

EXPLANATORY NOTE

**CLAUSE 85: DIVIDENDS BY REFERENCE TO WHICH A
DEDUCTION IS ALLOWED: NO UNDERLYING TAX**

SUMMARY

1. Clause 85 amends the operation of section 799 ICTA so that no underlying tax relief will be given if a tax deduction is given in another jurisdiction calculated by reference to the amount of the dividend.
2. Section 799 ICTA provides the detailed rules for computing underlying tax relief in respect of foreign dividends for the purposes of both double taxation agreements (DTAs) and unilateral relief provisions at section 790 ICTA.

DETAILS OF THE CLAUSE

3. Subsection (1) inserts a new section (2A) in section 799 ICTA. The new subsection 799(2A) ICTA provides that no underlying tax relief will be taken into account in the case of a dividend if a tax deduction is given in another jurisdiction determined by reference to the amount of the dividend.
4. Subsection (2) provides that the amendment has effect in relation to dividends paid on or after 16 March 2005.

BACKGROUND NOTE

5. Some schemes that were notified under the avoidance disclosure rules have sought to make use of the fact that certain payments may be characterised as interest for tax purposes in another jurisdiction but as a dividend under UK law. The payer obtains a

tax deduction for the payment in the other jurisdiction, but in the UK credit for underlying tax is given against the receipt.

6. To deal with this, from 16 March, no underlying tax relief will be given if a tax deduction is given in another jurisdiction calculated by reference to the amount of the dividend.

EXPLANATORY NOTE

CLAUSE 86: LIMITS ON CREDIT - INCOME TAX AND CORPORATION TAX - TRADING PROFITS

SUMMARY

1. Clause 86 amends the operation of sections 798 and 798B to modify the application of sections 796 and 797 when foreign tax is paid on trade income. It ensures that the foreign tax credit is limited to the UK tax on so much of the trade profit as is derived from the income that suffered foreign tax. Section 796 applies for income tax, and section 797 applies for corporation tax.

DETAILS OF THE CLAUSE

2. Subsection (1) replaces the existing sections 798 to 798B ICTA with new sections 798 to 798C.

Section 798

3. Subsection 798(1) gives this section effect in relation to the application of section 796 ICTA to trade income. Section 796 ICTA sets out a limit for the amount of credit for foreign tax that may be given against income tax.
4. Subsection 798(2) requires the comparison in section 796(1)(a) and (b) ICTA to be undertaken on the basis of net income after expenses, not gross income. Hence the amount to be excluded in section 796(1)(b) ICTA is the amount of income that suffered foreign tax less expenses attributable to it. The effect is to limit credit relief by reference to the tax on profit derived from the income, not by reference to the gross amount of income.

5. Subsection 798(3) requires the expenses to be taken into account in subsection (2) to include a reasonable proportion of all indirect expenditure, e.g. overhead expenses, as well as those expenses directly attributable to the income on which foreign tax was paid.
6. Subsection 798(4) gives a special rule for the pooling of royalty income. All royalties arising from the same asset are treated as if they were a single item of income. This means that the section 796 ICTA limit needs to be applied only once in respect of the aggregate royalty income from the same asset, rather than once for each royalty receipt.
7. Subsection 798(5) gives a list of what is meant by “trade income”. The list includes those parts of the Taxes Acts where income is taxed according to trade income rules. As well as actual trade income, this includes post cessation receipts and income from rental businesses.

Section 798A

8. Subsection 798A(1) gives this section effect in relation to the application of section 797 ICTA to trade income. Section 797 ICTA sets out a limit for the amount of credit for foreign tax that may be given against corporation tax.
9. Subsection 798A(2) modifies the effect of section 797(1) ICTA, which limits credit for foreign tax to no more than the “corporation tax attributable to the relevant income or gain”. Subsection 798A(2) limits the scope of “relevant income or gain”, to only so much income or gain as accrues from the transaction that gives rise to the foreign tax payment. This ensures that credit relief may not be given against tax due on other trade profits that are unrelated to the payment of foreign tax.
10. Subsection 798A(3) gives further explanation of how the relevant income or gain is to be calculated. It requires account to be taken of:
 - a. All deductions or expenses incurred in the transaction giving rise to the foreign tax payment.

- b. A reasonable proportion of all deductions or expenses that relate partly but not wholly to that transaction – this includes, for instance, all general overhead and funding costs.
 - c. Expenses incurred by a connected company may also be taken into account if it is reasonable to do so. “Connected” takes a standard meaning from section 839 ICTA, which is based upon common control.
11. Subsection 798A(4) lists those types of income that are to be considered trade income for the purposes of sections 798A ICTA and 798B ICTA. This includes income from trades, professions, vocations (including foreign trades), rental businesses, post cessation receipts, and any other case where the rules applicable to trade income are used to calculate taxable profits.

Section 798B

12. Section 798B deals with certain special cases that fall within the new section 798A. It gives rules for how the modification to section 797(1) ICTA specified in the new section 798A(2) should proceed.
13. Subsection 798B(1) extends the scope of “relevant income” in the new section 798A(2) in cases where a foreign tax payment is made in connection with the holding of an asset (such as a foreign dividend) and the asset is in a “hedging relationship” with a derivative contract.
14. In such a case, the income attributable to the foreign tax payment is extended to include so much of the income or loss arising from the derivative contract as is attributable to the hedging relationship.
15. Subsection 798B(2) defines “hedging relationship” for the purpose of subsection (1). It includes either the case where the derivative is acquired in order to hedge (offset) risk resulting from the holding of the asset associated with the foreign tax payment, or the reverse case where the asset is acquired to hedge risk resulting from the derivative.

16. The above conditions are met in any case where the asset or contract is wholly or partly designated as a hedge for accounting purposes, but the conditions may also be met even where there is no such formal designation.
17. Subsection 798B(3) gives a special rule for the pooling of royalty income. This rule has the same effect for corporation tax as is provided by the new section 798(4) for income tax. All royalties arising from the same asset are treated as if they were a single item of income. This means that the section 797(1) ICTA limit needs to be applied only once in respect of the aggregate royalty income from an asset, rather than once for each royalty receipt.
18. Subsection 798B(4) is an anti-fragmentation rule. Where as a result of a scheme or arrangement, income that would be trade income of company A is received by company B, then the income is deemed to be trade income of company B regardless of whether company B is carrying on a trade.
19. Subsection 798B(5) allows income to be dealt with on a portfolio basis where that reflects the way the income is treated by the taxpayer. A portfolio basis means that the income inside the portfolio is aggregated and treated as a single item of income for the tax credit claim. Where some but not all of the portfolio relates to payments of foreign tax, then the portfolio result should be apportioned in a fair and reasonable manner following the aggregation process, to determine the income attributable to the foreign tax payment.
20. A portfolio basis is acceptable where it is not reasonably practicable to subdivide the portfolio into its component transactions, or where the effect of doing so would make no material difference to the credit calculation. Where these conditions are not met the portfolio should be subdivided into smaller parts that do meet these conditions, so that a more precise calculation may be undertaken.

Section 798C

21. Section 798C allows part of a foreign tax payment to be given as a deduction from trade profits in some circumstances where part has been given as a credit against tax due on trade profits. This is a relaxation of the usual rule given in section

795(2) that relief may be by credit or deduction, but not any mixture of the two.

22. Where credit is denied for part or all of a payment of foreign tax, a deduction may be given, but not to exceed the loss that would arise from the transaction that gives rise to the foreign tax payment after deduction of the foreign tax.
23. Section 86(2) removes the parts of section 803 ICTA that referred to provisions of the previous section 798, which are no longer relevant. Because this is a corporation tax provision, the reference to section 798 is amended to section 798A
24. Section 803 ICTA is an anti-abuse provision. It will prevent section 798A being side-stepped by a bank using of a foreign company to receive income. Where that happens, relief for underlying tax on dividends paid by the foreign company is subject to the same restriction as would apply to a UK company.
25. Section 86(3) gives the commencement rule. For corporation tax the clause takes effect for the purpose of determining the availability of credit for foreign tax paid on or after 16 March 2005. For income tax, the clause applies to foreign tax paid on or after 6 April 2005.
26. Section 86(4) clarifies the tax payment date in cases where tax is deducted from a payment. The tax payment date is the same as the date on which the income was paid.
27. Section 86(5) gives a transitional rule that applies to foreign tax credit given in respect of dividend income received before 1 January 2006. In this transitional period, the new sections 798 and 798A will not cause less than 50% of the tax paid in respect of foreign dividends being given as credit against tax. The transitional rule is however denied if the foreign tax was paid as part of a scheme or arrangement entered into for the purpose of obtaining the benefit of the transitional rule.

BACKGROUND NOTES

28. A technical note issued at PBR 2004 set out the Government's proposals for amendment of sections 796 and 797 to set out more

clearly the limit on credit relief that applies when foreign tax is paid on trade receipts.

29. On 10 February 2005, the Paymaster General confirmed that the proposed legislation would be introduced with effect from Budget Day, and that action would be taken against avoidance schemes that produced excessive credit for foreign tax paid on trade receipts, with effect from 10 February. The anti-avoidance rule is given effect through section 87 and paragraph 5 of Schedule 5.

EXPLANATORY NOTE

**CLAUSE 87: SCHEMES AND ARRANGEMENTS
DESIGNED TO INCREASE RELIEF**

SUMMARY

1. Clause 87 sets out a wide-ranging anti-avoidance rule, which applies if there is a scheme or arrangement, the main purpose or one of the main purposes of which is to obtain allowance by way of credit for foreign tax, and the scheme is a prescribed scheme. A prescribed scheme is one that meets one or more of the descriptions set out in paragraphs 2 to 6 of Schedule 28AB ICTA. Schedule 5 insert the new Schedule 28AB ICTA.
2. Where this clause applies, the Inland Revenue will issue a notice requiring the taxpayer to self assess taking into it account.

DETAILS OF THE CLAUSE

3. Section 87(1) introduces three new sections of ICTA after section 804: sections 804ZA to 804ZC.

Section 804ZA

4. Subsection 804ZA(1) allows the Board of Inland Revenue to issue a notice if they have reasonable grounds to believe that conditions A to D are met in respect of any part of the income or chargeable gain taken into account in determining a person's tax liability for a chargeable period.
5. Subsection 804ZA(2) sets out condition A. This is that the person must have claimed against their UK tax for that chargeable period a credit for foreign tax suffered on the income or gain referred to in subsection (1).

6. Subsection 804ZA(3) sets out condition B. This is that the person has entered into a scheme or arrangement that has as its main purpose, or one of its main purposes, to include an amount of foreign tax to be taken into account for that chargeable period.
7. Subsection 804ZA(4) sets out condition C. This is that the scheme or arrangement in condition B must be a prescribed scheme or arrangement as defined by Schedule 28AB ICTA (see subsection (11)).
8. Subsections 804ZA(5) to 804ZA(7) set out condition D. This is that the amount of credit claimed for foreign tax by the person to whom the notice issued, together with all connected persons, is more than a minimal amount in the chargeable period or a corresponding chargeable period. A chargeable period corresponds with another chargeable period if the two have one or more day in common.
9. The Board of Inland Revenue will indicate in guidance what it considered to be a minimal level of credit relief claim.
10. Subsection 804ZA(8) sets out the form of a notice. It contains a statement of the Board's view that conditions A to D are met in relation to a specified chargeable period. If the credit relates to underlying tax in respect of dividend income (see section 799 ICTA), the notice must identify the foreign company that is relevant to the underlying tax relief claim. Finally, the notice must state that section 804ZB applies to the person who receives the notice.
11. Subsection 804ZA(9) allows the notice to also include the Board's view of the adjustments required by section 804ZB(2).
12. Subsection 804ZA(10) allows the adjustments required by section 804ZB(2) to include, in a case where credit is claimed for underlying tax relief, an adjustment to the amount of foreign tax that the specified foreign company is treated as having paid.
13. The foreign company is treated as having paid only so much foreign tax as would qualify for credit relief if it were UK resident. This cancels the effect of the scheme or arrangement in respect of the foreign company, which ensures that the

underlying tax relief calculation is based on the lower amount of foreign tax.

14. Subsection 804ZA(11) applies Schedule 28AB ICTA for the purpose of determining what constitutes a prescribed scheme or arrangement in condition C.
15. Subsection 804ZA(12) defines the term “tax return” for the purposes of sections 804ZA to ZC for individuals, partnerships and companies, by reference to the usual assessing provisions in TMA 1970 and Schedule 18 FA 1998.

Section 804ZB

16. Subsection 804ZB(1) applies section when a notice has been issued under section 804ZA and conditions A to D are met.
17. Subsection 804ZB(2) requires a person who has received a notice to make such adjustments in his tax return as are necessary to counteract the effects of the scheme or arrangement within condition B in section 804ZA, insofar as those effects relate to the purpose of causing an amount of foreign tax to be included in a credit relief claim.

Section 804ZC

18. Subsections 804ZC(1) and 804ZC(2) determine the procedure where the Board issues a notice under section 804ZA before the taxpayer has made a return.
19. In such a case, the taxpayer may disregard the notice in any return made within 90 days of the issue of the notice, and may amend the return at any time up to the end of this 90 day period for the purpose of complying with the notice.
20. Subsection 804ZC(3) deals with the case where the return has already been made. In such a case, the Board may only issue a section 804ZA notice if a notice of enquiry has been issued in respect of the return.
21. Subsection 804ZC(4) limits the right of the Board to issue a section 804ZA notice in any case where enquiries into a return have been completed. In such a case, the Board can

- only issue a notice if the requirements in subsections (5) and (7) are satisfied.
22. Subsection 804ZC(5) gives the first requirement, which is that the Board could not have been reasonably expected to realise that a section 804ZA notice was required on the basis of information made available before any enquiry was completed
 23. Subsection 804ZC(6) defines what is meant by “information made available” by reference to self assessment provisions in TMA 1970 (for individuals) and Schedule 18 FA 1998 (for companies) that apply for the purpose of determining when discovery assessments may be made.
 24. Subsection 804ZC(7) contains the second requirement, which is that the Revenue asked for information in the course of an enquiry into the return, and if the information had been duly supplied, it is reasonable to suppose that the Board would have issued a notice at that time.
 25. When a section 804ZA notice is issued after a return is made, subsection (8) gives the taxpayer 90 days starting from the date of issue of the notice to amend his return to comply with the notice.
 26. Subsection 804ZC(9) prevents the Revenue from issuing a closure notice in respect of an enquiry into a return until either:
 - a. the taxpayer has amended his return, or
 - b. the 90 day period specified in subsection (8) above has expired.
 27. In a case where a section 804ZA notice is issued after enquiries have been completed, subsection (10) prevents the Revenue from issuing a discovery assessment until either:
 - a. the taxpayer has amended his return, or
 - b. the 90 day period specified in subsection (8) above has expired.
 28. Subsection 804ZC(11) makes it clear that subsections (2)(b) and (8) above do not prevent a return from becoming

incorrect if the taxpayer fails to make an appropriate adjustment to the return within the 90 day time limits provided for in those subsections.

29. Subsection 804ZC(12) defines terms used in the section by reference to self assessment provisions in TMA 1970 (for individuals) and Schedule 18 FA 1998 (for companies).
30. Section 87(2) gives effect to Schedule 5, which inserts Schedule 28AB ICTA.
31. Sections 87(3) to (5) give the commencement rule, which applies by reference to the date that foreign tax is paid. Subsection (3)(b) specifies that where tax is deducted at source from income received, the date of payment of foreign tax is the same as the date of payment of the income.
32. The section applies for the purpose of credit arising from foreign tax paid on or after 16 March 2005, except that in any case falling within paragraph 5 of Schedule 28AB, the section applies to credit arising from foreign tax paid on or after 10 February 2005.

DETAILS OF THE SCHEDULE

Schedule 5

1. Paragraph 1 sets out how the Schedule determines whether a scheme or arrangement is a prescribed scheme or arrangement.
2. Sub-paragraph 1(1) specifies that a scheme or arrangement is a prescribed scheme or arrangement if one or more of paragraphs 2 to 6 apply to it.
3. Sub-paragraphs 1(2) to 1(5) amend the interpretation of paragraphs 2 to 6 in a case where the scheme involves is one that has the obtaining of underlying tax relief as its main purpose or one of its main purposes.
4. In an underlying tax case, the scheme is a prescribed scheme if it would be a prescribed scheme of a foreign company if that company were resident in the UK, but without assuming its activities to be carried on in any different place.

5. Paragraph 2 sets out the first prescribed scheme or arrangement. It applies if a scheme causes foreign tax that is properly attributable to one source of income or gain to be paid in respect of a different source of income or gain. This describes a process of artificial attribution of foreign tax to certain income that is in reality unrelated to the foreign tax.
6. Paragraph 3 sets out the second prescribed scheme or arrangement. It describes a payment of foreign tax that is artificial in the sense that the payment does not increase the overall tax liabilities of scheme participants.
7. This may be because the tax payment made by the claimant is matched by a tax saving for another scheme participant. Or it may be that an amount of tax that would have been paid anyway by a scheme participant is artificially attributed to the claimant, but without altering the amount that would have been paid in the absence of the scheme.
8. The foreign tax referred to in paragraph 3 is the aggregate amount of all foreign tax paid in respect of scheme transactions by all scheme participants, taking account of both tax payments and tax savings that arise from the scheme.
9. Paragraph 4 sets out the third prescribed scheme or arrangement. There are two different sub-conditions that may apply:
 - The first, where a claim or election was made that increased the amount of credit relief that a scheme participant is entitled to claim; or
 - The second, where a claim or election could have been made that would have reduced the amount of credit relief that a scheme participant was entitled to claim.
10. In either case, the claim or election is one that could have been made under the law of any territory or in accordance with any bilateral treaty (“arrangements made in relation to any territory”).
11. Paragraph 5 sets out the fourth prescribed scheme or arrangement. It refers to a situation where a scheme or arrangement has the effect that the foreign tax credit given as a result of the scheme or arrangement reduces the amount of tax payable to an amount less than would have been payable if the transactions making up the scheme had never taken place. This will apply in any case where

credit for foreign tax arising from scheme income not only covers the tax on the scheme income, but is also set against other tax due on other income, thereby reducing total UK tax liabilities.

12. Paragraph 6 sets out the fifth prescribed scheme or arrangement. It includes any scheme or arrangement whereby a tax deductible payment is made by a person in return for which they, or any person connected with them, receives income that has been subject to foreign tax.
13. Hence paragraph 6 describes a case where a person obtains a tax deduction for a payment and in return receives income (or a person connected with them receives income) for which credit relief is available in respect of foreign taxes.

BACKGROUND NOTES

14. This clause acts against schemes that seek to avoid UK taxation through artificially increased claims for credit in respect of foreign taxes.
15. In such cases the effect of the scheme will be counteracted, but the clause will allow credit relief to be given insofar as is necessary to eliminate genuine double taxation.

EXPLANATORY NOTE

CLAUSE 88: SELF-ASSESSMENT AMENDMENTS

SUMMARY

1. Clause 88 makes certain amendments to self-assessment machinery, in consequence of the changes introduced by clause 87.

DETAILS OF THE CLAUSE

2. Subsection (1) extends the range of matters that may be the subject of an enquiry into an income tax return, to include the question of whether a notice under section 804ZA ought to be issued to counter excessive relief for foreign tax.
3. Subsection (2) removes the two conditions that must normally be met before an income tax discovery assessment under section 29 TMA 1970 may be made, in a case where a notice under section 804ZA has been issued.
4. The conditions are not necessary in such a case, because of the conditions that are imposed by section 804ZC(4) (see clause 87(1)) for the issue of a section 804ZA notice, which would make the section 29 conditions redundant.
5. Subsection (3) extends the range of matters that may be the subject of an enquiry into a corporation tax return, to include the question of whether a notice should be issued under section 804ZA (countering schemes that produce excessive relief for foreign tax).
6. Subsection (4) removes the two conditions that must normally be met before a corporation tax discovery assessment under paragraph 41 Schedule 18 FA 1998 may be made, in a case where a notice under section 804ZA has been issued.

**BOARD OF INLAND REVENUE
RESOLUTION 27**

**FINANCE (No. 2) BILL 2005
CLAUSE 88**

7. As with subsection (2), the restrictions on discovery assessments are not needed in view of the separately imposed restrictions on the notices issued under section 804ZA ICTA.
8. Subsection (5) provide that the amendments in subsections 88(1) to (4) above apply from the same commencement dates as for clause 87.

EXPLANATORY NOTE

**CLAUSE 89: ADP DIVIDENDS AND DOUBLE TAXATION
RELIEF**

SUMMARY

1. Clause 89 amends the operation of section 801 ICTA 1988, which provides for underlying tax relief to be given against the tax due on foreign dividends.
2. The clause prevents the DTR rules being used to avoid CFC tax. It ensures that if a UK interest holder obtains exemption from apportionment of CFC profits because the CFC operates an acceptable distribution policy (ADP), the ADP dividend is proportionate to the tax that would have been due in respect of an apportionment. In particular, it prevents taxes paid outside of the CFC's territory avoiding the operation of the mixer cap.

DETAILS OF THE CLAUSE

3. Subsection 89(1) introduces the clause to amend section 801 ICTA.
4. Subsection 89(2) adds a new paragraph (aa) to section 801(2A) ICTA, which removes the exemption from the mixer cap for any dividend paid to what is referred to as an "ADP controlled foreign company". This is a CFC that operates an ADP, such that that no apportionment of its profits is made to UK interest holders.
5. Subsection 89(3) introduces a new subsection (2B) to section 801 ICTA, which alters the way that the mixer cap applies to an ADP controlled foreign company. It replaces the usual formulation of the mixer cap, given in section 799(1A) ICTA, with a different formula, which is based solely upon the amount of the dividend received by the CFC, without reference to the underlying tax attached to it.

6. The new formula is $\frac{D}{1-X} \times X$, where D is the amount of a dividend and X is the rate of corporation tax expressed as a decimal – currently 0.3.
7. Subsection 89(4) introduces two new subsections to section 801 ICTA, both of which define terms used in the section:

Section 801(6) ICTA defines the terms “ADP controlled foreign company” and “ADP dividend”.

Section 801(7) ICTA defines “accounting period” and “controlled foreign company” in a way consistent with the CFC legislation.
8. Subsection 89(5) sets out the commencement rule. The changes to section 801 ICTA will be effective when considering the DTR that attaches any ADP dividend paid on or after 2 December 2004, irrespective of the date of any dividend received by the CFC.

BACKGROUND NOTES

9. This clause was announced at 2004 Pre-Budget Report with immediate effect. It blocks certain known avoidance schemes that aim to undermine the controlled foreign company rules.

EXPLANATORY NOTE

**CLAUSE 90: FOREIGN TAXATION OF GROUP AS
SINGLE ENTITY: EXCLUSION OF ADP CFCS**

SUMMARY

1. Clause 90 amends section 803A ICTA in order to limit its scope so that it does not apply to a controlled foreign company (CFC) for which exemption is available under the acceptable distribution policy (ADP) test.
2. Where a foreign jurisdiction taxes companies on a consolidated basis, section 803A ICTA treats all group companies in that jurisdiction as a single entity for double taxation relief purposes.

DETAILS OF THE CLAUSE

3. Subsection (1) provides that section 803A ICTA is to be amended
4. Subsection (2) inserts a new subsection (1A) in section 803A ICTA.
5. The new subsection (1A) provides that where a company within the meaning of section 801 ICTA is an ADP CFC in respect of any of its accounting periods, and the whole or any part of any profits or gains are included within the aggregate profits or gains for the purposes of section 803A(1) ICTA, then such a company is excluded from section 803A(2) ICTA.
6. Subsection (3) provides that the amendment has effect in relation to dividends paid on or after 16 March 2005.

BACKGROUND NOTE

7. Avoidance schemes notified under the avoidance disclosure regime have sought to exploit section 803A ICTA to circumvent the CFC legislation. This change from 16 March in relation to the provision will limit its scope so that it does not apply to a CFC for which exemption is available under the acceptable distribution policy ADP test.

EXPLANATORY NOTE

**CLAUSE 91: TAX AVOIDANCE INVOLVING ANNUAL
PAYMENTS AND DOUBLE TAXATION RELIEF**

SUMMARY

1. Clause 91 amends the operation of section 125 ICTA 1988, which sets out circumstances in which tax deductions may not be given for annual payments. It extends its scope to include any annual payment made in consideration for the receipt of a dividend or dividends.
2. The clause also removes subsections (4A) to (4D) of section 801 ICTA. Where they apply, these subsections deem underlying tax to have been paid in a specified amount.
3. The purpose of both sets of amendment is to prevent avoidance schemes that aim to create tax deductions from contrived arrangements whereby annual payments are given in return for a right to receive foreign dividends.

DETAILS OF THE CLAUSE

4. Subsection (1) introduces the clause to amend ICTA.
5. Subsection (2) amends section 125 ICTA to extend the scope of paragraph 125(2)(b) ICTA which currently refers to an annual payment made in return for non-taxable consideration, with the result that the section denies a tax deduction for such a payment.
6. This rule is retained in the new subsection 125(2)(b)(ii) and is supplemented by the new subsection 125(2)(b)(i), which similarly denies a tax deduction for an annual payment made in return for consideration in the form of any dividend, or a right to receive any dividend.

7. Subsection (3) amends the heading given to section 125 in the Act, so as to properly describe the amended scope of the section.
8. Subsection (4) introduces the second part of the clause, which amends section 801 ICTA 1988.
9. Subsection (5) and (6) repeal subsections (4A) to (4D) of section 801 ICTA, and make a consequential change to subsection (2). Subsections 801 (4A) to (4D) ICTA are concerned with the calculation of underlying tax on a dividend paid by a UK resident company. This is relevant to the calculation of underlying tax if a UK dividend is paid to a foreign company, which then pays a dividend back to the UK.
10. In this circumstance, differences between the UK company's taxable profit and its distributable profit mean that the underlying tax might not always be sufficient to cover the tax due on the foreign dividend.
11. The tax due on the foreign dividend is given by the formula in section 799(1A) ICTA. If (or to the extent that) a foreign dividend is paid out of profits included in a UK dividend, but the underlying tax is less than the amount given by the formula, subsections 801 (4A) to (4D) ICTA deem it to be increased by the amount of the difference.
12. Subsection (7) gives the commencement rule for the change to section 125 ICTA. It is effective for determining the tax deduction for any annual payment made on or after 2 December 2004.
13. Subsection (8) gives the commencement rule for the repeal of section 801(4A) to (4D) ICTA. It is effective for the calculation of DTR for any dividend paid on or after 2 December 2004. In accordance with section 834(3) ICTA, a dividend is treated as paid on the date on which it becomes due and payable.

BACKGROUND NOTES

14. Sections 125 ICTA and 801(4A) to (4D) ICTA have been exploited by some artificial and extremely aggressive planned avoidance schemes, which have been notified to the Inland Revenue under the rules for disclosure of marketable tax avoidance

**BOARD OF INLAND REVENUE
RESOLUTIONS 27 AND 30**

**FINANCE (No. 2) BILL 2005
CLAUSE 91**

arrangements. The amendments introduced by this clause are necessary to ensure that these schemes are rendered ineffective.