 792ff.

16 See TA 1988 s 790.

17 CTA 2009 s 931R(3).

18 See Article 11(6) of the OECD Model Tax Convention for an example of a "special relationship" provision.

19 The author has been very much helped in preparing this section of this chapter by a draft note by Mark Persoff of Clifford Chance. Though the author reaches a different conclusion from Mr Persoff, the arguments in the (unpublished) note are cogent and represent the alternative position very well.

20 Where the debt cap provisions apply to a permanent establishment in the UK of a company resident in a state with which the UK has a tax treaty, the provisions in the relevant tax treaty equivalent to Article 7(3) of the OECD Model Tax Convention may provide a better argument against the debt cap (at least on the current wording of Article 7(3)). This is because Article 7(3) contains an express provision dealing with the deduction of expenses. See the discussion at paragraph 6.93 below.

21 On this view, the debt cap provisions are no different from any other domestic provision which limits the deductibility of an expense for the purposes of computing the tax base. A provision which precluded deduction of an expense incurred partly for the purposes of an associated enterprise (and so not wholly and exclusively for the purposes of the trade of the enterprise incurring the expense) would not be incompatible with Article 9 simply because it made reference to associated enterprises.

22 See Article 11(3) of the OECD Model Tax Convention for the definition of interest in the Model. The debt cap legislation does not re-characterise disallowed interest as a distribution, for example.

23 Even then, the matter is not conclusive as Article 7(3) would not override a general rule of domestic law requiring certain conditions to be fulfilled before an expense is deductible, or limiting the amount of the expense which can be deducted (see the new draft Commentary to Article 7(3) of the OECD Model).