INTERNATIONAL HEADQUARTER COMPANIES: A NEW STRUCTURE FOR TAX PLANNERS *(1)

Introduction

The United Kingdom is now at the forefront of jurisdictions which should be considered in inter national tax planning. With the introduction of the concepts of Foreign Income Dividends ('FIDs') and International Headquarters Companies ('IHCs') the UK offers substantial tax advantages for companies which earn primarily non-UK income which it wishes to pass on to its non-UK shareholders.

Such income, if declared as a FID by an IHC, can be received in the UK and passed on to non-UK shareholders of the IHC without the imposition of any UK tax.

Prior to the introduction of these concepts into the UK tax legislation, the UK tax system operated to the disadvantage of companies which earned substantial foreign dividends or income which exceeded its UK income.

This was clearly recognised by the then Chancellor of the Exchequer, Norman Lamont, in March 1993 when he introduced the consultative document proposing the reform of the corporation tax system stating that -

> 'It has long been recognised that our system of corporation tax poses problems for companies which are based in the United Kingdom but which earn the majority of their profits overseas. A particularly acute form of this problem arises when companies based abroad are considering setting up a headquarters company here to consolidate their European operations, and find that the likelihood of surplus ACT prevents them basing that operation in the United Kingdom.
>
> The Government has always made it clear that a prime consideration for tax policy is to make the United Kingdom an attractive place in which to do business. In an increasingly competitive global economy we cannot afford the luxury of a tax system which discourages business from operating

> from the United Kingdom.'

The concepts and rules relating to FIDS and IHCs were introduced into the Income and Corporation Taxes Act 1988 ('TA 1988') by the Finance Act 1994 as sections 246A to 246Y.

The Motivation for Reform

In order to place the above amendments in proper perspective, it is necessary to deal briefly with the taxation of dividends and Advance Corporation Tax ('ACT') prior to these amendments.

In an attempt to alleviate the incidence of economic double taxation which arises where a company is taxed on its profits and its shareholders are taxed on the dividends arising from those profits, the UK adopted the 'imputation system'. The essential feature of this system is ACT. For the company it is an advance payment and partial discharge of its corporation tax liability. For the shareholder, it is a credit in an amount equal to the ACT which the shareholder uses to off-set against his tax liability for the relevant tax period.

When a company pays a dividend (or any other qualifying distribution) it is obliged to pay ACT. The rate of ACT is algebraically expressed as -

$$\frac{I}{100 - I}$$

I being the basic rate of tax which for the 1994/1955 accounting period is 20%. (Section 14 TA 1988.) Thus if a company has profits of £120 000 and declares a dividend of £100 000 then ACT payable will be -

$$£100\ 000 \times \left[\frac{20}{100 - 20} \right] = £25\ 000.$$

Not all the ACT paid by a company can be set-off against its liability for corporation tax. The amount of ACT which can be set-off for any accounting period is limited in terms of section 239(2) of TA 1988. The maximum ACT which can be set-off against the company's corporation tax is the amount of ACT which would have been paid if the dividend declared together with ACT thereon equalled the profits of the company for the relevant tax year. On the example given above the maximum ACT which the company can set-off against its corporation tax liability is 20% of £120 000 being £24 000 (a dividend of £96 000 plus ACT of £24 000). The company would thus have surplus ACT of £1 000.

The problem of surplus ACT (ACT which cannot be set-off in a particular accounting period) became particularly acute when a substantial proportion of a company's profits took the form of foreign source profits, as there was often no realistic prospect of the company ever setting off all or any of the ACT it had paid. The reason for this was that the foreign profits would have bome foreign tax for which the company would have received relief from double taxation and thus had no UK tax liability against which the ACT could be set-off. The problem of ACT for these companies thus became a permanent feature.

This additional tax burden often inhibited UK companies from expanding internationally and discouraged the location of International Headquarter Companies within the United Kingdom.

The New System

The new system provides the opportunity for avoiding the payment of ACT in certain circumstances and when this is not possible the refund of surplus ACT in respect of dividends out of foreign source profits. This is achieved by affording companies the option to have such dividends declared out of these profits treated as FIDs and the introduction of special provisions for IHCs.

Foreign Source Profits and FIDs

FIDs can only be declared out of foreign source profits. Section 246(1) defines foreign source profits as any income or chargeable gains of a company which are subject to corporation tax and in respect of which it has been allowed double taxation relief for foreign tax. FIDs which a company receives from another company are treated as foreign source profits out of which FIDs can again be declared.

Where a UK company receives a dividend from a foreign company, tax will have been deducted in the country of source by way of a withholding tax, if there is a treaty at a rate between 5% and 15% depending on the shareholding, and if no treaty at the full rate applicable in the source state. Where the country of source taxed the profits of the company out of which the dividend has been declared and also taxes the dividend in the hands of the shareholder, the UK allows a credit not only for the withholding tax applied to the dividend but also for (at least part and sometimes the whole) of the tax levied on the profits of the company which underlie the dividend. See sections 795 and 799 TA 1988.

The relief for the underlying tax is only given if

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the UK resident is a company which either -

(a) controls directly or indirectly; or

(b) is a subsidiary of a company which so controls at least 10% of the voting powers of the foreign company.

Any foreign source profits in respect of which no foreign tax has been paid are effectively the equivalent of UK source profits for ACT purposes and the company on a declaration of a dividend is obliged to pay ACT and cannot declare a FID.

In principle, a company can only distribute profits after it has made provision for the tax payable on those profits (although it can, of course, distribute a higher amount in one period if it has not distributed the full amount available for an earlier period). This principle is important in determining whether a FID can be treated as having been paid out of foreign source profits chargeable to corporation tax for any given accounting period. In the case of FIDs it is accordingly necessary to consider the level of those profits after accounting for UK and foreign tax liability.

That tax liability would be -

(a) in cases where the foreign tax rate is higher than the UK tax rate, an amount equal to the foreign tax payable (section 2461(5)); or

(b) in cases where the UK tax rate is equal to or higher than the foreign tax rate, the aggregate of -

(i) the foreign tax payable on the foreign income; and

(ii) the UK tax payable after the granting of relief from double taxation (section 246(6)).

Thus, for example, a company liable to pay UK corporation tax at a rate of 33% and which has paid foreign tax at a rate of 35% would need £100 of foreign source profit for every £65 of FID that can be treated as having been paid out of such foreign source profits. Where the rate of foreign tax is 33% or less the company would require £100 of foreign source profit for every £67 of FID that can be treated as having been paid out of such profit.

Where a company has foreign source profits which exceed the FIDs which it is entitled to declare it may choose the foreign profits out of which it is declaring the FIDs (section 246J). In the light of the provisions of sections 2461(5) and (6) of TA 1988 it would generally be most advantageous to declare the FIDs out of the foreign source profits which have borne tax at the highest foreign rate.

In terms of sections 246A and 246B of TA 1988 the company is given the opportunity to elect to have a dividend treated as a FID. This election may only be made as regards a dividend which is paid or to be paid in cash.

If a company satisfies the requirements set out in section 246S of TA 1988 and thus qualifies as an IHC and elects to pay an FID in terms of sections 246A and 246B above, it will not be liable to pay ACT in respect of those dividends (section 246T TA 1988).

International Headquarter Companies

In order to qualify as an IHC in any given accounting period, a company must fulfil at least one of the first to third conditions and the fourth condition set forth in section 246S.

The first condition is that the company is wholly-owned by a foreign held company throughout the accounting period concerned.

The second condition is that -

(a) the company is wholly-owned by another company throughout the relevant accounting period;

(b) that other company is not resident in the UK at any time during that accounting period;

(c) throughout the accounting period and the immediately preceding twelve month period, the shares in that other company are quoted in the Official List of a recognised stock exchange other than a stock exchange in the UK;

(d) at a time falling within the accounting period or the immediately preceding twelve month period, shares in that company have been subject to dealings on a recognised stock exchange other than a stock exchange in the UK; and

(e) throughout the accounting period and the immediately preceding twelve month period, the shares in that other company are not quoted in the Official List of a recognised stock exchange in the UK.

The second condition is, however, also treated as fulfilled in relation to a company ('the company concerned') during an accounting period if -

(a) the company concerned is throughout the accounting period wholly-owned by another company, and that other company is throughout the period wholly-owned by a company which satisfies the conditions set out in subparagraphs*(b)* to *(e)* of the second condition referred to above;

(b) there are two or more companies ('intermediary companies') which throughout the

accounting period beneficially own between them all the share capital of the company concerned and there is another company which throughout the period wholly-owns all the intermediary companies and which satisfies the conditions set forth in subparagraphs *(b)* to *(e)* of the second condition referred to above; or

(c) there are two or more companies ('relevant companies') which throughout the accounting period beneficially owned between them all the share capital of the company concerned, and one of the relevant companies is a company which throughout the period wholly-owns all the other relevant companies and which satisfies the conditions set forth in subparagraphs *(b)* to *(e)* of the second conditions referred to above.

The third condition is that:

(a) at each given time in the accounting period each shareholder of the company owns at least five per cent of the company's share capital; and

(b) at each given time in the accounting period at least eighty per cent of the company's share capital is owned by persons who are not companies and who are not resident in the UK at any time in the accounting period or companies which are foreign-held companies in the accounting period or a combination of such persons and companies.

The fourth condition is that throughout the accounting period not more than twenty per cent of the company's ordinary share capital is ultimately owned by persons who are not companies and who are resident in the United Kingdom. Where any shares are not directly owned by a person who is not a company, their ultimate ownership is found by tracing ownership through any corporate holders to persons who are not companies on such basis as may be 'reasonable'.

Where a company elects to treat itself as an IHC and elects to declare a FID no ACT is payable (section 246T of TA 1988). As the UK does not have a withholding tax regime on dividends a FID declared by an IHC can pass to a foreign shareholder without any UK tax being deducted.

Companies which do not treat themselves as IHCs and which pay FIDs are liable for ACT. Provision is however made in sections 246N, 246P and 246Q of TA 1988 for such ACT to be either repaid to the company or set-off against its liability for corporation tax or partly repaid and partly so set-off.

Matching FIDs with distributable foreign profits from different accounting periods

Companies have great flexibility in the use of their foreign source profits in the declaration of FIDs.

In terms of section 246J and 246K of TA 1988 there is no pre-requisite for a company to limit the FIDs which it pays in a particular accounting period to foreign source profits arising during that same period.

A company can pay a FID in a given accounting period provided that the dividend matches with the company's distributable foreign profit for that period or the immediately preceding period, without any need to exhaust, the foreign source profits for either of those periods (section 246J(4) of TA 1988).

In addition, section 246J(5) of TA 1988 entitles companies to declare FIDs out of foreign profit arising in both current and subsequent accounting periods provided that they utilise all of their current profits before using those from a subsequent period.

Section 246J(5) referred to above affords a company the opportunity of anticipating large foreign source dividends and thus to declare a dividend out of or partly out of such future dividends which will be received in the immediately following accounting period.

Additional considerations

1. Double taxation relief

By definition, a FID can only be declared out of foreign source profits which have borne foreign tax and in respect of which double taxation relief has been granted either in terms of a double tax treaty read together with section 788 of TA 1988 or as a result of the unilateral relief from double taxation afforded by section 790 of TA 1988.

It is therefore necessary when contemplating the use of an IHC in international tax planning to carefully consider the terms of any double tax treaty which might be applicable to the foreign source profit earned by the IHC.

One of the main considerations to be taken into account in this regard is whether the IHC will in fact be entitled to claim the benefit of any double tax treaty between the UK and the country from which it derives its foreign income.

Many double tax treaties contain provisions which limit their benefits to certain categories of persons and companies. For example, article 16 of the UK/USA Double Tax Treaty provides that the Treaty's benefits in relation to dividends, interest and royalties -

> 'shall not apply to a corporation which is a resident of one of the Contracting States and which derives dividends, interest, or royalties arising within the other Contracting States if -
>
> *(a)* (i) the tax imposed on the corporation by the first-mentioned Contracting State in respect of such dividends, interest or royalties is substantially less than the tax generally imposed by that State on corporate profits; or
>
> (ii) the corporation is a resident of the United States and receives more than 80% of its gross income from sources outside the United States as determined by and for the period prescribed in section 861*(a)*(i)(B) and *(a)*(ii)(A) of the United States Internal Revenue Code of 1954, as they may be amended from time to time in minor respects so as not to affect their general principle; and
>
> *(b)* 25% or more for the capital of such corporation is owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State and are not nationals of the United States.'

It is clear from the provisions of article 16 of the UK/USA Double Tax Treaty that an IFIC would only be precluded from relying on the tax benefits afforded by the treaty if the IFIC falls within the ambits of both Article 16(1)*(a)*(i) or (ii) and article 16(1)*(b)*.

An IHC has the same liability for corporation tax as any other UK company. The concession made to an IFIC is the ability to declare dividends out of foreign source profits (FIDs) without paying ACT or the ability to claim back from Inland Revenue surplus ACT paid by it. The payment of ACT is a matter concerning the collection of taxes. It does not impact upon 'the tax imposed on the corporation by the first-mentioned state ... 'in that the rate at which an IHC is taxed or the profits on which it pays tax are not affected by the new legislation. It is thus submitted that on a proper construction of article 16, an IHC would not fall within the provisions of both parts of the article and would therefore not be precluded from relying on the tax benefits available under the UK/USA Double Tax Treaty.

Most double tax treaties and tax systems contain provisions aimed specifically at ensuring that the benefits of a particular country's double taxation treaties are enjoyed by *bona fide* residents of that country. The practice of 'treaty shopping' - the siting of a company in a particular jurisdiction for the sole purpose of enjoying the benefits of the double tax treaties entered into by it, is being combated more and more vigorously.

That is well illustrated by the recently concluded USA/Netherlands and USA/German Double Tax Treaties, both of which have articles headed 'Limitation of Benefits 'which set out comprehensive and detailed provisions defining the qualifications to be fulfilled for a taxpayer to benefit under the relevant treaty.

Most countries have attempted to counter treaty shopping by having anti-abuse articles in their double tax treaties. In the United States the courts and the Inland Revenue Service have applied a doctrine of substance over form to deny recognition of entities established for treaty shopping purposes. Where one is contemplating the use of an IHC for the receipt of US income one will have to bear this very much in mind.

One of the issues which the legislation on IHCs has not adequately dealt with and which appears to mitigate against the use of the IHC is that if an IHC were to realise a gain on the sale of the shares owned by it in foreign subsidiaries, the IHC would be subject to corporation tax on the gain in the normal way. It is however possible to structure the group of which the IHC is part in such a way that any disposals which will result in the capital gain are made in a tax effective way.

Endnotes

1 (Popup - Popup)

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