

Taxation of Foreign Profits - Implications for UK Funds

October 2009

The Finance Act 2009 introduced new rules regarding the taxation of foreign profits with the aim of maintaining the UK's competitive position in the global economy. All UK and foreign dividends falling into an exempt class will be tax free if received on or after 1 July 2009, subject to certain conditions and anti avoidance measures.

In this bulletin we consider the impact of these changes for investment trust companies (ITCs) and authorised investment funds (AIFs).

How the exemption applies depends on the size of the recipient company, ie whether it is 'small' or 'not small'. Companies that are not small are those with annual turnover and/or balance sheet totals greater than €10 million and have 50 or more employees. Small companies are those with annual turnover and/or balance sheet totals not exceeding €10 million and less than 50 employees.

The concept of 'annual turnover' doesn't fit well with an ITC and this is an issue which is currently being discussed with HMRC. However, on the basis that this is satisfactorily clarified to refer to gross income only and many ITCs will have gross income not exceeding €10 million and less than 50 employees, the majority are likely to fall within the definition of a small company. However, AIFs are specifically treated as being not small for the purposes of the legislation. Different considerations will therefore apply to these two types of funds.

Small companies

For companies classed as small, the dividends must be paid by a resident of the UK or a qualifying territory in order for them to be exempt. Qualifying territory means one with which the UK has a double taxation agreement (DTA) that includes an appropriate non-discrimination clause.

For example, distributions from offshore companies resident in Ireland would be exempt but those from Cayman or Bermuda would not be.

In addition, certain non-dividend distributions (such as interest which is reclassified as a dividend) are not exempt. For the distribution to be exempt it also cannot be claimed as a tax deduction by a non-UK resident in any non-UK territory. Lastly the distribution cannot be made as part of a tax advantage scheme.

Companies that are not small

For companies which are not small, all UK and foreign dividends will be exempt provided they fall into certain categories (considered below) which should be monitored.

Of most relevance here are portfolio dividends paid on shares which represent less than 10% of share capital, profits and assets of the paying company, which are now exempt. Although in most cases for investment by funds this will be the case, clearly this should not be taken for granted and would need to be reviewed. There are specific anti-avoidance

rules in relation to the operation of this exemption and these should be carefully reviewed when applying the rules.

Another important exemption is where dividends are received from companies controlled by the recipient. Some large ITCs may control an underlying company and they should ensure all 'control' tests are met. Generally, for the purposes of the legislation, control exists where the recipient of the dividend controls the payer; or the recipient is one of two persons who taken together control the payer; or either the recipient or other person satisfies the 40% test in the controlled foreign company rules. Again the satisfaction of this test should be monitored regularly and the specific anti-avoidance rules that apply to this particular exemption should be carefully reviewed.

The exemptions are subject to various exemption specific and general anti-avoidance rules and although most funds are unlikely to be caught by these it is important to bear them in mind where there are any unusual shareholdings or structures involved.

Double Tax Agreements (DTAs) with a 'subject to tax clause'

There have been concerns that access by taxpayers to the benefits of the UK's DTAs may be affected, particularly for those DTAs that contain a condition that dividends must be 'subject to tax' in the recipient's country in order to benefit from reduced withholding tax.

In fact the potential adverse impact of these changes may only relate to a small number of DTAs although they include for example Germany, Russia, Portugal and Israel. Under the UK-Germany DTA the treaty withholding is 15%, but the non treaty rate is 26.375% and therefore the impact could be significant. In some cases the domestic withholding rate is below the DTA rate, rendering the DTA irrelevant in that context, however it is important to review portfolios carefully to ensure that the benefit of the dividends not being taxed in the UK is not outweighed by increased withholding taxes.

To address the 'subject to tax' issue, the new rules enable taxpayers to make an election to become 'subject to tax' on dividends from specified countries and/or specified companies. The election must be made on or before the second anniversary of the end of the accounting period in which the distribution is received. The availability of management expenses may mitigate the additional UK tax which would otherwise be payable on a taxable dividend.

Recipients should agree on a process for opting to tax dividends from specified countries with their custodians as soon as possible in order to ensure that treaty rates continue to be granted at source in order to maintain cash flow and avoid administrative costs involved in the withholding tax reclaim process.

Impact of exemptions

For ITCs receiving overseas dividends, a decreased tax charge may result in the need to pay larger distributions in order to meet the 15% retention test in s 842 ICTA 1988 (s 842). This could impact on not just those trusts which are tax paying, but those which charge management expenses to capital and currently have tax relief allocated between the revenue and capital accounts.

Where deferred tax has previously been provided in respect of accrued overseas income, the release of the deferred tax liability could have a one off impact on the amount retained. In addition, as a result of the changes, eligible unrelieved foreign tax (EUFT) cannot be utilised going forward and this could also have an impact on the tax charge to the extent that a deferred tax asset has previously been recognised.

The additional excess management expenses created may enable funds to consider other investment options, which although prima facie taxable may result in no overall tax charge due to the use of these new 'freed up' management expenses. For example, funds may be able to make greater use of bonds or invest in non-qualifying offshore funds in order to create wider, more diversified portfolios.

The changes will impact on the streaming rules for AIFs and will therefore also impact on funds investing in AIFs. Foreign dividends received by AIFs are now effectively treated as franked for the purposes of the streaming rules, so the non-taxable franked element in relevant funds will increase.

For authorised fund of funds there maybe the risk of overstating their tax charge due to the increase in the franked element from streamed income, until such time as vouchers are received. AIFs generally will need to consider the impact of the changes for unit pricing purposes and in some cases tax provisioning may need more regular review in the initial period when some dividends are taxable and some are not, depending on whether they are received on or after 1 July 2009.

Other considerations

EU tax cases

If they have not already done so, funds should consider making reclaims under the Denkavit/Fokus Bank cases which open up the opportunity to seek reclaims of withholding tax from EU member states. Clearly, going forward, any overseas tax suffered on dividends will be a real cost to the fund and consideration should be given to making claims for prior years as soon as possible due to the limitation periods (which vary according to jurisdiction) in which a reclaim can be made. To the extent that recovery claims could create a corresponding UK tax charge (for prior years) consideration should also be given to resubmitting UK tax returns under the Manninen case such that overseas dividends received prior to 1 July 2009 are not taxable.

New products

Following greater clarity regarding the use of derivative instruments, at least for AIFs, there has been increased focus on using derivatives in funds. Interestingly though, to the extent that there is a revenue return embedded in the derivative, it may be less tax efficient than receiving the underlying revenue stream directly.

This is because returns on derivative products follow the accounting treatment for tax purposes, so if such items are treated as revenue in the accounts they will be taxable, whereas dividends from equities are now generally exempt.

Conclusion

Clearly the exemption from tax on overseas dividends is a very positive step for UK taxpaying companies as a whole, including UK funds. As is often the case, such changes are not always as straightforward as they seem at first and for some funds there will be resulting implications that need to be reviewed carefully.

AIFs

For AIFs the considerations are likely to be restricted to issues such as the 10% portfolio dividend rule; the impact on corporate streaming rules particularly in relation to the increase in the non-taxable, franked element of foreign dividends and as a result the possible risk of overstating their tax charge. The impact on unit pricing purposes may require more regular review of tax provisioning due to the transitional period of when dividends were received around the 1 July 2009 period.

ITCs

For ITCs, more detailed consideration of issues such as which exemption applies according to whether they are classified as small or not small; whether dividends are received from qualifying territories (for small ITCs); whether the control tests are met (for large ITCs); and the 10% portfolio dividend rule, will be required. Additionally for s 842 compliance purposes, ITCs will need to review the impact of changes on the 15% retention test and possibly pay larger distributions as a result. This affects both tax paying trusts and those which charge management expenses to capital and currently have tax relief allocated between the revenue and capital accounts. As discussed, the movement in deferred tax assets and liabilities, as well as EUFT that cannot be utilised going forward, may all impact on the tax charge and hence the amount of retained income. Finally additional excess management expenses created may enable funds to consider other investment options as outlined above.

Who should I contact for assistance?

If you would like to discuss any of the matters raised in this release, please contact Anne Stopford or Dana Ward on the details below.

Anne Stopford
Tax Partner
T 0207 865 2285
E anne.stopford@gtuk.com

Dana Ward
Tax Partner
T 0207 728 3316
E dana.ward@gtuk.com