These notes refer to the Finance Act 2009 (c.10) which received Royal Assent on 21 July 2009

FINANCE ACT 2009

EXPLANATORY NOTES

INTRODUCTION

Section 34Schedule 14: Corporation Tax Treatment of Company Distributions

Summary

1. Section 34 and Schedule 14 determine the scope of the corporation tax charge on income on both UK and foreign company distributions. The rules for distributions received by small companies are distinct from the rules for medium and large companies, but in each case the result is that the great majority of distributions will be exempt from corporation tax. The Schedule contains anti-avoidance rules to prevent abuse of distribution exemption.

2. The changes introduced by this section are part of the package of measures being introduced as a result of the Government's review of the taxation of foreign profits.

Details of the Section

3. The section introduces Schedule 14.

Details of the Schedule

4. Schedule 14 is divided into three Parts. Part 1 introduces a new Part 9A to the Corporation Act 2009 (CTA) to deal with company distributions. Part 2 makes other amendments to CTA, the Income and Corporation Taxes Act 1988 (ICTA) and other legislation. Part 3 gives the commencement and transitional rules for the Schedule.

Part 1 – Insertion of new Part 9A of CTA 2009

5. This Part of the Schedule includes only one paragraph, which introduces a new Part 9A to CTA. Part 9A replaces the existing rules that tax foreign dividends and that give exemption for UK distributions. Part 9A is divided into four Chapters. The first Chapter establishes a charge to corporation tax on income distributions received from UK or foreign companies. Chapter 2 sets out the conditions for a distribution received by a small company to be exempt from corporation tax and Chapter 3 does the same for large or medium–sized companies. Chapter 4 includes interpretation provisions.

Chapter 1 of Part 9A of CTA

6. Section 931A establishes that in principle UK and foreign distributions are subject to corporation tax on income, unless they are exempt according to the rules given later in the Part.

7. Subsection (2) limits the scope of the Part by excluding distributions of a capital nature. Capital distributions will continue to be taxed or exempt according to the rules applying to chargeable gains and are unaffected by this legislation.

Chapter 2 of Part 9A of CTA

8. Chapter 2 gives the conditions for a distribution received by a small company to be exempt. The definition of a small company for this purpose is given in Chapter 4 of Part 9A (section 931S).

9. Section 931B makes a distribution received by a small company exempt subject to the following conditions:

- the company paying the distribution must be resident of the UK or a "qualifying territory", which is a term defined in section 931C. The company must not be resident in more than one jurisdiction;
- the distribution must not be an amount of interest that is treated as a distribution in accordance with section 209(2)(d) or (e) of ICTA. In practice this will mainly refer to interest paid at more than a commercial rate (section 209(2)(d)). Paragraph 14 of the Schedule ensures that wherever possible excessive rates of interest will be dealt with by transfer pricing rules;
- the distribution must not be a dividend that qualifies for a foreign tax deduction; and
- the distribution must not be made as part of a tax advantage scheme, as defined in section 931U.

10. Section 931C(1) defines a qualifying territory for the purpose of section 931B as a territory with which the UK has a double taxation treaty that includes a non-discrimination provision in a standard form.

11. 'Non-discrimination provision' is defined in subsections (4) and (5) in terms that follow Articles 24 and 3 of the OECD Model Convention on Income and on Capital. Subsection (3) gives conditions about the meaning of the term "resident" for the purpose of section 931B in terms that follow Article 4(1) of the Model Convention, which defines what is meant by "resident of a Contracting State".

12. Subsection (2) allows HM Treasury by regulations to provide that a territory is a qualifying territory even if it does not satisfy subsection (1), or that it is not a qualifying territory even if it does satisfy that subsection. Subsection (6) provides amongst other things that the regulations may make different provision for different types of company. Any such regulations will be subject to affirmative resolution procedure (see paragraph 28 of the Schedule).

Chapter 3 of Part 9A of CTA

13. Chapter 3 gives the conditions for a distribution received by a large or medium-sized company to be exempt.

14. Section 931D makes a distribution exempt from corporation tax provided:

- it falls into one or more of the exempt classes; and
- it is not one of two types of distribution that do not qualify for exemption.

15. The first non-qualifying type relates to interest that is treated as a distribution, and to certain other distributions in respect of securities. The second non-qualifying type refers to distributions that qualify for a tax deduction in a foreign jurisdiction. These exclusions are identical to the second and third conditions that apply to small companies in section 931B.

Exempt classes

16. There are five exempt classes set out in sections 931E to 931I. Distributions will frequently fall into more than one of these classes, but it is sufficient to fall into any one

of them for a distribution to be exempt, provided the anti-avoidance rules in sections 931J to 931Q do not apply.

17. Section 931E provides exemption for distributions paid to a parent company that controls the company making the distribution. Control for this purpose is defined by reference to the controlled foreign company (CFC) control rules, including the extension to joint ventures that have a 40 per cent interest combined with another 40 per cent to 55 per cent interest. The definition of control for CFC purposes was extended in Finance Act 2008 by reference to entitlement to the majority of income or capital rights. There is an anti-avoidance rule specific to this section in section 931J.

18. Section 931F provides exemption for all distributions paid in respect of non-redeemable ordinary shares. The terms "ordinary share" and "redeemable" are defined in section 931U. A share is an ordinary share provided it carries no preferential rights to income or capital. There is an anti-avoidance rule specific to this section in section 931K

19. Section 931G provides exemption for distributions in respect of portfolio holdings. Portfolio holdings are holdings of less than 10 per cent of shares of the same class as those in respect of which the relevant distribution is made. 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). There is an anti-avoidance rule specific to this section in section 931L.

20. Section 931H provides exemption for any dividends paid out of profits that are not derived from transactions that achieve (and that have as a main purpose to achieve) a UK tax advantage of more than a negligible amount. Profits not derived from such transactions are referred to as "relevant profits".

21. If a company has any profits that are not relevant 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.

22. There is a transitional rule in Part 3 of this Schedule that treats 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) as relevant profits. Any dividend paid out of such profits will therefore qualify for this exempt class.

23. If a dividend is paid partly out of relevant profits and partly out of other profits, it is treated as two separate dividends for the purposes of this Part and also for the purposes of Part 18 of ICTA, which allows double taxation relief to be given in respect of a non-exempt part of a dividend.

24. Paragraph 8 of the Schedule amends section 799 ICTA to ensure that section 931H and the double taxation relief rules in Part 18 ICTA are consistent with one another in the way that profits are specified in relation to a taxable dividend.

25. Section 931I provides 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. The loan relationship exemption would not in itself give exemption from taxation under Part 9A, which is instead provided by this section.

26. Section 931I refers to section 521C of CTA, which is itself being introduced by Schedule 24 of this Act (section 48). The term "unallowable purpose" will be defined by section 521E.

Exempt classes: anti-avoidance

27. Sections 931J to 931Q contain anti-avoidance rules. Sections 931J to 931L contain rules that can prevent distributions from falling within specific exempt classes. Where sections 931M to 931Q apply they prevent distributions from being exempt at all.

28. The terms "scheme" and "tax advantage scheme" that are used in these sections are defined in section 931V. A tax advantage scheme is a scheme that has as its main purpose, or one of its main purposes, to obtain a tax advantage of more than a negligible amount.

29. Section 931J is an anti-avoidance rule that applies to dividends that fall into the section 931E exempt class (distributions from controlled companies). Section 931E mirrors the CFC control rules and so in general the protection afforded by the CFC rules minimises the risk of avoidance schemes that use distributions exempt under this class. Section 931J blocks 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.

30. Section 931J applies only where there is a scheme or arrangement that has as a main purpose to obtain exemption under section 931E. For example, it would apply to the following type of scheme:

   - a group company that is outside the scope of the CFC rules receives income that is diverted from the UK under an avoidance scheme or arrangement;
   - the company is then brought under the control of a UK member of the group in order to allow subsequent dividends to fall within the section 931E exempt class; and
   - a dividend is paid out of the company's distributable profits, which include those diverted from the UK during the pre–control period.

31. Where it applies, this section prevents a distribution from being exempt by virtue of the controlled companies exempt class. It will not prevent a distribution from being exempt by virtue of any other class.

32. 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).

33. As with section 931H, if the section applies to part but not all of a dividend, it is treated for the purposes of both Part 9A and Part 18 of ICTA as if it were two dividends.

34. There is a transitional rule in Part 3 of this Schedule that prevents any profits earned more than 12 months before the commencement date for the Schedule (that is, before 1 July 2008) from being treated as pre-control profits. Any dividend paid out of such profits will therefore not fall within this anti-avoidance rule.

35. Section 931K is an anti-avoidance rule that applies to dividends that fall within the section 931F exempt class (distributions in respect of non-redeemable ordinary shares). It applies only where there is a scheme or arrangement that has as a main purpose to obtain exemption under section 931F.

36. The anti-avoidance rule in this section 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.

37. Where it applies, this section 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.

38. Section 931L is an anti-avoidance rule that applies to dividends that fall within the section 931G exempt class (distributions in respect of portfolio holdings). It applies only where there is a scheme or arrangement that has as a main purpose to obtain exemption under section 931G.

39. The anti-avoidance rule in this section will 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 given in section 931G.

40. Where it applies, this section prevents a distribution from being exempt by virtue of the portfolio holdings exempt class. It will not prevent a distribution from being exempt by virtue of any other class.

41. Section 931M is an anti-avoidance rule that applies to distributions that arise from a tax advantage scheme (see section 931V) and that are part of an arrangement that yields a return economically equivalent to interest.

42. Subsection (1) excludes from the anti-avoidance rule any distribution that is exempt by reason of section 931E (distributions from controlled companies). Subsection (6) restricts the section to cases where there is a connection between the recipient and payer.

43. Subsection (7) defines the meaning of "connection" in subsection (6) by reference to an amended loan relationship definition of "connected company" in section 466. The reason for using the loan relationship definition is to ensure that section 931M has sufficient scope to cover all those cases where loan relationships legislation is disapplied by reason of a connected person rule, but there is a risk that the CFC rules may not apply because of an absence of control of the payer by the recipient.

44. The definition of "economically equivalent to interest" in this section is aligned with that given in section 486B of CTA, which is being introduced by Schedule 24 of this Act (section 48).

45. Section 931N is an anti-avoidance rule that applies to tax advantage schemes (see section 931V) that include a deduction given under any foreign tax law in respect of an amount calculated by reference to a distribution.

46. There are rules in sections 931B(c) and 931D(c) that deny exemption for any distribution that itself qualifies for a foreign tax deduction. This section prevents those rules being sidestepped through avoidance schemes that arrange for tax deductions to be given indirectly.

47. Section 931O is an anti-avoidance rule that applies to tax advantage schemes (see section 931V) involving payments for distributions. The language of this section is similar to that used in section 125 of ICTA, which was amended in 2005 in response to avoidance schemes involving annual payments. This section introduces a rule that will deny exemption in any case where the recipient or a person connected to the recipient makes a payment or gives up income in return for a distribution.

48. Section 931P is an anti-avoidance rule that guards against the risk that the terms on which goods or services are provided might be varied in a way that reduces taxable profits in return for a right or expectation that a distribution will be paid to compensate for the lost profits. It applies where there is a tax advantage scheme (see section 931V) that involves the payment of a distribution, but does not apply in any case where the transfer pricing rules in Schedule 28AA to ICTA cancel the tax advantage arising from the variation in terms.

49. Section 931Q is an anti-avoidance rule that denies exemption to distributions that have been artificially diverted from a company (referred to as "C" in the section) for which the distribution would have been a trade receipt. Part 9A does not apply to distributions that are trade receipts (although there is a special rule for insurance companies in

paragraph 22 of this Schedule that has an equivalent effect), which are instead taxable as part of trade profits. This might create an incentive for a trading company to divert distributions that are trade receipts to a different company in order to obtain exemption under Part 9A.

50. The section applies only where there is a scheme or arrangement that has as a main purpose to obtain Part 9A exemption and where it is reasonable to assume that the distribution would have represented a trade receipt of C. Subsections (3) and (4) require that in considering whether it is reasonable to make this assumption, it must be assumed that C was a party to any transactions giving rise to the distribution.

Chapter 4 of Part 9A CTA 2009

51. Chapter 4 interprets terms used in Part 9A and also establishes how Part 9A interacts with certain other parts of CTA.

52. Section 931R allows a company to 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:

- 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
- it is possible that exemption could lead to an increased rate of withholding tax.

53. 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 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 is received.

54. Section 931S gives the definition of "small company", thereby establishing the scope of Chapter 2. The definition follows the 2003 European Commission recommendation except that certain financial companies listed in subsection (2) are not treated as small companies.

55. Section 931T defines the terms "payer" and "recipient" in relation to a distribution. These terms are used throughout Part 9A. It also defines the term "relevant person", which is used in several of the anti-avoidance sections as a means of referring to any company connected with the recipient of a distribution.

56. Section 931U defines "ordinary share" and "redeemable" for the purposes of sections 931F and 931K. An ordinary share carries no preferential rights and a share is redeemable if as a result of its terms of issue or any collateral arrangements either the holder or the issuer is entitled to redeem the share.

57. Section 931V defines "scheme" and "tax advantage scheme". The term "scheme" is broadly defined. A scheme is a tax advantage scheme if one of its main purposes is to obtain a tax advantage, as that term is defined in ICTA.

58. Section 931W gives priority to other Parts of CTA that in some cases include distributions under alternative heads of charge (trade profits, property income and life insurance taxation). Hence Part 9A will apply only where distributions are not taxed under these alternative heads of charge.

Part 2 – Other amendments

59. Paragraph 3 includes exempt foreign distributions within franked investment income (FII) for the purpose of calculating entitlement to small companies' relief. This treatment is consistent with that of UK distributions.

60. Paragraph 4 replaces the current exemption from corporation tax for foreign distributions received by charities and extends it to include all company distributions within Part 9A (i.e. all company distributions that are not of a capital nature). This replaces the exemption previously provided by section 1285 of CTA for UK distributions and by section 505(1)(iib) of ICTA for foreign distributions, which is repealed under sub-paragraph (3).

61. Paragraph 5 makes minor consequential amendments to some insurance anti-avoidance legislation.

62. Paragraph 6 has the effect that entitlement to a tax credit for the purposes of section 231 of ICTA applies whether or not the company making the qualifying distribution is resident in the United Kingdom.

63. Paragraphs 7 to 10 make changes to the rules giving underlying tax credit in respect of foreign dividend income. These rules are not necessary for any exempt foreign dividend and so are being simplified by the removal of the onshore pooling rules (sections 806A to 806K of ICTA).

64. Section 799 ICTA is amended in a way that affects the specification of profits for the purpose of calculating credit for underlying tax. In a case where a dividend is taxable because it is paid in respect of profits that are not "relevant profits" for the purposes of section 931H (dividends derived from profits not designed to reduce tax), those same profits are specified as the profits that form the basis of the underlying tax credit calculation.

65. Paragraphs 11 to 12 amend Schedule 23A to ICTA, which deals with manufactured dividends. Paragraph 11 amends paragraph 2 of Schedule 23A, which deals with manufactured UK dividends. Paragraph 12 amends paragraph 4 of Schedule 23A, which deals with manufactured overseas dividends.

66. The broad aim of the amendments is to align the tax treatment of manufactured dividends (whether payable in respect of UK or overseas equities) with their real equivalents. Similarly, the amendments aim to ensure that the payment of a manufactured dividend is deductible if and to the extent that the equivalent receipt is taxable.

67. In some cases exemption for the real dividend depends on the nature of the shares in respect of which it is payable. Paragraph 2 of Schedule 23A ensures that where a manufactured dividend is paid in respect of UK shares the payment is treated as made in respect of the shares in question. Paragraph 12 introduces new sub-paragraph (4A) of paragraph 4, which ensures that Part 9A will also apply to a manufactured overseas dividend as if it were paid in respect of the shares in question.

68. Paragraph 11 also introduces new subparagraph (3B) of paragraph 2 of Schedule 23A, to ensure that where exemption under Part 9A depends upon identity of the payer of the dividend, then the payer of a manufactured UK dividend shall be treated as the payer of the real dividend of which the manufactured payment is representative.

69. Paragraph 12 also introduces new subparagraph (4B) of paragraph 4 of Schedule 23A for the same purpose in relation to manufactured overseas dividends.

70. Paragraph 13 makes a consequential change to the offshore funds legislation to reflect the repeal of section 1285 (see paragraph 27) and its replacement by the rules in Chapters 2 and 3 of Part 9A.

71. Paragraph 14 makes the amendment necessary to ensure that transfer pricing rules take priority over section 209(2)(d), thereby limiting the scope of the denial of Part 9A exemption given in sections 931B and 931D.

72. Paragraphs 15 to 17 make consequential amendments to sections 85A and 89 of the Finance Act 1989. These sections contain detailed rules for the taxation of the profits of life assurance business on the I-E basis.

73. Paragraphs 18 and 22 extend the benefit of exemption under Part 9A rules to general insurance companies, including corporate members of Lloyd's. In each case, distributions will be excluded from the calculation of insurance trade profits to the same extent as is provided for by the Part 9A rules.

74. Paragraph 19 makes a consequential change to Real Estate Investment Trust (REIT) rules.

75. Paragraphs 20, 21, 23, 24, 26, 29 and 30 make minor consequential changes to CTA.

76. Paragraph 25 extends exemption to receipts from the sale of foreign dividend coupons to the same extent as the dividend would itself be exempt according to the rules given in Part 9A.

77. Paragraph 27 removes the general exemption for UK distributions by omitting section 1285. UK distributions instead qualify for exemption under the rules in Part 9A unless they are taxed elsewhere.

78. Paragraph 28 provides that regulations made under section 931C are subject to affirmative resolution procedure.

Part 3 – Commencement etc.

79. Paragraph 31 gives the commencement rule for the Schedule, which applies to all distributions paid on or after 1 July 2009.

80. Paragraph 32 sets out transitional provisions applying to sections 931H and 931J. In each case the purpose of the transitional rule is to prevent the need to consider transactions (or series of transactions) that were completed before 1 July 2008. To the extent that it is necessary to consider whether a distribution would have fallen into an exempt class before 1 July 2009, it is to be assumed that Part 9A was in force at that time.

Background Note

81. Part 9A aligns the treatment of UK and foreign distributions and provides that the great majority will not be taxable.

82. Exemption is available to all sizes of company and for distributions arising from any size of shareholding.

83. In recognition of the fiscal risks associated with distribution exemption there are anti-avoidance rules to prevent abuse whereby profits that would otherwise have been subject to tax are returned as a tax exempt distribution.