International Aspects of The Budget

***Jonathan Ivinson**, Partner and Head of Tax, Hogan & Hartson, outlines the international aspects of the Budget*

The influence of Europe looms large in this Budget. The provisions relating to domestic transfer pricing, cross-border royalty payments, international accounting standards (IAS) and the European Company all owe their existence to EU tax and legal developments. This is likely to be a consistent driver of changes to UK tax legislation, particularly if the European Court of Justice (ECJ) continues its aggressively interventionist approach to perceived discrimination in the field of direct tax and the Commission continues to exploit the resulting uncertainty to press ahead with plans for some form of common European corporate tax system.

The introduction of transfer pricing rules between UK-resident companies owes little to logic and much to recent decisions of the ECJ in cases such as *Lankhorst*, which have thrown into question the legitimacy of the UK's transfer pricing rules in the sense that they only apply to transactions carried out with related parties in other EU Member States and do not apply to purely domestic transactions. In order to preclude any discrimination claims that may arise as a result of this state of affairs, from 1 April 2004 transactions between related UK companies will fall within the transfer pricing rules contained in ICTA 1988, s 770A and Schedule 28AA and such companies will have to prepare and retain supporting documentation in order to justify the pricing policies adopted.

It is difficult to see this as anything other than a pointless distortion of the UK tax system to accommodate the disruptive political agenda of the ECJ. How can UK companies obtain tax advantages by manipulating inter-company pricing when companies broadly pay the same rate of corporation tax and where group relief offers a lawful mechanism for consolidation? Yet, in the midst of the manifest illogic of these proposals, there hides an eminently sensible provision, which allows for an exemption from these rules for small and medium-sized companies, for which the administrative burden imposed by the rules may be disproportionately large. This will apply to companies where, broadly, there are fewer than 250 employees, the annual turnover is less than €50 million or the balance sheet is less than €43 million. This provision is highly significant, because companies which fall into the classification of small or medium-sized will not only be exempt from the rules relating to transactions with a related party resident in the UK but also in relation to transactions with a related party in a territory with which the UK has a double taxation treaty that includes a suitable non-discrimination article. This is very good news for small UK businesses which engage in cross-border, related-party business which have been forced to worry about transfer pricing documentation almost as soon as they have begun to trade. Notwithstanding the rather tortuous method of getting there, this provision provides a welcome degree of certainty to small and medium-sized UK and foreign businesses which enter into related-party transactions.

European legislation, in particular the EU IAS Regulation (EC/1606/2002), accounts for the measures which will be introduced in the Finance Bill 2004 to ensure that companies which adopt IAS for accounting periods beginning on or after 1 January 2005 will receive broadly equivalent tax treatment to companies that continue to use UK generally accepted accountancy practice (UK GAAP). The European rules apply to companies that have issued publicly traded securities and require them to use IAS in their consolidated accounts for accounting periods commencing on or after 1 January 2005. However, the European Commission has proposed that a further Directive be introduced to make the use of IAS compulsory for all statutory audited accounts throughout the EU. Inevitably, this proposal is as much about accounting transparency across borders as preparing the way for a common consolidated tax basis across the Member States. This Budget measure will apply to all companies and therefore anticipates such a further Directive.

The Finance Bill will also include legislation to implement the EU Interest and Royalties Directive (2003/49/EC). Draft legislation has been released on this subject. The Directive took effect on 1 January 2004 and enables a company established in an EU Member State to make payments of interest and royalties to associated companies which are established in other EU Member States without being required to withhold tax at source. Certain treaties between the UK and EU Member States do not provide for the elimination of withholding tax on interest and royalties, so this legislation will be of benefit to UK companies making payments to associated companies in such Member States. The draft legislation entitles companies to make a payment of royalties free of withholding tax if it reasonably believes that the Directive applies. However, in respect of interest payments, the Inland Revenue must first issue an 'exemption notice' following a request by the recipient of the payment to receive the interest gross.

There are, inevitably, further developments relating to the ongoing gestation of the 'European Company' (also known as the 'Societas Europaea'), which is an entity for residents of EU Member States with a presence in more than one EU Member State. These entities will be taxed according to the law of the Member State in which they are resident.

Consequential amendments will be necessary to UK tax legislation in order to allow for their introduction in the UK. The Pre-Budget Report envisaged the publication of draft legislation in the Finance Bill 2004. This has now been deferred until the Finance Bill 2005 in order to allow for proper consultation in the light of other proposed changes to EU legislation – in particular, the Mergers Directive.

There will be much discussion about the introduction of the new disclosure regime for tax avoidance schemes. One lower profile response to tax avoidance announced by the Chancellor involves cross-border cooperation with other tax authorities in order to counter avoidance. The aim is to share information with a view to building a complete picture of complex cross-border transactions. The Inland Revenue is in negotiations with the tax authorities in Australia, Canada and the United States to set up a joint tax force to counter tax abuse.

The other significant international development involves changes to the rules governing the tax treatment of UK residents who invest in offshore investment trusts. These have been the subject of a consultation exercise. The crux of the issue is whether and to what extent the gains of such trusts should be taxed as income rather than capital in the hands of UK residents. Where such funds are structured as collective investment schemes and units are redeemed at net asset value, any gains on the disposal of units in the hands of UK residents are charged to income tax rather than capital gains tax, unless the Inland Revenue certifies that the offshore fund is a 'distributing fund'. The capital gains tax regime is more favourable for such investors, as the classification of the gains of offshore funds as income gains means that the capital gains tax annual exemption and taper relief are unavailable to them in respect of such gains. Under the current rules, to qualify as a distributing fund, such funds must distribute annually at least 85% of the income shown in their annual accounts or, if higher, 85% of their UK equivalent profits. They must also observe certain rules known as the spread of investment rules. Changes will be introduced in the 2004 Finance Bill. Essentially, the new rules permit investors in offshore funds to be charged to tax in the same way an investor in an equivalent UK fund in a wider range of circumstances. In particular, whereas under the existing rules the profits of offshore funds in respect of loan investments are calculated using the accrued income scheme rules, the test for establishing UK equivalent profits will now follow the 'loan relationships' rules, resulting in a more generous treatment. Furthermore, the current spread of investment restrictions will be abolished and each separate sub-fund and share class will be looked at on its own merits and will not be tainted by other non-qualifying sub-fund or share classes within the same fund. The new legislation will apply to the first accounting period of an offshore fund ending on or after the date of Royal Assent.

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Finally, it comes as no surprise that the review initiated in the April 2002 Budget of the residence and domicile rules has not moved beyond the discussion paper stage. In this Budget, the Chancellor announced that the Government continues to consider the responses to the consultation documents and remains determined to proceed 'on the basis of evidence and in keeping with its key principles'. This statement rather suggests an indefinite delay. A consultation document is promised, setting out possible solutions to the question of reform. It looks as if, for the time being at least, common sense has prevailed and the wider economic benefits to the UK of high-net-worth, non-domiciled individuals has outweighed the political capital to be gained from driving such individuals into the arms of more pragmatic, low-tax jurisdictions such as Switzerland.