The rules for the taxation of dividends received by UK resident companies (and, in those few cases where relevant, non-UK resident companies trading through permanent establishments in the United Kingdom to which dividends are related) were completely rewritten in the Finance Act 2009. The upshot of the new rules is that dividends received by such companies will nearly always be exempt from UK tax. Unfortunately, the devil is, as so often is the case, in the detail; the manner in which HMRC insisted on approaching the issue has resulted in a series of rules that look complex, and which are bound to be unnecessarily off-putting to multinational groups considering establishing holding companies in the United Kingdom.

The Previous Rules
The new rules took effect on 1 July 2009.

Until then, things were very simple as far as distributions made by UK resident companies and received by other UK resident companies were concerned. Under Section 208 of the Income and Corporation Taxes Act 1988 (referred to in what follows as the “Taxes Act”), and its successor, Section 1285 of the Corporation Tax Act, corporation tax was simply not chargeable on dividends or other distributions of a UK resident company.

Things were not so simple as far as amounts received from non-UK resident companies were concerned. Dividends received from a non-UK resident company were subject to corporation tax, and taxed as income, but a shareholder in receipt of such dividends could claim credit for any foreign tax imposed (generally by way of withholding tax) on the dividend itself, and (subject to some horribly complex limitations) if a shareholder owned (broadly) 10% of the voting power in the company paying the dividend, it could also claim credit for underlying foreign tax (i.e. tax imposed on the profits out of which the dividend was paid).

It should be added that these rules applied to corporate shareholders holding shares in the dividend-paying company as investments. Where the shares were held as trading stock, any dividends or other distributions received would be taxed as income. That has not changed.

Dividends and Distributions
In applying both the old and the new rules a distinction has to be made between dividends and distributions.

A “distribution” is a much broader concept than a “dividend”. A “distribution” will include any dividend, but will also include various other distributions out of the assets of a company to its shareholders (the details can be found in Section 209 Taxes Act).

The distinction was important because the exclusion from corporation tax for distributions received by a UK resident company from another UK resident company extended to all distributions (not just dividends). Where a UK resident company received an amount from a non-UK resident company, however, that amount would be taxable as income if it was a dividend, but the broader concept of “distribution” would not be relevant. Thus something that would be a distribution if paid by a UK resident company, but not a dividend, would not be treated as income if it were received from a non-UK resident company.
The EC Dimension

The rules relating to UK corporation tax on dividends and other distributions – i.e. the exclusion from corporation tax for distributions received from other UK resident companies, and the imposition of corporation tax with credit for foreign tax (including underlying tax) on dividends received from non-UK resident companies – had been in place for many years. But the distinction between the treatment of dividends paid by UK resident companies and dividends paid by non-UK resident companies was challenged, by reference to the provisions of the EC Treaty, in the case known as Test Claimants in the FII Group Litigation v HMRC.

The ECJ handed down its judgment in this case in December 2006, and that judgment was to the effect that the different treatments of distributions paid by UK resident companies and dividends paid by non-UK resident companies, at least where the recipient company held at least 10% of the voting power in the paying company (so that, in the case of foreign dividends, credit could be claimed for underlying tax) did not breach the EC Treaty as long as “the rate of tax applied to foreign-sourced dividends is no higher than the rate of tax applied to nationally-sourced dividends”.

It was left to the domestic courts to decide whether or not the rate of tax applied to foreign dividends was no higher than the rate of tax applied to domestic dividends once credits for foreign tax (including underlying tax) had been taken into account.

Henderson J. was faced with that issue in the High Court in London, and his conclusion, delivered in October 2008, was that, at least insofar as it applied to dividends paid by companies within the EEA, the UK system of exempting domestic dividends and taxing foreign dividends was contrary to the EC Treaty.

The ECJ had given a clearer answer to the question as it applied to “portfolio” dividends – that is to say, dividends received from companies in which the recipient company did not have sufficient voting power for it to claim credit for underlying tax. In that situation it was clear to the ECJ that the UK tax system was in contravention of the EC Treaty, as it taxed foreign dividends but not domestic dividends.

So something clearly had to be done; and even before Henderson J.’s judgment in the High Court consultation had begun on proposals to exempt foreign dividends from corporation tax.

The Structure of the New Rules

Unfortunately, what HMRC had in mind was far from a simple exemption for foreign dividends. Furthermore, because of the need to ensure that the new rules apply equally to distributions from UK resident companies and from non-UK resident companies, the introduction of the new rules has resulted in unwelcome complexity as regards the UK corporation tax treatment of distributions paid by UK resident companies to other UK resident companies (previously simply excluded from the scope of corporation tax).

The new rules start by saying that all dividends and other distributions, other than distributions “of a capital nature”, are subject to corporation tax.

The new rules then provide a number of exemptions to ensure that most dividends and distributions will be exempt from corporation tax.

But these exemptions are then overridden, in appropriate cases, by various anti-avoidance rules.

The Basic Charge

Before examining the detail of the exemptions (and related anti-avoidance provisions), it is necessary to look at the basic charging provision. This is contained in the new Section 931A of the Corporation Tax Act (inserted into the Corporation Tax Act by the Finance Act 2009). This new section imposes tax on “any dividend or other distribution of a company” other than “a distribution of a capital nature” (and subject to the various exemptions).

The exclusion of distributions “of a capital nature” from the scope of corporation tax on dividends paid by a UK resident company to another UK resident company is a little surprising, and no clear explanation has been given by HMRC of its purpose or its effect. The term “distribution” clearly includes distributions “of a capital nature” – indeed, the definition of “distribution” in Section 209 of the Taxes Act starts by referring to any dividend “including a capital dividend.”
The words are taken from Chapter 2 of Part 10 of the Corporation Tax Act and Section 402 of the Income Tax (Trading and Other Income) Act, both of which impose tax on dividends received from non-UK resident companies other than dividends “of a capital nature”.

It seems that these words are designed to reflect the fact that, historically, the charge on amounts received by shareholders in respect of their shares in non-UK resident companies was a charge on income, not capital, and it seems that the distinction between the two is in future to be determined by reference to the old case law (which, very briefly, distinguishes between amounts received by a shareholder that do not affect the share itself and amounts received in repayment of, or by way of reduction of the capital in, the share).

Small Companies: A Simpler Approach

The rules applying to “small” companies are much simpler than those applying to other companies. For that reason, although “small” companies are probably much less likely to receive dividends from other companies than large companies are, the easiest way to approach the complexities of the new rules is to start with the provisions relating to “small” companies.

For these purposes, a company is “small” if it is a “micro” or “small” enterprise as defined in the Annex to Commission Recommendation 2003/361/EC. That is to say, briefly, a company is “small” if it has fewer than 50 employees and neither its annual turnover nor its balance sheet value exceeds €10 million (although insurance companies, authorised unit trusts, OEICs and friendly societies can never be “small” companies for this purpose).

A dividend received by a small company will be exempt from corporation tax if the following conditions are satisfied.

(i) The payer is resident in the United Kingdom or a “qualifying territory” (basically a territory with which the United Kingdom has a double tax treaty that includes a non-discrimination provision);

(ii) If the amount paid is not a straightforward dividend, but is another sort of distribution, it must not be one falling within Section 209(2)(d) or (e) of the Taxes Act (this is explained further below);

(iii) “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

(iv) The distribution is not made “as part of a tax advantage scheme” (which means, not surprisingly, a scheme one of the main purposes of which “is to obtain a tax advantage”, as defined in Section 840ZA of the Taxes Act.

This exemption for “small” companies can be contrasted with the exemptions for distributions that apply to other companies.

The second and the third conditions are exactly the same.

The requirement that the paying company be a resident of the United Kingdom or of a qualifying territory does not apply to dividends paid to companies other than small companies. Nor does the requirement that the distribution must not be made as part of a tax advantage scheme.

However, where a company other than a small company receives a distribution, the distribution must fall within one of five different exemptions if the shareholding company is not to be taxed on it and, furthermore, must not fall within the scope of the four or five anti-avoidance provisions that restrict each of those exemptions.

Taxes Act Section 209(2)(d) and (e)

As already mentioned, the exemptions from the charge to tax – whether the dividend or other distribution in question is received by a “small” company or any other company – will not extend to distributions that fall within Section 209(2)(d) and (e) of the Taxes Act.
That is to say, these exemptions do not extend to a return in excess of a reasonable commercial return on securities (Section 209(2)(d)) or (Section 209(2)(e)) to interest or other distributions in respect of securities which:

(i) were issued in respect of shares or other securities in the issuing company other than wholly for new consideration;

(ii) are convertible, but not listed or issued on terms reasonably comparable with listed securities;

(iii) carry a results-dependent consideration;

(iv) are connected with shares in the issuing company; or

(v) are “equity notes” (broadly, those issued for 50 years or more) held by an associated company (or a holder funded by the issuer or by an associated company).

The purpose of excluding distributions that fall within these rules is, again, not immediately clear. However, Section 212 of the Taxes Act has the effect that distributions that fall within Section 209(2)(e) (i.e. those within any of the five categories just listed), but do not fall within Section 209(2)(d) (returns in excess of a reasonable commercial return on securities) are not in fact to be treated as distributions for the purposes of corporation tax unless the recipient company is entitled to an exemption from tax in respect of it.

Accordingly, it appears that the purpose of excluding distributions falling within (i) to (v) above from the exemption from corporation tax on distributions is that, by making them otherwise taxable (i.e. not exempt), they can fall within Section 212 – with the result that they are not treated as distributions. In other words, the effect appears to be that they are not subject to corporation tax despite the fact that they cannot fall within one of the new exemptions. If that is, indeed, HMRC’s policy objective, it has to be said that there must be a more straightforward way of achieving it.

As for the exclusion from the exemptions of distributions falling with Section 209(2)(d) (returns in excess of a reasonable commercial return on securities), the purpose of excluding these distributions appears to be to allow the transfer pricing rules to apply rather than the rules applying to distributions. Again, the reasoning is rather convoluted.

It has to be borne in mind that one purpose (perhaps, recently, the main purpose) of characterising something as a distribution was that the result is that the paying company cannot deduct it in calculating its taxable profits. So the purpose of characterising an excessive return on securities as a distribution was to prevent the paying company obtaining tax relief. Given that excessive returns are normally paid to connected parties, it seems now to be thought that the transfer pricing rules can be left to produce an appropriate result. To that end, a technical amendment has been made to the transfer pricing rules, allowing the recipient of such a distribution to disregard the fact that it is a distribution.

The effect of this is that if the excessive return is disallowed in the hands of the paying company under the transfer pricing provisions, the recipient company can claim a corresponding adjustment (so that it is not taxed on that excessive return, even though it falls within the new Section 931A, taxing dividends and distributions, and not within any of the express exemptions from that charge).

Again, if this was HMRC’s policy objective, there must have been a more straightforward way of achieving it.

In summary, the exclusion of distributions that fall within Section 209(2)(d) and (e) of the Taxes Act from the various exemptions that apply to the tax charge on dividends and other distributions in the new Section 930A of the Corporation Tax Act is probably nothing to worry about – they would probably not be subject to corporation tax anyway.

Distributions on Ordinary Shares

For a company other than a “small” company to claim that a dividend or other distribution (other than a distribution of a capital nature) is exempt from corporation tax that dividend must fall within one of five exempt classes (and must not fall within any of the four or five anti-avoidance rules that apply to those classes).

The most logical of the exempt classes to start with is the exemption in Section 931F for dividends or other distributions made in respect of non-redeemable ordinary shares.
An "ordinary share" for this purpose is a share that does not carry "any present or future preferential right to dividends or to a company's assets on its winding-up".

The exclusion of redeemable shares is an important one. It is not clear why it is required, but the fact is that HMRC have long seen redeemable shares as instruments more akin to debt than to equity, and its hostility to redeemable shares can be seen in Section 931K. That is a particular anti-avoidance provision relating (only) to this exemption, and is designed to secure that shares are treated as redeemable shares where there is a scheme under which persons have rights which, if they were attached to the shares themselves, would result in those shares being treated as redeemable (or not being ordinary shares).

**Distributions from Controlled Companies**

The exemption that most multinational groups will first look to, however, is probably the exemption in Section 931E, which is the exemption for dividends or distributions paid by a company controlled by the recipient.

For this purpose, the definition of "control" is the definition used for the purposes of the United Kingdom's controlled foreign companies rules. It is important to note, however, that the exemption is not restricted to dividends from foreign companies – it applies equally to distributions from UK resident companies.

This exemption, too, has its own anti-avoidance rule, in Section 931J. This applies if there is a scheme designed to secure that the exemption for distributions from controlled companies applies, but a dividend is paid out of profits that were available for distribution before the recipient acquired control of the payer.

The anti-avoidance rule does not apply to dividends paid out of profits that arose in a period of account that ended before 1 July 2008.

**Distributions on Portfolio Holdings**

The third of the five exempt classes, by contrast, is the exemption for a company that holds less than 10% of the relevant class of shares in the paying company.

Again, this exemption has its own anti-avoidance rule (see Section 931L). This anti-avoidance rule applies where there is a scheme designed to secure the exemption for distributions on portfolio holdings but that exemption would not apply if the shareholdings of persons connected with the shareholder company were added to the shareholder company's own shareholding.

**Dividends from Good Transactions**

The fourth of the exempt classes applies to any dividend – but not to other distributions – paid out of what might be called "good" profits.

The exemption is actually defined by excluding from it dividends that are paid out of profits that reflect the results of one or more transactions whose purpose and result was to achieve a reduction in UK tax.

The exemption sounds very generous. However, it does mean that the recipient company will have to be confident that the paying company has either never done anything to reduce its UK tax bill by more than a negligible amount, or, if it has, that all of the profits "tainted" by such transactions have previously been distributed by way of dividend. It might not, in practice, be easy for the recipient company to be confident that these conditions are satisfied.

**Shares Accounted for as Liabilities**

The fifth exempt class is the most obscure.

It is contained in Section 931I, and it exempts dividends (again, not other 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 the loan relationship rules.

This refers to the new Section 521C of the Corporation Tax Act, itself introduced in the Finance Act 2009. The new Section 521C describes the shares treated as liabilities in accordance with generally accepted accounting practice the
returns on which are taxed as if they were loan relationships. It applies, however, only to shares that are held “for an unallowable purpose” – that is to say, shares held in order to obtain a tax advantage.

The purpose of Section 931I, accordingly, is to ensure that any dividends paid on shares which are accounted for as liabilities but which are not held for an unallowable purpose are exempt. Having escaped tax under the loan relationships provisions, therefore, the dividend also escapes any charge to tax under Section 931A.

**First Anti-Avoidance Rule**
Each of the five exempt classes is then subject to three or four general anti-avoidance rules (as well as any particular anti-avoidance rules applying to the particular class, as mentioned above).

The first of these, in Section 931M, applies to schemes in the nature of loan relationships. But, although it applies only where there is a connection between the payer of a distribution and the recipient, it does not apply to distributions that fall within Section 931E (the exemption for distributions from controlled companies). Accordingly, it has a very narrow scope. Where it does apply, it applies only to a distribution that is part of a return economically equivalent to interest.

**Second Anti-Avoidance Rule**
The second general anti-avoidance rule applies to all distributions which would otherwise be exempt. It denies exemption for any distributions which are made as part of a tax advantage scheme which includes a payment (or the giving up of a right to income) which is made in return for receiving the distribution – but only where relief for any such payment is denied by virtue of the anti-avoidance rule contained in Section 1301 of the Corporation Tax Act (which denies relief for certain “annual payments”).

**The Third Anti-Avoidance Rule**
The third anti-avoidance rule applies, again, to all distributions which would otherwise be exempt.

Again, it applies only where a distribution is made as part of a tax advantage scheme. This time, the rule applies to any such scheme that involves the payment of a distribution as part consideration for the provision of goods or services (and so applies to defeat schemes designed to replace taxable profits with exempt distributions). It does not apply, however, if the relationship between the parties is such that the transfer pricing rules can apply.

**The Fourth Anti-Avoidance Rule**
The fourth and final general anti-avoidance rule also applies to all distributions that are otherwise exempt and is designed to deny exemption to a distribution made as part of a scheme the purpose of which is to divert the distribution away from a company for which it would have been treated as a trading receipt. In other words, it applies where shares are held as trading stock (in which case, as noted above, the distributions would be taxable) and a scheme is entered into in order to secure that distributions on those shares are received by a company which does not hold the shares as trading stock.

**Electing Out**
Even if a company is satisfied that it can claim exemption for a distribution that it receives, it can elect for that exemption not to apply. That might seem to be a very strange thing to do, but there are two circumstances in which it would make sense.

First, some provisions of some of the United Kingdom’s double tax treaties provide that withholding tax will not be imposed on dividends by the other territory, but only as long as the dividend is subject to tax in the hands of the recipient. It might, accordingly, make more sense for a UK company to elect that a dividend received from such a territory is taxable, in order to avoid withholding tax being imposed upon it.

The other situation in which it might make sense for a company to elect that a distribution that it receives is taxable is if the distribution is received from a controlled foreign company and is paid out of profits earned before 1 July 2009. Such profits would be excluded from the United Kingdom’s CFC charge if they were distributed to a UK resident company which paid tax on them. A UK company might, accordingly, prefer to avoid a CFC charge at a tax on a dividend paid out of those profits.
Conclusion
Most dividends and other distributions will be exempt from UK corporation tax. There is, however, a large amount of unfortunately complex detail that needs to be worked through before it can be verified that any particular dividend or other distribution will be so exempt.

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