CHAPTER 7

DOUBLE TAX RELIEF

7.1 Introduction

TIOPA 2010, s.18

This chapter looks at the rules for dividends paid on or after 1 July 2009, and other sources of overseas income whenever received.

The basic concept of Double Tax Relief (DTR) is that when a company operates overseas it will pay overseas tax on its overseas income. Where the company is resident in the UK, that income will be taxed again in the UK. DTR is designed to **alleviate** this **double charge** on the same source of income.

Where the overseas tax is at a lower rate than the UK rate, the company will pay the difference between the overseas and UK rate in the UK. Where the overseas tax is higher, relief is restricted to the UK tax, leaving no liability in the UK on the overseas income. Unrelieved foreign tax may, in certain circumstances, be relieved, and this is discussed later.

This chapter will look at what is known as **unilateral relief**. Unilateral relief is the DTR given by the **UK legislation,** it does not rely on a Double Tax Treaty (DTT) being in place. The mechanics of the relief given under DTTs are not covered here.

7.2 Foreign taxes suffered

The foreign taxes suffered by a company will depend on how it carries on its business abroad. If it is operating through a branch or permanent establishment, it may suffer foreign corporation tax or its equivalent. If the company is receiving royalties or interest from abroad, then withholding tax may be suffered. If the company is operating through subsidiaries, then it may suffer withholding tax on dividends received. It follows that the dividends will normally have been paid from post tax profits of the subsidiary.

7.3 Credit relief for UK permanent establishments of non resident companies

Non resident companies which have a permanent establishment in the UK can claim credit relief for foreign taxes paid on income that is taxable on the permanent establishment.
The non resident company has to show that **all steps** have been taken to **minimise** foreign tax suffered.

The source by source basis can be disregarded for royalties in respect of an asset which arise in more than one jurisdiction. The royalties can be treated as one source of income and the tax credits aggregated. TIOPA 2010, s.47

The source by source basis can be disapplied in the case of a portfolio of income. A portfolio basis applies where transactions, arrangements or assets are treated by the company as a series or group. The income from the portfolio is aggregated and treated as a single source. Where only some of the portfolio relates to foreign tax, apportionment will be required. This basis is acceptable where it is not practical to subdivide the portfolio into its component parts or where the effect of doing so would be immaterial. TIOPA 2010, s.48

7.4 Calculating the relief - general rules

TIOPA 2010, s.42

The relief available is calculated on a **source by source** basis. The basic rule is that the relief available is the lower of the UK corporation tax due on that source of income and the foreign tax suffered. We need to use a columnar approach. We bring in each source of foreign income gross of all foreign taxes paid.

Illustration 1

A UK resident company, Lloyd Limited, has UK profits of £500,555. It also has overseas profits (Source 1) of £230,000 after foreign tax suffered of £50,000 and overseas income (Source 2) of £27,000 having suffered withholding tax of £3,000. Lloyd Ltd has one associated company.

The computation for Lloyd Ltd will be as follows:

	Total	*UK*	*Overseas source 1*	*Overseas source 2*
	£	£	£	£
UK Profits	500,555	500,555		
O/S source 1	280,000		280,000	
O/S source 2	30,000			30,000
	810,555			
Tax 28%	226,955	140,155	78,400	8,400
Foreign tax			50,000	3,000
DTR	(53,000)		50,000	3,000
MCT	173,955			

We can see that in the case of the overseas source 1, the tax suffered was less than the UK tax liability on that source of profit, thus the DTR is restricted to the overseas tax suffered. This is also the case for overseas source 2.

In determining the profits of an overseas PE, s.20 CTA 2009 (covering the rules relating to a PE of non resident company) is to be applied. TIOPA 2010, s.43

Where overseas tax has been paid on trading profits, double tax relief is restricted to the UK tax on the overseas income that gave rise to the overseas tax. The overseas income must take account of all related expenses. This ensures that credit is only given against the UK tax due on the profits that relate to the overseas tax paid. TIOPA 2010, s.44

FA 2005 clarified the position relating to the limit for tax credit as trading income.

The relief is limited to only so much income as accrues from the transactions that gives rise to the foreign tax payment. TIOPA 2010, s.44(2)

In calculating the relevant income account needs to be taken of: TIOPA 2010, s.44(3)(4)(5)

(a) all deductions and expenses incurred in the transaction.
(b) a reasonable proportion of expenses that relate partly but not wholly to the transaction, e.g. overheads.
(c) expenses incurred by a connected company if it is reasonable to do so. "Connected" is as defined by s.1122 CTA 2010.

Trade income is defined as including trade profits, profits from a property business, miscellaneous income, post cessation receipts and any other income or profits chargeable or computed under the rules for trading income. TIOPA 2010, s.44(6)

If a company has **losses, management expenses and qualifying charitable donations** then this will impact on the calculations. Companies are allowed to **allocate** these items against the various sources of income in the **most advantageous order**. If Lloyd Ltd above has qualifying charitable donations of £200,000 it is clearly best to allocate these against the UK income column as this will not impact on the DTR available. TIOPA 2010, s.42(3)

Illustration 2

Wade Ltd, a UK resident company with 18 subsidiaries, has profits from a UK property business of £10,000, chargeable gains of £130,000, management expenses of £160,000, overseas income (source 1) of £45,000 after withholding tax of £15,000 and overseas income (source 2) of £45,000 after withholding tax of £5,000.

The computation will be as follows:

	Total	*UK*	*O/S 1*	*O/S 2*
	£	£	£	£
UK Property business	10,000	10,000		
Chargeable Gain	130,000	130,000		
Miscellaneous income	110,000		60,000	50,000
Management expenses	(160,000)	(140,000)	_______	(20,000)
Total	90,000	Nil	60,000	30,000
UK tax 28%	25,200		16,800	8,400
Foreign tax			15,000	5,000
DTR	(20,000)		15,000	5,000
Tax payable	5,200			

By allocating the management expenses first against the UK income and then against the overseas income (source 2), we have maximised the DTR available.

Had we allocated the management charges to UK income then against overseas income (source 1), this income would have been reduced to £40,000 with a UK tax bill of £11,200. As this is lower than the overseas tax suffered of £15,000 the DTR would have been restricted to £11,200 plus the £ 5,000 on the other overseas income. This would have wasted foreign tax paid of £3,800.

Where the rule restricting credit relief to the corporation tax as a source of income prevents full relief, the amount disallowed can be treated as a deduction in calculating the **trade** profits. This treatment is only allowed to the extent that the deduction does not exceed the amount of any loss on that source of income. TIOPA 2010, s.35(2)(4)

HMRC give the following example:

Sale of shares	9,300
Gross dividend	1,000
Purchase of shares	(10,000)
Overheads/interest	(100)
	200

Tax withheld from the dividend is £150 but credit relief will be limited to tax on the £200, ie £56. Thus there is a potential deduction for the balance of £94.

However, the deduction is limited to any loss on the transaction after excluding foreign tax from the income. In this case there is a profit of £200 less the foreign tax of £150, giving a profit of £50, so no deduction is available.

For tax deducted at source, it is treated as paid when the income is paid.

7.5 Special rules for loan relationships

Loan interest is taxed under the loan relationship rules whether it is from the UK or overseas. Tax is always calculated on the net debits or credits arising from all loan relationships. If the **interest received** includes **overseas interest**, then s.50 comes into operation to enable non-trading **debits** on loan relationships to be **first set against UK** source profits, thus following a similar rule to that shown above for charges etc. The impact of this is to **maximise** the foreign interest income and thus maximise the DTR. TIOPA 2010, s.50

Similar rules apply to IFAs, allowing maximum relief for tax paid on non trading intangible credits. TIOPA 2010, s.51

7.6 Carry forward or carry back of unrelieved foreign tax in respect of an overseas PE

TIOPA 2010, s.72

Relief is available for taxes suffered outside the UK on profits of an overseas PE. Where the profits are taxed as trade profits of a trade carried on partly but not wholly outside the UK, unused relief may be **carried forward** to the next accounting period or **carried back** to accounting periods beginning in the previous **three years**.

The carry forward is indefinite, (unless the PE ceases to exist), though the tax credit can only be set against corporation tax due on profits from the same PE.

The carry back is on a **LIFO basis**.

The time limit for a claim is **4 years** from the end of the accounting period in which the surplus tax credit arose or, if later, one year after the foreign tax was paid. TIOPA 2010, s.77(3)

Partial claims are allowed. A claim must state how much of the surplus is to be treated as carried forward and how much, if any, is to be treated as carried back.

Relief is given first against overseas tax of the account period, then for amounts brought forward, then for amounts carried back. TIOPA 2010, s.73(1)(3)

TIOPA 2010, s.74(4)

7.7 Exemption for Dividends

Finance Act 2009 brought in changes to the way that foreign profits are taxed in the UK and one of the major changes is the tax treatment of overseas dividends.

CTA 2009, s.931A

The basic rule is that dividends are exempt from UK taxation whether received from a UK company or an overseas company.

We will see later how a dividend that does not qualify for exemption is taxed. There are anti-avoidance rules to prevent abuse of the distribution exemption.

The rules only apply to income distributions; any capital distributions are dealt with under the capital gains tax rules. CTA 2009, s.931A(2)

When deciding whether a dividend is exempt we first need to consider whether we are looking at a small company as there is a separate set of rules for small companies.

7.7.1 Small companies

A company is a "small company" in an accounting period if it is, in that period, a micro or small enterprise, as defined in the Annex to Commission Recommendation 2003/361/ EC of 6 May 2003. CTA 2009, s.931S (2)

Open-ended investment companies, authorised unit trust schemes, insurance companies and friendly societies cannot qualify as small companies. CTA 2009, s.931S (2)

Dividends received by small companies will be exempt if

(a) the payer is a resident of (and only of) the United Kingdom or a qualifying territory at the time that the distribution is received; CTA 2009, s.931B

(b) the distribution is not of a kind mentioned in paragraph E or F of section 1000(1) of CTA 2010 (certain non-dividend distributions);

(c) no deduction is allowed to a resident of any territory outside the United Kingdom under the law of that territory in respect of the distribution; and

(d) the distribution is not made as part of a tax advantage scheme.

Note that for (a) above a qualifying territory is one where there is a double tax treaty with the UK and that treaty includes a non discrimination clause. To qualify under (a) a company must only have one place of residency. A company is a resident of a territory if, under the laws of the territory, the company is liable to tax there CTA 2009, s.931C

(i) by reason of its domicile, residence or place of management, but
(ii) not in respect only of income from sources in that territory or capital situated there.

This definition of residence is in line with that used in the OECD model treaty that we looked at in an earlier chapter.

7.7.2 All other companies

For all other companies there are five exempt classes of distribution. In addition the distribution must not be interest classed as a distribution under CTA 2010 s.1000(1) E or F and must not be a dividend that qualifies for a tax deduction in the territory where it is paid. CTA 2009, s.931D

When looking at interest treated as a distribution under CTA 2010 s.1000(1) E or F the transfer pricing rules take priority. TIOPA 2010, s.155(6)

The five exempt classes are

1) Distributions from controlled companies

The definition of control here is that used for controlled foreign companies (CFCs), we will look at this definition in a later chapter. The definition extends to joint ventures; see s.755D(3) and (4) ICTA 1988. CTA 2009, s.931E

There are rules to block avoidance schemes that seek to obtain exemption despite the fact that the CFC control rules did not apply at the time when the profits included in the dividend were earned. These rules only apply if there is a scheme or arrangement that has as a main purpose the obtaining of an exemption under this head. Where it applies, this section prevents a distribution from being exempt by virtue of the controlled companies exempt class. If the specific anti-avoidance rule here applies it will not prevent a distribution from being exempt *by virtue of any other class.* CTA 2009, s.931J

If a dividend is paid as part of a scheme that falls within this section and the company has any pre-control profits, this anti-avoidance rule will apply. However, once those pre-control profits have been fully paid out in the form of taxable dividends, the anti-avoidance rule will cease to apply to any subsequent dividend (or part dividend). If the section applies to part but not all of a dividend, it is treated as if it were two dividends. Any profits earned more than 12 months before the commencement date (that is, before 1 July 2008) will not be treated as pre-control profits.

2) Distributions in respect of non redeemable ordinary shares. CTA 2009, s.931F

An "ordinary share" means a share that does not carry any present or future preferential right to dividends or to a company's assets on its winding up.

There is an anti-avoidance rule which will apply if rights are obtained under an avoidance scheme that are equivalent to the rights of either a preferential shareholder or a holder of a redeemable share. Where it applies, this rule prevents a distribution from being exempt by virtue of the non-redeemable ordinary shares exempt class. It will not prevent a distribution from being exempt by virtue of any other class. It applies only where there is a scheme or arrangement that has as a main purpose the obtaining of an exemption under this head. CTA 2009, s.931K

3) Distributions in respect of portfolio holdings CTA 2009, s.931G

Portfolio holdings, are defined as holdings that represent less than 10 per cent of their class of share. The 10 per cent limit must be met by reference to share capital, income rights and capital rights. Shares are not of the same class if different proportions of their nominal share capital are paid up (for this purpose any amount paid in respect of share premium is disregarded).

The exemption under this class will not apply if a shareholding that would be too large to qualify for the portfolio holdings exempt class is split between a number of connected companies in order that each company's holding falls below the 10 per cent threshold. CTA 2009, s.931L

4) Dividends derived from transactions not designed to reduce tax. CTA 2009, s.931H

To qualify under this head the dividend has to be paid out of "relevant profits". This means that the profits must not be derived from transactions that achieve a UK tax advantage.

If a company has any profits which are therefore derived from avoidance transactions, this exempt class will not be available and will remain unavailable until all those profits have been paid out as taxable dividends. However, once those "avoidance" profits have been fully paid out in taxable form, this exempt class will become available for any subsequent dividends paid from relevant profits, including the remaining part of a dividend that is paid partly but not wholly out of profits other than relevant profits. If a dividend is paid partly out of relevant profits and partly out of other profits, it is treated as two separate dividends.

All profits earned from transactions that took place more than 12 months before the commencement date for the Schedule (that is, before 1 July 2008) are treated as relevant profits.

5) Dividends in respect of shares accounted for as liabilities CTA 2009, s.931I

This gives exemption for distributions paid in respect of shares that would be taxed as loan relationships except that they are not held for an unallowable purpose and are consequently exempt from taxation under loan relationship rules.

In addition to the specific anti avoidance rules mentioned above for exempt classes 1 to 3 there are anti avoidance rules which, if they apply, will prevent a distribution from being exempt under any class. These rules apply to CTA 2009, s.931M

a) Schemes in the nature of loan relationships;
b) Schemes involving distributions for which deductions are given; and
c) Schemes involving payments for distributions.

"Scheme" includes any scheme, arrangements or understanding of any kind whatever, whether or not legally enforceable, involving a single transaction or two or more transactions; "tax advantage scheme" means 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). "Tax advantage" has the meaning given by section 1139 of CTA 2010. CTA 2009, s.931V

7.7.3 Election that a distribution should not be exempt

A company can make an election that a particular distribution that would otherwise be an exempt distribution shall instead be taxable. Two reasons why a company might wish to make such an election are as follows:

i. dividends can only be taken into account for the purposes of the CFC acceptable distribution policy (ADP) exemption if they are subject to tax; and
ii. it is possible that exemption could lead to an increased rate of withholding tax.

A company may elect for one or more dividends paid in an accounting period not to be exempt.

If part, but not all of a dividend, is an Acceptable Distribution Policy dividend (ADP dividend) , the company may elect for only the ADP part to be taxable, while retaining exemption for the other part. Any such election must be made within two years of the end of the accounting period in which the distribution was paid. We will look at ADP dividends in chapter 7.

7.8 Double tax relief for dividends that are not exempt

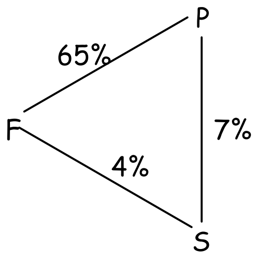
If an overseas dividend is taxable then credit relief will be given.

Overseas dividends received by a UK resident company may have suffered **withholding tax**. Withholding tax **is always recoverable** (subject to the limits for credit relief). In addition, as dividends are paid out of post tax profits, the dividend will also have suffered what is called underlying tax.

A credit for **underlying tax** can only be claimed when a company holds directly or indirectly **10%** of the voting power of the company paying the dividend, or is a subsidiary of such a company. TIOPA 2010, s.12 TIOPA 2010, s.14

Illustration 3

P Ltd a UK company holds 7% of the share capital in S Ltd, an overseas company. P Ltd has a 75% subsidiary F Ltd which holds 5% of S Ltd.



Both P Ltd and F Ltd will be able to claim underlying tax in relation to dividends paid by S Ltd. P Ltd controls 11% of the share capital - being 7% held directly and 4% through its control of F Ltd. As P Ltd can control F Ltd, it can also control the 5% owned by F Ltd – **we do not multiply through**. F Ltd is a subsidiary of a company that satisfies the 10% holding test.

We initially calculate the **underlying tax** (referred to as "UT" in the legislation) by using the following formula:

$$\frac{\text{Dividend paid}}{\text{Relevant profits}} \times \text{Actual tax paid}$$ TIOPA 2010, s.58(1)

The relevant profits are the profits of any period shown as available for distribution in the company **accounts** - they are not taxable profits. TIOPA 2010, s.59(8)

The accounts must be drawn up in accordance with the laws of the company's home state, making no provision for reserves, bad debts, impairment losses or contingencies other than those required by that law. TIOPA 2010, s.59(8)

The dividend paid is the gross dividend before any withholding tax is deducted.

The actual tax paid is the foreign **tax paid** on the profits out of which the dividend is paid.

Note that s 58 TIOPA 2010 does provide for a cap for the underlying tax as follows:

(D + PA) x M

Where D = the dividend i.e. amount received plus withholding tax
PA = underlying tax given by the calculation above
M = is the rate of corporation tax applicable to profits of the recipient in the AP in which the dividend is received or the average rate over the whole AP.

Thus if a company receives a dividend that has withholding tax and underlying tax, we have to work out the gross overseas income that will go in the computation in two stages.

Illustration 4

Virginia Ltd, a UK company that pays tax at the full rate, receives a dividend from Agassi Inc, an overseas company. Virginia Ltd has a 20% shareholding in Agassi Inc. The amount of the dividend received was £40,000 after withholding tax of £7,000. The accounts of Agassi Inc out of which the dividend was paid show:

	£
Profits	550,000
Tax	(130,000)
Distributable profits	420,000
Dividend	(235,000)
Retained profits	185,000

Actual tax paid for the year was £125,000.

The first step is to calculate the dividend, this is the amount received of £40,000 plus the withholding tax of £7,000 = £47,000.

We can now calculate the underlying tax:

$$\frac{47{,}000}{420{,}000} \times 125{,}000 = £13{,}988$$

Thus the total gross income will be:

	£
Amount received	40,000
Withholding tax	7,000
Dividend	47,000
Underlying tax	13,988
Gross	60,988

The total foreign tax suffered is £7,000 withholding tax plus £13,988 underlying tax = £20,988.

If we continue looking at the dividend received by Virginia Ltd:

The maximum underlying tax that can be claimed is:

(47,000 + 13,988) x 28% = £17,077

This is greater than the underlying tax suffered of £13,988

Thus there is no restriction on the claimable underlying tax.
However, we can see that the total DTR available to Virginia Ltd is going to exceed the UK tax on its income from the dividend.

Illustration 5

If we assume that Virginia Ltd has UK income of £2,000,000:

	Total	*UK*	*Agassi Dividend*
	£	£	£
Trade profits	2,000,000	2,000,000	
Overseas income	60,988		60,988
TTP	2,060,988		
UK tax	577,077	560,000	17,077
Foreign tax			20,988
DTR	(17,077)		17,077
MCT	600,000		

Therefore Agassi has unused relief of £(20,988 – 17,077) = £3,911

7.9 FII

The definition of "Augmented Profits" for calculating whether the small profits rate applies includes Franked Investment Income. For dividends received on or after 1 July 2009 Franked Investment Income includes net overseas dividends grossed up by 100/90.

Example 1

Murray Ltd, a UK resident company with 50 subsidiaries, has non-trading profits (loan relationships) of £15,000, chargeable gains of £170,000, management expenses of £290,000, overseas income (source 1) of £80,000 after withholding tax of £20,000 and overseas income (source 2) of £112,500 after withholding tax of £12,500. The overseas income is not dividend income.

You are required to show the UK tax payable by Murray Ltd.

Example 2

Court Ltd has TTP of £250,000. During the year it received the following exempt dividends.

	Dividend received	**WHT**
Net Ltd UK resident company	45,000	
Nadal SA overseas resident company	54,000	6,000

You are required to show the UK tax payable by Court Ltd. Note that Court Ltd does not have any subsidiaries.

Answer 1

	Total	UK	O/S 1	O/S 2
	£	£	£	£
Non-Trading profit (LR)	15,000	15,000		
Chargeable Gain	170,000	170,000		
Overseas income source 1	100,000		100,000	
Overseas income source 2	125,000			125,000
Management expenses	(290,000)	(185,000)	(28,571)	(76,429)
Total	120,000	Nil	71,429	48,571
UK tax 28%	33,600	Nil	20,000	13,600
DTR	(32,500)		(20,000)	(12,500)
Tax payable	1,100		Nil	1,100

Management expenses have been allocated as follows to maximise the DTR available:

1) first against the UK income;
2) then against the overseas source 1 to reduce the total after the management expenses to £71,429 (being £20,000 divided by 28%) to ensure the full amount of overseas of £20,000 is offset;
3) then finally the balance of £76,429 to overseas source 2.

Answer 2

Court Ltd will pay the following tax

		£
TTP x 28%	250,000 x 28%	70,000
Less Marginal relief	7/400 x (1,500,000 - 360,000(W1)) x 250,000/360,000	(13,854)
		56,146

W1 Calculation of 'profits'

		£
TTP		250,000
UK div grossed up	45,000 x 100/90	50,000
Overseas Div grossed up	54,000 x 100/90	60,000
		360,000