

Technical note

Dividends

The Government remains attracted to providing as wide a dividend exemption as possible, especially in respect of participation holdings. However, in the light of the analysis of the estimated fiscal risk of dividend exemption, we would like to discuss the alternatives for revenue protection measures to support dividend exemption. The Government does not believe that it needs to limit dividend exemption to situations where the Controlled Company rules apply to the company paying the dividend.

Controlled foreign companies

The Discussion Document set out a possible model for an income-based Controlled Companies regime. Discussions with business suggest that it may be possible to develop an income-based approach that does not:

- apply to all embedded royalties or intellectual property which does not have a connection to activities which took place or take place in the UK; or
- apply to capital gains overseas;

However, while there remain attractions to an income-based approach there appears to be a preference among business for the existing, entity-based model to continue. Therefore, the Government sees attraction in exploring improvements to the entity-based model

as an alternative to focusing on developing an income-based model. It would welcome engagement with business on both of these alternative approaches.

Interest

The aim of the worldwide debt cap, as set out in the Discussion Document, is to target situations where a UK group bears more debt than is required to finance the worldwide group. In addition this measure could provide an effective means of targeting many 'upstream' loans to the UK, which are used to repatriate overseas cash. However, in order to protect those groups that are temporarily cash-rich the Government would intend to allow the worldwide debt cap measure to be set aside where a group is in a short-term cash rich position (e.g. following a sale).

In addition, the Government has listened to the concerns of business in relation to the extension of the unallowable purpose rules to include a main benefit test and, in light of the arguments advanced, it has decided not to take this measure forward as part of the foreign profits package. However, it is still the Government's intention to engage with business in relation to strengthening the existing unallowable purpose rules for loan relationships and derivative contracts by extending them to cover schemes and arrangements.

The Government remains of the view that the introduction of comprehensive interest allocation rules would not be justified or

proportionate. However, a number of respondents from business have suggested that instead of the proposed Controlled Companies rules, it would be preferable for the Government to introduce additional but still limited restrictions on interest deductibility. Given the issues raised by our analysis of the costs associated with dividend exemption, the Government welcomes further discussion with stakeholders on this matter.

Treasury consents

The Government is keen to pursue reform of the Treasury Consents regime and the repeal of the rules contained in Sections 765 and 765A ICTA 1988. These rules would be replaced by a modernised and more targeted reporting requirement.

The possible design of a targeted reporting requirement is currently under discussion with business. This proposal will be fully consulted on prior to any reform being undertaken in this area.

Costs

Corporate tax paid on foreign dividends (excluding ADP dividends) amounted to £200mn in 2005/6 (the latest year data is available). £100m was paid on portfolio dividends, almost entirely by collective investment funds and life assurance companies. The remaining £100mn was paid on direct dividends and the hundred businesses in receipt of the most foreign dividends paid a third of this. By 2012/13 the yield on foreign dividends is forecast to have risen to £300mn.

Beyond this static cost, the Government believes there would be a significant further cost from the behavioural response to exemption. The Government recognises that the objective of an efficient and fair tax system is one which business shares. Behavioural responses will vary, but to some extent, a multinational business can choose how to allocate its profits between the territories in which it operates. The evidence on multinationals' profitability demonstrates that the exercise of discretion over where to allocate profits is highly sensitive to tax implications.

Large UK multinationals typically pay minimal CT on foreign dividends. But the planning required to achieve this, including repatriating profits outside Case V, involves some costs, the risk of challenge by the tax authorities and can result in more complex group structures. Exemption would remove these costs, risks and constraints and would increase incentives for business to shift profits

into low tax territories. It is inevitable this would result in some loss of the UK tax base. This response is difficult to forecast, however, and therefore the Government would like to discuss with business the estimates made.

The Government's central estimate of this revenue impact is £600 million by 2012/13 (when the full impact of exemption on CT receipts might have fed through). £200 million of this reflects increased diversion of active income, including passive income re-characterised as active income, into subsidiaries in low tax territories. This estimate is based on evidence from taxpayer data and economic models considering the effects of changes in effective tax rates on the location of profits and associated behavioural responses. Within the current CFC rules business would be able to "swamp" passive income with the active income of these subsidiaries. Combined with greater exploitation of CFC avoidance schemes this would double the £200 million cost from the diversion of active income. Exemption, including exemption for portfolio dividends, creates further risks associated with aggressive avoidance schemes. Evidence on the tax loss from similar risks in the past suggests a central estimate of £200 million for this, assuming that action could be taken quickly to effectively counter such schemes.

Sensitivity analysis of the estimated behavioural response suggests a range of £200 million to £1.1 billion around the central estimate of £600 million, although the nature of some of the risks, especially from

aggressive avoidance schemes, means it is not possible to set an upper limit on them.

Some discussion with business of the estimated costs and fiscal risks of introducing dividend exemption has already taken place. Some businesses have asserted that dividend exemption would result in a significant repatriation of cash to the UK, which could be used to repay indebtedness, so increasing the UK tax take and mitigating the above costs. However, given business can (and currently does) largely repatriate foreign profits without incurring a CT liability, it is unclear why there is a significant constraint on adjusting the capital structure within the Group if there is an opportunity to gain a tax advantage – or put another way, why would a group choose to use any additional repatriated funds to repay tax-efficient debt located in the UK. Other businesses have suggested any surplus cash has already been repatriated by way of loans to the UK, so that dividend exemption would only encourage distributable reserves to be repatriated to the UK. If businesses respond to exemption by repatriating reserves to the UK to enable them to return funds to shareholders, this will increase their external gearing and part or all of this increased external debt is likely to be placed in the UK. The Government would particularly welcome further dialogue in this area.

The Government is keen to discuss these fiscal estimates with business as it believes this is an essential part of finding the right balanced package. In particular it wishes to discuss with business

whether the claim of significant additional profit repatriation and the use of these profits to reduce UK indebtedness can be substantiated.