The Offshore & International Taxation Review

MIXING UP UK DOUBLE TAXATION RELIEF[1]

Hein Coops[2]

Introduction

Many of the larger mergers, which have recently taken place, have been focused on geographical rather than functional expansion. Through this drive for international geographical expansion and due to a rise in capital mobility, complex group structures were formed in which large companies own several subsidiaries abroad. These subsidiaries are often active companies, making large profits, which they usually want to pay out to their parents by means of a dividend. Unlike interest, a dividend is not deductible from the company profits and therefore is an expensive way of financing a company. On top of that, companies often have to pay dividend tax on this capital flow from subsidiary to parent, because it has its source in a country. The parents company's country of residence will normally provide a way of relieving this double taxation by means of the exemption or credit method. The United Kingdom used to do this by means of the credit system with a maximum of 30% of the paid dividend. This is the amount of UK tax attributable to the income, which has been subjected to foreign tax in the UK.[3] This system is used in many other countries, but besides this the UK uses a source-by-source credit system, which means that the tax on any single dividend flow in excess of 30% cannot be credited against UK corporation tax. To get around this maximum (often referred to as a cap) companies came up with offshore mixer structures, in which a foreign-based company receives the dividends from the subsidiaries, before these are paid onward to the parent residing in the UK. By doing this, the high taxed profits from countries like Italy could be mixed with profits coming from low-tax jurisdictions

---

1 This article was originally written in June 2001 as the author's graduation essay for his LLM.

2 Hein Coops LLM, International Tax Lawyer, Loyens & Loeff, PO BOX 71170 1008 BD, Amsterdam, The Netherlands Tel: 0031 20 578 5785 Fax: 0031 20 578 5800
E-mail hein.coops@loyensleoff.com

3 The OECD commentary to article 23 at para. 16 calls this form of relief the ordinary credit, which in the UK amounted in 2000 to an amount of 5.5 billion (Board of Inland Revenue Finance Bill 2000).

(often tax havens), which results in an average rate of 30% or less. This mixed dividend could accordingly be paid out to the UK parent. The Inland Revenue recently estimated that there were 200 UK multinationals using mixer structures as a way of tax planning.[4]

Smart tax planners would be sure to use the capped 30% to the fullest extent using these mixer structures. This would result in higher credits given by the UK government, because usually a high tax dividend was no longer blocked by the cap of 30%. The government found it unreasonable that other countries levied substantially higher taxes on dividends and got away with that because the companies knew that in the end the UK government will give relief for it. So in the end they were only paying the regular 30% UK rate.

It also resulted in investments in low tax countries just to offset the existing investment in high tax countries, and vice versa.[5] On March 18th 1998, the UK government therefore issued a consultative paper on the way foreign tax should be relieved in general and the prevention of the mixer structures in particular. After the consultation, it decided not to change the UK double taxation regime and to limit the use of offshore mixer structures by introducing new legislation on March 31st 2001. In this article, references to section numbers will be to sections of the Income and Corporation Taxes Act 1988, unless otherwise stated.

Two Ways of Giving Double Taxation Relief

After the need for expansion by tradesmen, it was to be inevitable that borders would be crossed and that more than one government would like to see itself sharing in the profits of a business. The justification I find most suitable for this is the payback for the use of the sources of a country, like (economical) infrastructure and other structures of organization in that country. Besides that, a country will always try to compare itself with the other country on its tax proceeds and the way these are generated. This can result in two countries sharing the tax proceeds of the profit of one business, and so the business is unfairly treated compared to other businesses generating their proceeds from only one country. This is called juridical double taxation and it takes place when two different tax subjects are taxed on the same income. For example: a subsidiary of a UK based company is taxed in the United States on the profits it makes. Part of these profits will be paid on to the parent company in the UK by way of a dividend, being the reward for investing in the US

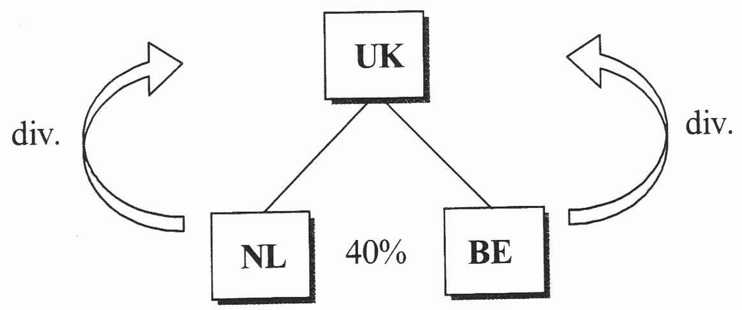
4 What next for UK mixers; International tax review, May 2001, p. 20.

5 Double taxation relief for companies, Outcome of the review; Inland Revenue, March 2000, page 5.

company. The US will impose a withholding tax on this dividend of let's say 20%, as it finds that these dividends have their source in the US and that it therefore has a right to tax them. Arriving in the UK, these dividends will form part of the (investment) income of the UK company and will therefore be taxed with corporate income tax. In short, this means that the same capital is taxed three times. In most countries, the shareholder gets a relief for the fact that the company in which he owns shares has already paid corporate income taxes on the profit out of which the dividends are paid.[6]

Furthermore, most countries feel that a company should be compensated for the fact that the dividend payment itself is taxed in two countries. This is usually arranged for in a bilateral tax treaty. This compensation can be reached in several ways, which can be divided in two groups; the capital import neutral and the capital export neutral way. In short, this means that it should not make a difference where the capital invested in a business comes from, or if someone invests his money in his country of residence or in some other country abroad. These neutralities correspond with two major ways used all over the world to give relief for double taxation, namely the exemption method and the foreign tax credit method.

The main difference between the two systems is that with the credit method one gets a credit for foreign tax paid, while with the exemption method the profit made abroad is not included in the calculation of the domestic profit. The different outcome of the total tax charged therefore lies in the different percentages of corporate tax in the two countries.



The following example clarifies these two methods of double tax relief. Let's assume that a UK Co is charged with 30% corporate tax and can use the exemption method for a Dutch subsidiary and the credit method for a Belgian subsidiary to relieve the double taxation. With a dividend of 100 coming from both subsidiaries and a local UK income of 200 the following calculations apply.

6 This is what happens with the full or partial imputational system.

	NL sub	BE sub
Total income	400	400
Income foreign subsidiary	100	100
Underlying tax suffered (40%[2])	40	40
UK Double Tax Relief	30 (100 x 30%[1])	40 (100 x 40%[2])
Total UK Corp. tax suffered (30%[1])	90 (300 x 30%)	80 ((400 x 30%) - 40)

Since 1916, which was the time that taxes started to rise substantially, the UK government has used the credit system to relieve double taxation. The only exception was an agreement with Ireland in 1926, which exempted certain Irish income taxes to prevent double taxation for businesses trading with Ireland. Since then the credit system has prevailed. In the Parent-Subsidiary directive of the EU both ways of relief are approved, and there are advantages to both systems.

When using the exemption method all foreign income is exempt from domestic taxation and the result is that this part of the income does not risk being taxed twice. However, this does not result in export neutrality, because the foreign income is taxed at the foreign rate, which could mean that investing in the UK could be more advantageous than abroad if the foreign tax rate is higher. It does however result in import neutrality, because all investors investing in the UK will pay the UK rate when receiving their dividends. Their countries of residence will exempt the foreign income, and the company will only be charged with UK withholding or corporate income tax. Through this feature, the system becomes neutral as to where the after tax returns will flow or where the savings will be held.

The credit system, on the other hand, does result in export neutrality, because you will pay your domestic rate on your worldwide income. The foreign tax credit intends to prevent double taxation, but at the same time results in eliminating any influence from the foreign rate. One should realise though that for the credit system to be fully neutral to the allocation of investments, it is required for all countries investing in the UK to adopt the same system. So if an import neutral system is related to the flowing of savings, an ideal capital export neutral system is related to the flowing of investments, because it would not matter where one invests his money, when a country of residence does not make a distinction in the origin of the income proceeding from those investments.

These two ideal forms of the two systems of double taxation relief can unfortunately not operate side by side due to the distinctive features explained above. Apart from these technical issues the Inland Revenue was also concerned with the more general policy related issues, of which the most important one can be considered the simplification of the UK tax law. The exemption method seems to be the better one in this regard, because one can just disregard the foreign income for UK tax calculations if it is taxed twice. This is a lot easier than first having to find the underlying amount of profit and then calculating the credit related to the amount of profit represented by the dividend. Another disadvantage of the credit method is the risk of keeping the income out of the UK altogether. This might happen when groups decide that it is more favourable to keep the money in the low-tax jurisdiction, because in the UK it would be subject to a 30% tax rate.

On the other hand, the UK government understandably is satisfied with the credit method, because it keeps countries from trying to find low-tax (under domestic law or due to a treaty) jurisdictions when knowing that that particular tax will be the only tax payable. This would after all be the income exempt from UK tax.[7]

Most other European countries use the exemption system at least partially, besides the credit system and seem to be very content with it. As I explained above, both systems work better when most trading partners are using the same one. This could be another reason for the UK to switch to the exemption system, because 60% of international trade is done with European countries.[8]

If the government is unhappy with the system of exemption in its general form, it should at least consider using it in those specific circumstances where the unfairness of the credit system is particularly evident. In its review, the Inland Revenue proposed a combination of an exemption method on one side, which has an incentive effect on outward investment in low-tax countries, but on the other hand restricting it to protect the UK tax receipts. The latter could be attempted by only exempting the income, which would not be chargeable to UK tax anyway due to a high credit for foreign tax paid. This sounds like a very good alternative, but in its conclusion, the Inland Revenue simply dismisses the possibility by saying that the arguments for changing to an exemption method are not strong enough to make such a fundamental change in the UK system.[9]

As mentioned above one of these arguments has been the simplification of the system, but in my view the government has not given the weight to this argument that it deserves in the current UK system of corporate taxation.

---

7 Double taxation relief for companies: a discussion paper; 18th March 1999, IRS, p. 15 par. 4.2.

8 These figures were used by the Labour party for the 2001 election.

9 Double taxation relief for companies, Outcome of the review; Inland Revenue, March 2000, par. 1.11 p. 4.

The Inland Revenue also mentions that there can be no guarantee that an exemption system that meets the UK's needs would be simpler to operate for companies[10], but one can hardly imagine that any company would not prefer to use a clean-cut exemption system to the incredibly complicated legislation they have to deal with now.[11] Especially when a small amount of dividends are paid, it might be preferable to use the exemption system, because it involves less compliance costs.[12]

Technical Analysis of the Double Tax Relief in the UK

The UK prevents domestic double taxation in e.g. section 208 by stating that 'corporation tax shall not be chargeable on dividends of a company resident in the UK'. This is a form of participation exemption. In order not to create any barriers for companies to invest abroad, a similar regulation has to exist when a subsidiary that is not based in the UK distributes a dividend. This is what double taxation conventions with other jurisdictions aim to achieve, but in order to be entitled to a tax credit, one of course needs a basis in the form of a domestic statute of some kind. In adopting public international law, the UK has adopted a dualist approach, which means that a domestic statute is needed as an entitlement, and a directive from the EU for example will have to be implemented in UK law in order to have effect. The same principle applies to the bilateral tax treaties the UK concludes; a jurisdiction to tax a person created by a treaty does not necessarily imply that the UK also makes a claim to tax. An example of this is the dividend going abroad which is charged with a withholding tax, which is less than the maximum prescribed by the bilateral treaty. In that case the UK will adhere to its own legislation even though it is allowed to charge a higher tax.

These treaty issues are set out in part XVIII Chapter I of ICTA. The basis through which any treaty takes effect in domestic law is section 788 and the rest of the section defines the exact effects they can have on the domestic law, for example the tax acts covered by it. When receiving a foreign dividend, section 790 provides for the unilateral relief for the tax paid on the profits out of which the controlled company distributed the dividend. This is a unilateral relief for the so-called underlying tax. Subsection 6 of this section defines the word "controlled" by stating that the parent, which has to be a UK resident, or its subsidiary has to have directly or indirectly at least 10% of the voting power in the company. The term subsidiary

---

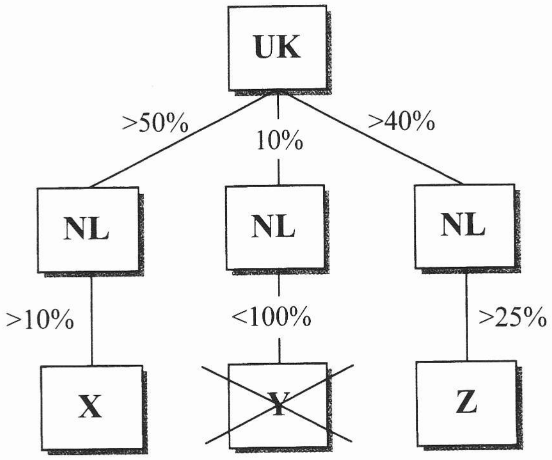
10 Double taxation relief for companies: a discussion paper; 18th March 1999, IRS, par. 4.18 p. 19.

11 I especially refer to the legislation concerned with onshore pooling, as I will explain below.

12 This view is also taken by the Chartered Institute of Taxation in their comment on the discussion paper of the Inland Revenue; 22nd September 1999.

used in this section is defined in section 792.

To illustrate this, the figure below shows the different kind of subsidiaries, of which Y is the only company that is not sufficiently controlled by UK Co.



The foreign tax credit is further defined in section 797 as having a maximum of the UK corporate tax attributable to that relevant foreign income in the hands of the recipient. This corporate tax is then defined in the second and third subsection referring to the relevant accounting period and the profit calculated in the right way. Furthermore, it can be derived from these sections that a credit has to be calculated on a source-by-source basis. This is one of the important reasons behind the Dutch mixer structures, since this is the main feature of the legislation that the use of an offshore pool is trying to avoid. The three sources X, Y and Z, will with the use of one mixer company, be treated as one source, which will have an underlying tax rate below the maximum of 30%.

Underlying tax is of course an extendable term and is therefore defined in section 799. After the *GCA International Limited v. Yates* case[13] it was questionable whether the limitation on a foreign tax credit should be computed by reference to the income as computed for UK corporate tax purposes or to the foreign measure of income.[14]

---

13 [1991] STC 151, in which it was decided that the credit should be based on the UK corporate tax calculations and no longer on the foreign ones.

14 Some aspects of UK Double taxation relief, Philip Baker; October 1998 IBFD, p. 454.

With the introduction of the new legislation however, the Inland Revenue seems to have taken an entirely different view regarding this matter, which can be illustrated by section 795A. This section states that the underlying tax for which a company is trying to get relief should be limited as much as possible by taking every reasonable action, which a company would have taken in the absence of the relief, to minimise the amount of tax payable in that country. In my view, it is not helpful to minimise the amount of foreign taxes for the calculation of the credit when we are not using these in our calculation. It can therefore be presumed that, as of April 2001, the foreign tax calculations should be used as a base for the credit.

Relief will be given in respect of so much of the foreign tax borne on the "relevant profits" by the company paying the dividend, as is properly attributable to the proportion of those "relevant profits" represented by the dividend (section 799[1]). The term relevant profits in this regard is defined as:

- if the dividend is paid for a specified period, the profits of that period;
- if the dividend is not paid for a specified period, but is paid out of a specified profit, those profits;
- if the profits are not paid neither for a specified period not out of specified profits, they are deemed to be the last profit for which accounts were made up, which ended before the dividends were made payable.

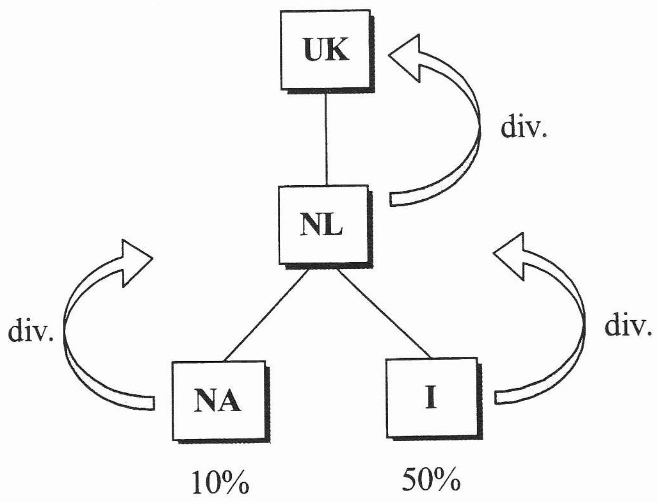
Whereas the source-by-source approach of the UK is relatively restrictive, the treatment of the lower tiers in a chain used to be liberal, because there was the possibility to specify the profits in the chain out of which the dividend was paid. It would enable you to link every part of a dividend to a specific tax rate. This has changed in the new legislation and it is no longer possible to specify the profits out of which the dividend was paid, but only the period for which it was paid. These rules also correspond with section 801C, which deals with the separate streaming of acceptable distribution policy "ADP" dividends, because these are deemed to derive from specific CFC profits.[15] Therefore, it is no longer possible to specify profits, because it could enable the avoidance of CFC legislation.

The Mixer Structure

To get around the source-by-source restriction companies invented the mixer company, which basically converts two sources into one single one with only one

15 Section 801C6+7; I will go over section 801C in a specific paragraph dealing with CFC's below.

single tax rate to be relieved. In the example below the high taxed dividends from Italy are mixed with the low taxed dividends from the Netherlands Antilles in the company resident in the Netherlands. If they are mixed in the right proportion, the Netherlands mixer company can pay them onward to the UK-parent, with the combined underlying tax rate of 30%, which can be fully offset against the 30% CIT rate in the UK. One can therefore see that it is crucial in a structure like this that the country with the right corporate tax rate has to be used as the subsidiaries resident country in order to use the UK 30% CIT maximum to its fullest extent. Another result is that the profits of different accounting periods are mixed, which is normally not allowed in the UK. The group controls the dividend payments and thus it is possible to get relief in the UK for a particular period for underlying tax that was paid in another period.[16]



[16] Double taxation relief for companies: a discussion paper; 18th March 1999, IRS, par. 6.12 p. 24.

	Sub N.A	Sub Italy	Total with Mixer
Income foreign subsidiary	200	200	400
Underlying tax suffered	20 (10%)	80	100
Net dividend received	170	60	230
UK Corporation tax suffered (30%)	60	60	120
UK Double Tax Relief	20	60	100 ([1]+[2])
Unrelieved foreign tax	0	20	0

This example illustrates the fact that a mixer structure can make a substantial difference, especially when Italy levies a tax which is substantially higher than the UK corporation tax. It is therefore quite common to use the Netherlands in these structures, mainly because it has an extensive participation exemption on corporate income as well as chargeable gains, which is uncommon compared with most other countries. The mixer company would then not be subject to tax on the receipt of a dividend, and besides that no withholding tax is imposed on dividends which it pays to its UK parent.[17]

Another important consideration in this respect is the CFC legislation, because the mixer will often be a non-trading company covered by that legislation. The acceptable distribution test would require the mixer company to distribute more than 90% of its profits within 18 months and especially this could be a problem for the creation of the appropriate mix of the dividends coming up. In essence, these structures try to obtain a full foreign tax credit, where the UK government only intended to give partial credit for the underlying tax paid abroad.

The New Legislation as of 31st March 2001

As mentioned above, it could be considered unfair that other countries levy high taxes on dividends, which will in effect be paid by the UK government by means of the foreign tax credit. In other words, the UK tries to deal with the long-lasting problem of tax competition between countries, by blocking structures like those with

[17] This is why I did not include the withholding tax in the example shown above.

mixers, and trying to take a part of the tax income of e.g. the Dutch government.[18] In the March 1998 paper, this view was translated in the first target formulated by the UK government, namely "not being able to do offshore what could be done onshore". More than two years later, a new and higher target was set. However, the indirect holdings of offshore companies were penalised compared with direct holdings, offshore was no longer able to achieve what could be achieved onshore.[19]

This so-called onshore pooling regime was introduced for foreign dividends paid on or after 31st March 2001 to a UK company, and imposes a foreign tax cap of 30% on creditable underlying and withholding tax on dividends received from foreign subsidiaries held directly under the UK company. This cap existed already for underlying tax paid by subsidiaries not held immediately under the UK parent, but in the lower tiers. It now also applies to creditable taxes on dividends from foreign subsidiaries held under the direct subsidiary of the UK company. This change was put through by the first amendment to the Finance Bill 2000.[20]

Tax planners have used these structures for quite some years and by doing so have adjusted their group structures. Over the years, large UK groups have set up holding companies in the Netherlands. When the UK government decided to change the legislation on this subject, this could have enormous fiscal consequences on these groups. This is especially true, when these groups have just decided to move their international headquarters to the UK, as many have in the last few years. Using a holding company in the Netherlands might increase the cost of getting a dividend from a subsidiary to the UK holding company. It has not only become less efficient to get the money from one place to another, but in some cases the Dutch government might even want to see some tax charged, because of the source related reasons explained above. Most groups probably have repatriated as much dividend income to the UK as possible before April 2001, still being able to use their advantageous offshore pooling group structure.

Another consequence could be a devaluation of overseas investments made by UK multinationals, due to falling net-tax returns. For some companies this might even have to result in downsizing their group structure.[21] Not only are those groups that

---

18 This view can also be subtracted from section 795A, which is designed to minimise the amount of credit the UK government is to give by which it it in effect funding other governments tax receipts.

19 Double tax relief; Note of a joint working group meeting between Inland Revenue and treasury officials et al, 5 December 2000, §4.

20 Finance Bill 2001, Schedule. 26 para. 4^2.

21 A mix-up over mixers, Adrian Ogley; Taxation 11th May 2000, p. 139.

set up mixer companies solely to create a tax efficient way of repatriating their dividends affected, but any group that has established intermediate holding companies to hold their overseas investments, for whatever reason, will be affected.

The legislation starts with defining the cap itself and goes on to some more specific sections, dealing with more exceptional circumstances. After a number of protests mainly by large UK groups which are operating internationally, it was decided to introduce some additional legislation in order to partially relax some of the legislation in the Finance Bill that had been subject to criticism. In short, if the cap has been applied at several levels in the underlying chain of ownership, the cap will be at 30% at all of those levels. Underlying tax above the cap will, within certain limits, be creditable against UK tax payable on dividends other than dividends from CFC´s as mentioned above and dividends where the underlying tax has already been capped. Similar relief will be allowed for some foreign tax above 30% paid on dividends received by UK companies directly from foreign subsidiaries (onshore pooling).

Section 797, which formerly dealt with the limitation in general, only applies to withholding tax as of April 2001. The new section 799^{1b} contains provisions regulating the capping of underlying tax at 30%. The cap on this underlying tax is described as follows: "the tax to be taken into account for the credit shall be so much of the foreign tax borne on the relevant profits by the body corporate paying the dividend, as is properly attributable to the proportion of the relevant profits represented by the dividend." It is calculated by multiplying the amount of the dividend plus the amount of underlying tax attributable to that dividend with the maximum relievable rate, which is the present corporate tax rate of 30% ($(D + U) \times M\% =$maximum relief).[22]

The most important section for the prevention of the mixer structure is 801^2, because it actually caps the dividend flow from the subsidiaries to the mixer company. "...., to the extent that it would be taken into account under this part if the dividend had been paid by a company resident outside the UK to a company resident in the UK and the arrangements had provided for underlying tax to be taken into account". In other words, the dividend flow from a low- and high-taxed subsidiary is dealt with in the same way as the flow from the mixer company to the UK parent company. The same counts for any subsidiary at a lower tier in the chain of ownership.[23]

22 The new formula since the latest amendment to section 799 in schedule 1, made public on 23 March 2001.

23 This is dealt with in section 801^3.

In section 801 ($2A^2$) it is mentioned that the cap will only apply when the subsidiary and the related (dividend paying) company are resident in two different countries. This means that a dividend paid by a Netherlands Antilles company to a Netherlands Antilles/Dutch dual-resident company is technically not subject to the mixer cap. The Inland Revenue has mentioned though that this apparent loophole is subject to possible removal at any time.

When the overseas subsidiary receives the dividend from a related company resident in the UK, a lower maximum has to be taken into account according to the new section 801[4a]. The maximum relief may then not exceed the amount of underlying tax used in the formula. The amount of foreign tax taken into account as underlying tax has then to be increased by an amount of underlying tax attributable to the excess of section 801[4a], as described above. These paragraphs try to keep companies from using the double tax relief legislation by placing a foreign subsidiary in between the UK holding company and one of its subsidiaries. In subsection 4(c) the link is made to section 806A, but 806A[5] , in certain circumstances excludes this kind of dividend.

The Controlled Foreign Company Legislation

In present international taxation, tax avoidance is one of the major issues. It can be described as the mitigation of a tax bill in a legal way, but not in the way the legislator had in mind when writing the law. A way of avoidance related to mixer structures is the use of tax havens as a place of residence of a subsidiary. Tax havens often have very advantageous systems of corporate taxation, with low or no withholding taxes on dividend payments and/or a low corporate income tax. The United Kingdom has implemented legislation to keep its companies from using these jurisdictions to divert their foreign income via these jurisdictions, keep it there and defer UK taxation on the dividends. This legislation is called Controlled Foreign Company ("CFC")-legislation. In mixer structures, it is often seen that a low tax jurisdiction, falling under the CFC-legislation is one of the subsidiaries used in the mixer structures. This is a perfect opportunity to kill two birds with one stone; avoid the CFC legislation and use a low taxed dividend to mix it with another high taxed dividend. Another way to get around the CFC-legislation is to conclude a joint venture with a foreign company, because the subsidiary is then no longer controlled for more than 50% by a UK company. A CFC is defined as a company not resident in the UK, but controlled to a significant extent (>50%) by individuals or companies who are resident. It is subject to a level of taxation of less than 75% of the level that it would have paid had it been resident in the UK. This general definition is subject to a few exceptions like the motive test to guard UK tax avoidance. When a company is considered a CFC, it is penalised by having to pay UK tax on the difference between the tax it would have paid over the paid up dividend and the overseas tax it actually has paid. This difference is then chargeable on UK companies with an interest of at least 25% in a CFC. The Finance Act 2000 introduced a new additional CFC control test, which also treats a company as a CFC if it is at least 40% controlled by a UK person and at least 40% and at the most 55% controlled by a foreign person.[24] The original CFC legislation only had a 50% control test for the UK company and therefore made it quite easy to transfer part of the control over a subsidiary to a foreign partner in a joint venture. The 55% maximum was then added to the original legislation proposed in the Finance Bill, to make sure that the UK company has sufficient control over the joint venture in order to consider it a CFC.

If, however, the dividends paid to the UK equal at least 90% of its profits, the UK government may tax these profits after all; this is therefore called pursuing an acceptable distribution policy (ADP). In this case the above-mentioned penalty is not enforced. In a mixer structure, however, the dividend flow creating the ADP could be used to pool with high taxed dividends. The government tries to prevent this practice in section 801C by excluding the ADP of the CFC from the other dividends coming up to the UK parent. In other words, the dividend payment by a CFC might be part of an ADP, but it cannot be mixed with any other dividend payment. The foreign tax paid on the ADP dividend can only be offset against the UK tax payable on that part of the dividend and not against the UK tax which might have to be paid on the parts of the dividend that are not related to the CFC. This latter part can apply for the EUFT pooling if the intermediate company paying the dividend to the UK is not a CFC and the dividend can thus be a qualifying dividend.[25] This leaves the UK to tax the part of these profits it feels it is entitled to, and which it would not have been able to when other foreign taxes could be offset against UK tax payable on the ADP dividends. The CFC legislation is complex, but this is the case in most countries using this king of legislation due to endless attempts to prevent avoidance. The sections dealing with the interweaving with the mixer caps and onshore pooling, however, are clearer and more concise.[26]

Fiscal Unities Abroad

In, for example, the Netherlands, a company may pay taxes on behalf of itself and its subsidiaries as if they form a single entity having one aggregated profit, if it applies for fiscal unity treatment. The subsidiaries may then even be foreign in

24 Chapter IV of Part XVII of, and specifically section 747 and 755D^{3+4} as read in schedule 31 FA 2000.

25 Section 806A^{2} jo. 806C^{1b}.

26 The sections dealing with onshore pooling will come up below in paragraph 2.2.4.

some cases but treated as part of that single entity, but for UK double taxation relief purposes they have to be resident in the same country with regard to the aggregated profits. The only way to get around this would be the use of a dual resident, which is resident as a matter of fact in one country and its place of corporation in another. Under the old legislation this would not have worked, because it used to be a requirement for relief that the foreign tax for which the credit was being claimed was actually paid by the company paying the dividend. Where a group of overseas companies is taxed as a single entity in its home state, those companies are to be regarded as a single tax payer for calculating underlying tax credit relief in the UK. After amendments, the new legislation does allow one or more intermediate companies to exist in between the UK company and the foreign "single entity".[27]

In the Netherlands it is possible to form a so-called fiscal unity with a company incorporated by EU law or any other country with which the Netherlands has concluded a double taxation treaty containing an anti-discrimination article. Furthermore, its body corporate structure has to be comparable to a Dutch limited liability company. This could have meant that there was still a possibility of mixing some high taxes, but the new law was combined with a restriction to the applicability of the incorporation principle, so that it can no longer be used for fiscal unity. In other words, an entity needs to have its place of residence in the Netherlands for treaty and domestic law purposes, so it all comes down to its place of effective management.[28] These changes make it impossible to use a Dutch fiscal entity for mixing purposes, because the treaty would then assign the corporate taxation to the Netherlands.

The Eligible Unrelieved Foreign Tax

Besides the limitations described above, the new legislation introduced an important amendment regarding the onshore pooling, carry back and carry forward of unrelieved foreign tax on a dividend. The latest changes were put in the fourth amendment to the Finance Act 2000 and concern changes to section 806A to M. Although the government does seem to be concerned to uphold the utmost simplicity in the tax legislation, which can be illustrated by the decision making process on the choice between the exemption and credit systems, the option of combining the two systems and using them for different forms of foreign income was not taken because it would not reflect this new simplicity. At the same time however, a piece of legislation was introduced, which is extremely complex. There follows a simple explanation of the sections concerning the so-called eligible unrelieved foreign tax

---

27 Section 803A, introduced by paragraph 12[1] of schedule 31

28 Tweede Kamer, vergaderjaar 1999-2000, 26854, nr. 3, p. 12-16.

("EUFT").

The Finance Act for the first time enables companies:

- to carry unrelieved tax on a dividend backwards and forwards to another period,
- set such tax against the UK tax payable on different foreign dividends from different companies,
- surrender such tax for use by another company of the same group,
- unrelieved tax can also be used in the same accounting period if a dividend is received from the same source in that period.[29]

Onshore pooling is only available for dividends paid to a UK company not mentioned in the exclusions of paragraph 2 of section 806A. These are dividends originating from an avoidance scheme dealt with in section 801A; dividends for which relief has already been given in the form of section 811; or a dividend that is (deemed) trading income.

Section 806A^{4+5} starts by dividing dividends into two different groups called case A and B. Case A dividends paid directly to the UK, which carry foreign withholding tax credits, which are limited by section 797 to the amount of UK tax attributable to that dividend, will contribute to the pool of relievable withholding tax ("RWT"). The contribution will be up to an amount, which would have been the credit relief if the corporation tax were 45%.[30]

The relievable underlying tax ("RUT") in the case B pool consists of the difference between the cap of section 799^{1} on underlying tax and the amount, which would have been relieved if the maximum relievable rate used in the formula (which is used to find the maximum possible credit) would have been 45% instead of 30%.[31] An important exception however is made when C is a UK resident paying a dividend to an overseas company (B) (see example below).[32]

29 This was only made possible after an amendment to the original bill in schedule 30, which would have forced companies to first carry back and accordingly carry forward the same amount in order to be able to offset it against a dividend of the same year.

30 Section 806B^{2}.

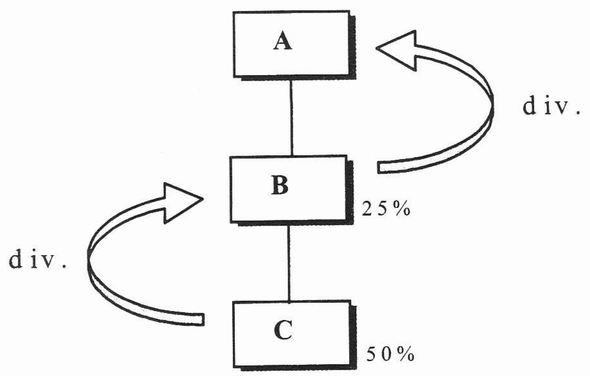
31 Section 806B3+4 jo. 7991A.

32 Section 8012+3 jo. section 806A4, introduced by Finance 2001, schedule 32 paragraph 4^{2}.

Section 799[1] combined with 801[2] provide that the underlying tax paid by companies placed underneath the direct subsidiary in the chain of ownership, is also taken into account for the EUFT. These so-called lower level dividends are dealt with in section 806B[5-9]. Paragraph 5 has a couple of important exceptions to the application of the 45% rate for the calculation of the maximum amount attributable to the EUFT pool. When B has other profits besides the dividend received from C, the maximum relief will only be the percentage of its profits that is related to the dividend coming from C.[33] Thus if B has other profits, it has to distribute those in that same year or the amount available for EUFT will be tainted by those profits.

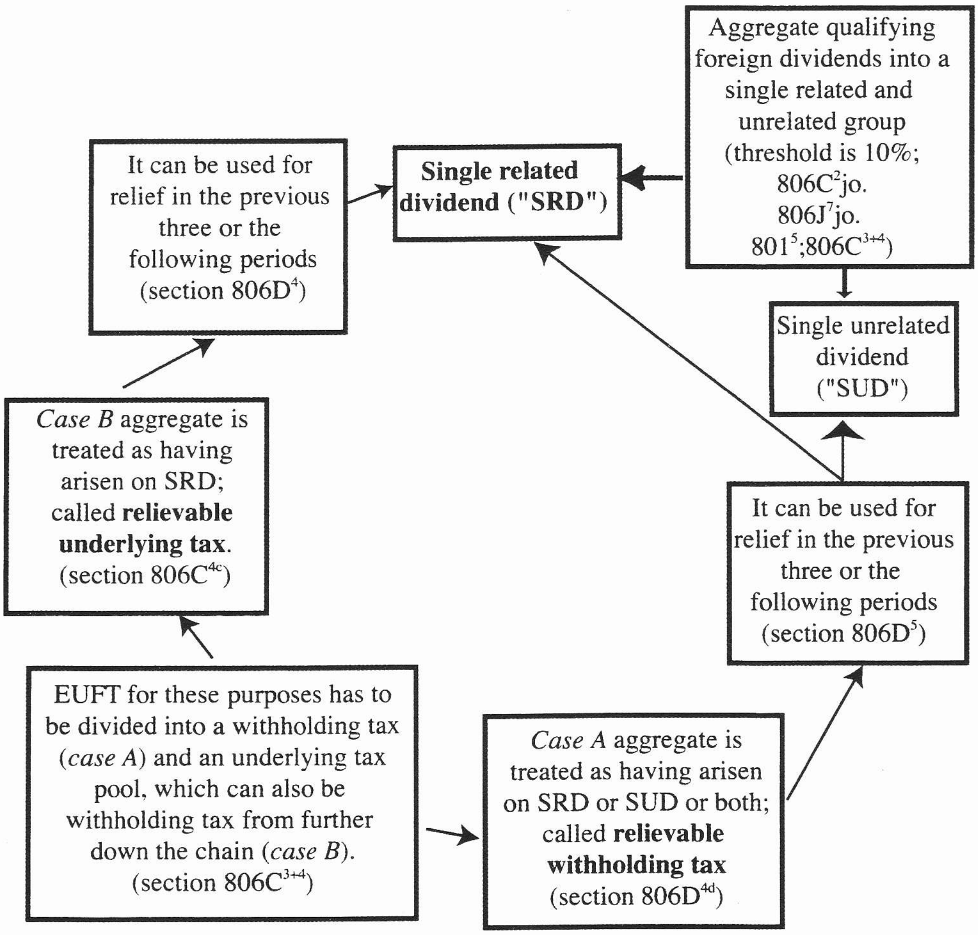
The legislation dealing with, what used to be called, double capping, was removed by the Finance Act 2001. The 45% rate can now be used for all dividend payments in a chain, instead of just for the payment to the UK parent company. The excess of a payment from C to B, which was capped by section 799, will therefore also fall in the case B pool. Ii is provided that this "highest dividend" does not necessarily have to be the case V dividend, which is paid to the UK company, but the highest dividend in the chain of capped payments will only use the 45% rate for as much as is not representing any lower dividend. This latter addition prevents the double use for EUFT of the same dividend.

For example, C distributes a dividend of 200 to B, which has another activity, making a profit of 25. Assuming that B only distributes that part of the dividend to A, which consists of the dividend it has received from C, the maximum EUFT available to A would have to be multiplied with the following division: 200 ./. 225 = 0.89. Using the formulas in section 799[1A] and 806B[7], the EUFT would be (((200 + 50) x 45%) x 0.89 = 100.125) -/- ((200 + 50) x 30% = 75) = 25.125, instead of 37.5 (without the 0.89).



33 Calculated by dividing the dividend distributed by B by B's profits out of which the dividend is paid.

The actual onshore pooling of the calculated EUFT's takes place in sections 806C and 806D. These sections talk of "qualifying foreign dividends" if they are: Case V dividends not exempt in section 806A[2]; not (representing) an ADP dividend paid by a CFC; and not giving rise to EUFT (806C[1]). This procedure can probably be best explained by a clear diagram as shown below.



As one can see in the example above, RWT and RUT can be used in the regular way to relieve tax, which means the maximum relief of 30% as laid out in sections 799 and 797 is applicable.

Section 799[1B] introduces another important changes regarding the dividends which have come from low taxed lower tiers and could have produced a QFD, but was mixed offshore with a dividend suitable for EUFT purposes. This makes the low taxed dividend tainted. This would be particularly unfair if the low taxed profits were substantially higher than the rest, so it was to introduce a possibility to elect to disclaim the use of EUFT for the high taxed dividend, which makes the combined dividend a QFD, which can be offset against surplus EUFT from other parts of a group. This election comes down to calculating the relative benefits of disclaiming the EUFT and treating the dividend as a QFD, or retaining the EUFT and paying tax on a dividend-by-dividend basis.[34] Neither outcome is perfect, but at least it is better than the former destined tainted dividend.

The EUFT may be carried forward indefinitely, starting with the first and carried back three years on a FIFO basis, meaning that the longest carry back has to be used first. Furthermore, if there are underlying tax and withholding tax to be relieved then the underlying tax always comes first. Detailed rules concerning these issues are explained in section 806E and 806F respectively. Another section that is within the scope of this subject is 806H, because it deals with the surrender of relievable tax to group members. The draft legislation is not available yet, but judging by the way the section is formulated it will be a precise and quite limited possibility for group relief. The sections I have not mentioned are mainly dealing with technical and procedural issues, which are not within the scope of this article.

Conclusion

Companies need continuous restructuring when growing or shrinking. The adaptation to this change in the relief of double taxation, however, might well result in forced, over hasty reconstruction decisions to the short statutory deadline. Furthermore, some companies are situated in countries with certain restrictions, which make it impossible to restructure at any given time due to disproportional costs or minority shareholder problems.[35]

The companies involved will have to choose between the benefits of the onshore pooling, the costs of restructuring and the partial loss of the capital gain participation exemption, which was an important reason for most companies to use the Netherlands as their base for a holding company in a mixer structure. Until 1st April 2002, any capital gain realised on the disposal of the participation would generally be fully taxable. The UK government recognised that this system put UK companies at a competitive disadvantage and could also distort their commercial decisions. A shareholding of 10% of the ordinary (not preference) shares, held for more than 1 year in the 2 year period before the disposal is considered substantial. The new exemption applies to disposals on or after 1st April 2002. This may mean that in the future discussion is rather important for companies deciding on the

34 Double taxation relief – The evolution from FA 2000 to FB 2001; Stephen Weston and Mark Johnson, World Accounting Report, p. 425.

35 Double tax relief; Note of a joint working group meeting between Inland Revenue and treasury officials et al, 5 December 2000, §15.

changes in their group structure with a separate company in the Netherlands, holding each subsidiary on behalf of the UK parent, will become less useful on capital gains on these shareholdings will now be exempt in the UK as well. However, it should be noted that the new exemption only applies to capital gains: the credit system has been retained for foreign dividends. Furthermore, one needs to keep in mind that the Dutch participation exemption only defers the UK taxation for the period in which the money is kept in the Dutch mixer company, assuming the money has to flow to the UK parent at some point.

The whole of the new legislation can be considered part of the government's anti-avoidance crusade, or an attempt to take back same tax returns from countries like the Netherlands, because it justifiably feels that it belongs to them. The reason for this is mostly source related, as explained above. When doing this, however, the UK government should realise that international competitiveness could be influenced by this decision. After the first Budget day proposals this influence could end up to be substantial, judged by the reaction of the multinationals and representative bodies of the taxation field. This obviously worried the government and it answered by soothing the possible wounds with a couple of new measures, of which the raising of the maximum relievable rate to 45% for EUFT purposes was the most important one. These changes received a relatively warm welcome, but instead of rewriting the legislation entirely, the government merely made a considerable number of changes to the original Finance Bill. This made the legislation almost incomprehensible for UK tax specialists. Besides that, a comprehensible regime does have its own inherent attraction to potential investors.[36] Kees van Raad's comparison of the amount of pages needed for the Dutch personal income tax act, could serve as an illustration of this trend. He also noted that all tax Acts and decrees now amounted to an 'excessive' 350 pages. The UK has 3,936 pages.[37] There are of course several reasons for this, which are beyond the scope of this article, but a clear and concise formulation could definitely bring this number down to some extent.

The Inland Revenue excused itself for this by mentioning that it had only had three weeks to draft the Finance Bill amendments, which did not leave them enough time to rewrite it entirely. It was stated that as soon as state of stability was achieved, a review could take place to see if the legislation could be rewritten in a simpler format. Time will tell what consequences these actions of the government have on the competitiveness of the international position of the UK tax policy. A disappointing development should definitely not be answered with more adjustments

---

36 Double tax relief; Note of a joint working group meeting between Inland Revenue and treasury officials a.o., 5th December 2000, §4.

37 Revenue Law; J. Tiley, Hart publishing, 4th edition, p.47.

to an existing law. The past has shown that this would only make a nearly incomprehensible law even worse off and leaves everyone in a state of long-term uncertainty.

One of the last changes in the new legislation, concerning the non-applicability of the mixer cap with dividends coming from the same jurisdiction, might very well be one of the gaps in the new legislation. Structures with the use of dual residents and/or fiscal unities might well be possible ways of using this part of the legislation to advantage, as long as the company is resident as a matter of fact in the country concerned.[38] As I mentioned above, this will no longer be possible with the Netherlands, but it might still be possible with other (EU) countries.

Something that should not be forgotten when looking at this new piece of legislation is the European Union and, in particular, a case called *Staatssecretaris van Financiën v Verkooijen,* which came before the EU court of justice in 1998.[39] It dealt with a Dutch company claiming exemption from Dutch income tax for its dividends received from a Belgian company. The Dutch government denied this relief because it would only give relief for Dutch dividends on which Dutch withholding tax had been levied. The taxpayer wanted relief even though no withholding taxes were levied, claiming that it was based on the free movement of capital (article 56 EC treaty). It would be an obstacle to Belgian companies raising capital in the Netherlands, since dividends from Belgian companies were taxed less favourably than dividends from Dutch companies. The taxpayer won this case. The UK literature is in doubt as to the difference between a structure with dividends flowing through a Dutch offshore mixer company instead of through an onshore mixer company. This might well be a discriminatory issue for the European Court at some point.

My overall conclusion is that both the legislation and the near future of double taxation relief are surrounded by too much uncertainty, and as Adam Smith pointed out, the principle of certainty is fundamental to any soundly based tax system.[40]

---

38 See section 803A.

39 Case C-35/98.

40 A mix-up over mixers, Adrian Ogley; Taxation 11th May 2000, p.139.