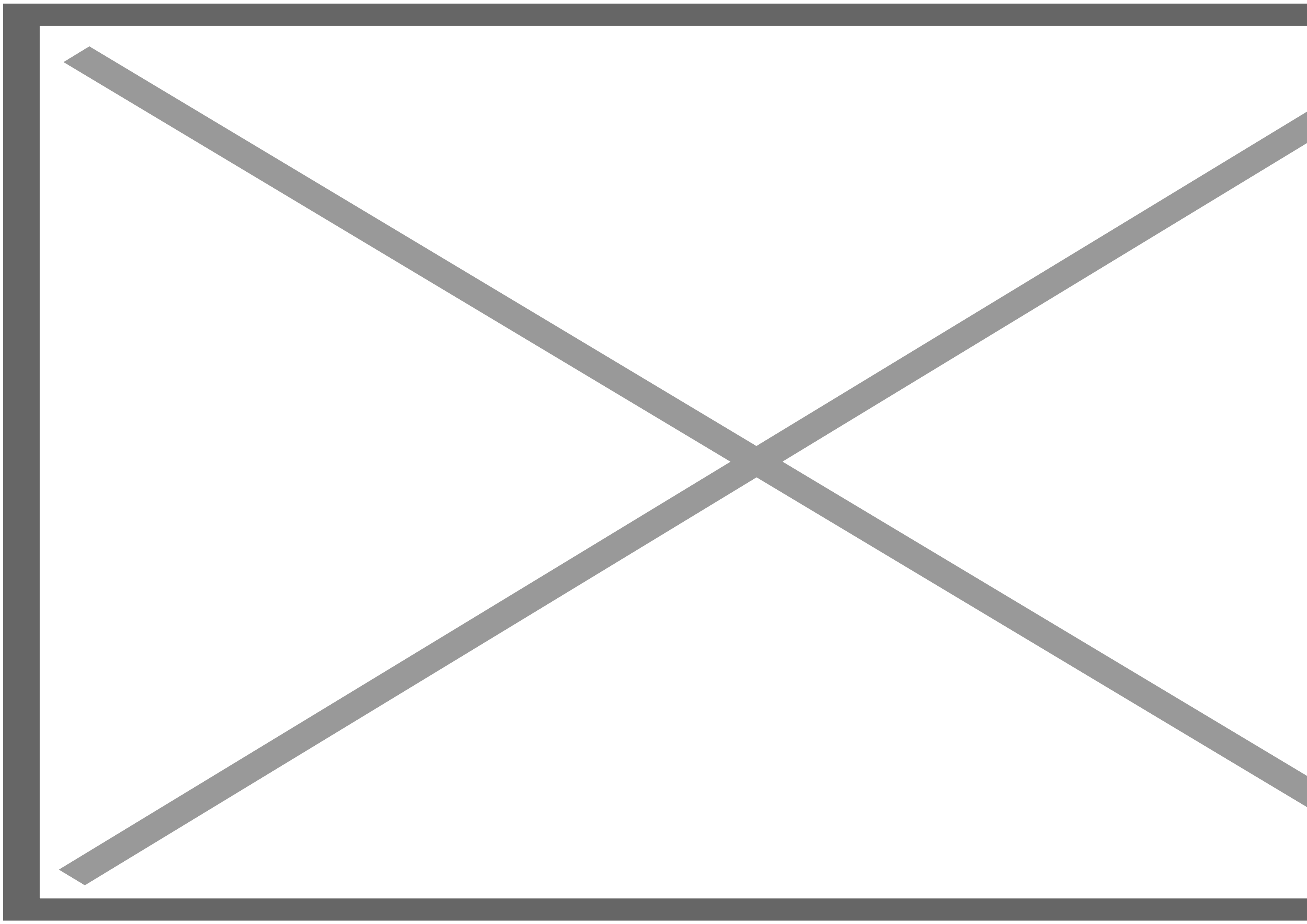
Small or large company?

Large Corporate OMB



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Stuart Pibworth outlines the exemptions from UK corporation tax for company dividends

Key Points

What is the issue?

The applicable conditions for the corporate dividend exemption differ depending on whether the recipient of the dividend is a small or large company.

What does it mean for me?

Care should be taken in (i) determining whether the recipient of a dividend is a small or large company, and (ii) once such determination is made, applying the appropriate conditions for exemption.

What can I take away?

Whether any particular dividend is exempt is a factual question that can only be determined by analysing the specific circumstances at the relevant time.

As tax advisers know only too well, where there are rules there are exceptions; the UK corporation tax treatment of dividends is no different. Dividends received by UK companies (and UK permanent establishments) are subject to UK corporation tax, unless an exemption applies. In practice, it is not always easy to conclude whether that is the case.

‘Small’ or ‘large’ company

The applicable conditions for exemption largely turn on whether the recipient of the dividend is a ‘small company’ or a ‘company that is not small’ (referred to in this article as a ‘large’ company).

A company is small if, in an accounting period, it has: (i) fewer than 50 employees; and (ii) an annual turnover and/or a total balance sheet not exceeding €10m (known as the ‘ceilings’). If either limb is not met (or if, at any time in the period, the entity is an open-ended investment company, authorised unit trust, insurance company or friendly society) the company will be large.

When applying the ceilings, the figures of the company must be aggregated with those of its so-called partner, or linked, enterprises, which would include subsidiaries and some joint ventures. In practice, such aggregation may make an otherwise small company large.

HMRC takes the view that, if a company goes over (or falls below) the ceilings in a given period, generally its status will not change (from small to large, or vice versa) until the position is repeated for a second consecutive year. This simplifies situations in which there are temporary fluctuations that would otherwise change the status of the company.

Small company exemption

Dividends received by small companies will be exempt if:

- at the time the dividend is received the payer is resident only of the UK or a qualifying territory. This is defined as a jurisdiction with which the UK has a double taxation treaty (DTT) containing an appropriate non-discrimination article – INTM412090 lists DTTs that HMRC regards as containing such articles;
- no deduction is allowed to any resident of a non-UK territory under the laws of that territory in respect of the dividend;
- the dividend does not fall within CTA 2010 s 1000(1) para E or F; and
- the dividend is not made as part of a tax advantage scheme (broadly, a scheme a main purpose of which is to obtain a more than negligible tax advantage).

Difficulties can arise when applying the first condition to dividends from non-UK payers:

- For these purposes residence is narrowly defined. A payer will be resident of a territory if, under local law, it is liable to tax by reason of its domicile, residence or place of management but not in respect only of income from sources there or capital situated there. Therefore, even if the payer is treated as resident of that territory under local law it still may not be considered resident for these purposes.
- Dividends received from dual-resident payers will not be exempt. This condition may be relevant if the payer is resident of one territory by reason of incorporation but resident of another by reason of being centrally managed and controlled from there (although a 'tie breaker' article in an applicable DTT may help).
- Treasury regulations provide that specified territories are not 'qualifying territories' for these purposes (even if they otherwise would be) in respect of any payer that is denied treaty benefits under the DTT. INTM652020 provides a list of these territories as at 31 January 2011. For example, let's say the payer is a holding company established under the Luxembourg 1929 Act. Although Luxembourg would ordinarily be a qualifying territory (as the UK-Luxembourg DTT contains an appropriate non-discrimination article), dividends received from the company would not be exempt because it is denied treaty benefits.

Care should also be taken when applying condition 2. This condition is not restricted to deductions for the payer. In addition, HMRC considers the concept of deduction to be broad and not necessarily limited to any deduction allowed in computing net profit for tax purposes.

There is an additional small company exemption which generally applies to dividends paid by a controlled foreign company (CFC) out of profits that are chargeable profits of such CFC in respect of which a UK CFC charge has arisen, provided also that conditions 2, 3 and 4 are met (the CFC exemption). Therefore, the CFC exemption ensures that a small company is not subject to both a UK CFC charge and UK corporation tax on dividends received from the CFC, in effect on the same CFC profits.

Large company exemption

Dividends received by large companies will be exempt if:

1. the dividend falls into an exempt class;
2. the dividend does not fall within CTA 2010 s 1000(1) para E or F; and
3. no deduction is allowed to any resident of a non-UK territory under the laws of that territory in respect of the dividend (see comments above).

Compared with the 'small' company exemption, two differences are apparent:

- there is no payer residence condition. Therefore, dividends paid by a payer resident of a non-qualifying territory, say Bermuda, to large companies would be exempt (if the conditions are met); the same dividend would be exempt for small companies only if the CFC exemption applied; and
- there is no general disapplication of the exemption if the dividend forms part of a tax advantage scheme (see below).

The exempt classes cover dividends:

from controlled companies (as defined under the UK CFC rules);

- on non-redeemable ordinary shares (the ordinary share class);

- from portfolio holdings (broadly, those in which the recipient has a less than 10% interest in the issued share capital, assets and profits);
- out of profits available for distribution that do not result from transactions, the effect and a main purpose of which is to achieve a more than negligible UK tax reduction; and
- on shares accounted for as liabilities and taxable as loan relationships.

Although fact-dependent, dividends received in most commercial arrangements will usually fall within an exempt class.

Practical difficulties may arise when considering the application of the ordinary share class when a non-UK payer does not have ordinary share capital (as that term is used for these purposes) albeit it has something comparable to it (say, a German GmbH). In these circumstances HMRC accepts that, if the capital of the non-UK payer exhibits characteristics that are analogous to ordinary share capital, dividends arising from it may fall within the ordinary share class.

Finally the anti-avoidance provisions should not be overlooked. The large company exemption includes anti-avoidance provisions, both targeted (aimed at specific exempt classes – TAAPs) and general (applicable to all exempt classes – GAAPs). When a dividend falls within a TAAP, only the relevant exempt class is disapplied; the dividend may still fall within another exempt class. Conversely, if a dividend falls within a GAAP the dividend will be taken out of all exempt classes. Unlike the small company exemption, the application of a GAAP does not turn solely on the ‘tax advantage scheme’ concept but requires something else, such as payment for dividends. The more nuanced approach to anti-avoidance under the large company exemption may have the practical consequence that a dividend that falls within the small company anti-avoidance provisions (and is taxable) would not fall within the large company anti-avoidance provisions (and may be exempt).

Election to tax

Although generally welcomed, in some circumstances the dividend exemption may have unintended adverse consequences, particularly for groups. For instance, the dividend exemption may restrict access to reduced withholding tax rates on dividends under a DTT if the rates are conditioned on a ‘subject to tax’ requirement, as is the case in the UK-Russia DTT. In these circumstances, depending on factors including the foreign tax rates and the UK corporation tax rate, it may be more efficient overall to incur UK corporation tax on the dividend than be subject to the increased foreign withholding tax.

To remedy unintended adverse consequences, the recipient may elect to tax a dividend that would otherwise be exempt. This must be made on or before the second anniversary of the end of the accounting period in which the dividend is received.

Conclusion

The dividend exemption is far from straightforward. Advisers should not fall into the trap of assuming that the exemption is available simply because it was anticipated that it would be available when the structure was established or that it was available for previous dividends paid by the same payer to the same recipient. Whether any particular dividend is exempt is a factual question that can be determined only by analysing the specific circumstances at that time.