Corporate Update

September 2007

Taxation of the foreign profits of companies

On 21 June, HMRC and the Treasury finally responded to recent European Court of Justice decisions with a discussion document detailing a package of reforms to taxation of foreign dividends, controlled companies, interest deductions and Treasury consents. If all the proposed changes are implemented, most groups of companies will be affected in some way.

Foreign dividends

Currently, companies pay Corporation Tax on the dividends they receive from their foreign subsidiaries. However, they can claim credit for foreign tax withheld from the dividends and, provided they control at least 10% of the voting power of the paying company, for foreign tax on the underlying profits out of which the dividends are paid.

The discussion document proposes replacing this "tax and credit" treatment with a new exemption for most foreign dividends received by large or medium-sized companies from subsidiaries in which they have at least a 10% shareholding. This would bring the UK into line with a number of other European countries which offer such a participation exemption from tax and could make subsidiaries more tax-efficient than overseas branches for some companies. A simplified credit system will apply for small companies.

Controlled companies

As the changes to the taxation of dividends could offer some scope for tax planning beyond that which would be acceptable to HMRC, the rules on the taxation of Controlled Foreign Companies (CFCs) are to be changed, to deal with certain undistributed foreign profits.

Companies do not pay corporation tax on the undistributed profits of their foreign subsidiaries unless the CFC rules apply. The purpose of these rules is to prevent companies from reducing their UK tax bills by artificially diverting profits to subsidiaries in low tax jurisdictions. Subject to various exemptions, a UK company with an interest of 25% or more in a CFC is subject to corporation tax on its proportionate share of the undistributed profits of the CFC.

The discussion document indicates that the scope of the rules will be expanded to include UK-resident controlled companies as well as CFCs. In addition, the threshold for control is to be reduced from 25% to 10%, to follow the foreign dividends exemptions rules. Income attributed to the controlling parent for UK tax purposes will be "passive" income, such as interest, royalties etc, rather than all of the income as at present.

The discussion document also suggests that dividends within the controlled group will be exempt from UK tax; groups can then earn and repatriate profits from tax havens without any UK tax – it will be interesting to see whether this provision survives to appear in the final legislation. The proposed new controlled companies' rules also appear to follow the existing transfer pricing rules, which were extended to cover UK/US rules three years ago, to comply with EU law. As with the changes to transfer pricing, it seems likely that UK-only groups will have an increased compliance burden with no particular tax benefit.

Interest deductions

The amount of interest that can be claimed as a deduction by UK members of a multinational group will be capped by reference to the group's total external finance costs, to prevent debt being loaded into the UK subsidiaries. This may create problems with mergers, depending on the format of the legislation when it is finally drafted.

Treasury consents

The present Treasury consent rules require UK companies with foreign subsidiaries to obtain consent from the Treasury before carrying out certain transactions, such as transferring shares in the subsidiaries. Despite having been considerably watered-down over the years, these rules remain unpopular, both for the compliance demands and because they are easily over-looked. The discussion document proposes abolishing the rules altogether, although it is likely that some form of reporting to the Treasury for these transactions will still be required.

Recognised Stock Exchanges (RSEs)

HMRC have announced that the London Stock Exchange and PLUS-listed markets have been designated as recognised stock exchanges under the Income Tax Act 2007 (ITA). This does not alter the availability of existing tax reliefs which rely on AIM shares not being "listed". AIM companies are not listed by the UK's competent authority. The designation of the London Stock Exchange as an RSE does not change this fact.

October 2007 implementation of the Companies Act - audit points:

Members' rights to raise audit concerns

Members holding at least 5% of the voting rights of a quoted company will become entitled to have published, on the company's website, a statement setting out any matter that they propose to bring up at the next meeting relating to the audit of the company's accounts or the circumstances connected with an auditor ceasing to hold office. A company can only refuse to publish the statement if a court agrees that the right is being abused.

This right applies for financial years beginning on or after 1 October 2007, but cannot be exercised by members until after 1 April 2008.

Business review

All companies will be required to produce a business review for financial years beginning on or after 1 October 2007, although there is an exemption for those under the small companies accounting regime. The review must be in the Directors' Report in the accounts, or at least cross-referenced in the Directors' Report.

The purpose of the business review is to "inform members and help them to assess how the directors have performed their duty [to promote the success of the company]". Companies should be aware that the information released will be available to anyone requesting a copy of the accounts from Companies House. However, information about developments or matters under negotiation does not need to be included if the directors consider it would be against the company's interests. Quoted companies will need to provide more information in the review than private companies, such as the main trends and factors likely to affect the future development, position and performance of the company.

UITF clarify scope of FRS20

The Urgent Issues Task Force ("UITF") recently issued Abstract 44 "FRS20 (IFRS 2) – Group and Treasury Transactions" which provides clarification on the application of FRS20 when an entity ("the subsidiary") or its parent undertaking (eg a listed company) grants options over shares of the parent to employees of the subsidiary.

The accounting treatment in the subsidiary depends on whether the share options are granted by the subsidiary, when the arrangement will be treated as cash settled, or the parent undertaking, when the arrangement will be treated as equity settled with the credit entry shown as a capital contribution from the parent.

In both situations, the subsidiary is required to apply FRS20. As a result, subsidiaries, that previously provided minimal disclosure in relation to employees' share options in parent undertakings, will now be required not only to provide substantial disclosures in respect of the share options but also to account for the arrangement in accordance with FRS20.

Advance clearances – consultation

There are some areas of tax in which HMRC will confirm the treatment of a transaction in advance, but these are very limited – for example, HMRC will generally only comment on its interpretation of legislation contained in one of the last four Finance Acts. This means that, in general, clearances are not available for UK transactions, leading to uncertainty and comparing poorly with some other European countries.

As a result of a review of the way in which HMRC interacts with large businesses in particular, it is proposed that the "four Finance Act" limit on clearances be discarded, and a new Advance Agreements Unit be established within HMRC to provide clearance on certain high value commercial issues. This is good news for businesses as it should reduce the risk that the tax treatment of a transaction will be challenged by HMRC subsequently.

Changes to VAT invoicing with effect from October 2007

This new law comes into force on 1 October 2007. There will be minor changes to the numbering of invoices and new rules to clarify the VAT treatment when making margin scheme supplies, supplies to business customers in the UK when the customer accounts for VAT and supplies to business customers in other EU countries.

VAT invoice numbering

Currently there is a requirement for a VAT invoice to have an identifying number. The change will require this number to be from a series that is unique and sequential. For most businesses this will have little impact on their current invoicing practice.

Invoices issued under the second-hand margin scheme

There will be requirements to include one of three references:

i) A reference to the relevant article in the EC Directive; or

ii) A reference to the relevant UK legislation; or

iii) Any other reference indicating that the second-hand margin scheme has been applied.

The current legend *"input tax deduction has not and will not be reclaimed by me in respect of the goods sold on this invoice"* will no longer be acceptable to reference the fact that the supply is a margin scheme supply. Businesses may, if they wish, use this legend until they migrate to a new form of acceptable reference over time as they reprint invoices or upgrade software.

HMRC will be publicising alternative legends which may be adopted. Examples of alternative legends will include:

- "This is a second hand margin scheme supply"
- "This invoice is for a second-hand margin scheme supply"

References required on invoices involving Intra–EC exempt or reverse charge supplies

For the purposes of the new requirements a supply is exempt (not zero-rated) if covered by the UK's VAT Act Exempt Schedule (eg financial services).

Invoices will require one of three references:

i) Reference to the relevant article in the EC Directive; or

ii) A reference to the relevant UK legislation; or

iii) Any other reference indicating that the supply is exempt, or subject to the "reverse charge".

The regulations make it clear that a requirement to issue invoices for exempt supplies only arises when the supply is business to business, across an EU border and an invoice is required by the member state of receipt. Because custom and practice varies widely even in member states whose legislation ostensibly requires an invoice, clients should always be guided by their customers about their need for an invoice.

Suggested statements that indicate the invoiced supply to be exempt or subject to reverse charging include:

Exempt supplies:

- "Exempt supply"
- "Exempt supply for VAT purposes"
- "This supply is exempt from VAT"

Reverse charge supplies:

- "Reverse charge supply"
- "This supply is subject to the reverse charge"
- "Subject to reverse charge in the country of receipt"
- "Subject to the reverse charge in another member state"
- "This is a UK exempt supply which may be chargeable in the country of receipt"
- "This is a UK exempt supply which may be chargeable in another member state"

Invoices for an Intra-EC zero-rated supply

For Intra-EC zero-rated supplies of goods (Dispatches) clients will need to include one of three references:

i) A reference to the relevant article in the EC Directive; or

ii) A reference to the relevant UK legislation; or

iii) Any other indication that the supply is a zero-rated Intra-EC supply.

It is possible that, in some cases, the format and information already used on invoices is sufficient to satisfy the new rules.

Examples of references under the third option include:

- "Zero-rated Intra-EC supply"
- "This is an Intra-Community supply"
- "Intra-Community supply subject to VAT in the country of acquisition."

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