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ECONOMIC DEVELOPMENT OF UNDER-DEVELOPED COUNTRIES  
INTERNATIONAL TAX PROBLEMS

Taxation in Capital-Exporting and Capital-Importing Countries of  
Foreign Private Investments.

United Kingdom Taxation of Private United Kingdom Investments Abroad.\*

- \* This study is the third in the series of country studies the first two of which, dealing with the Netherlands and Belgium, were issued as documents E/2865/Add.1 and 2 respectively.

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# Table of Contents

	<u>Page</u>
<u>Part One.</u> General Survey of Taxes on Income and Profits . . . . .	5
Chapter I. Income Tax . . . . .	5
A. Taxpayers and Rates . . . . .	5
1. Standard Tax . . . . .	5
2. Surtax . . . . .	6
B. Taxable Income . . . . .	6
1. Scope of Income Concept . . . . .	6
2. Net Income . . . . .	7
C. Tax Year and Basis Period . . . . .	7
1. Tax Year . . . . .	7
2. Basis Period . . . . .	8
D. Taxation at Source . . . . .	9
E. The Schedules . . . . .	10
F. Business Income . . . . .	11
1. Accounting Period . . . . .	11
2. Accounting Method . . . . .	11
3. Deductions . . . . .	11
4. Losses . . . . .	12
G. Corporate Income and Dividends . . . . .	12
1. In General . . . . .	12
2. Grossing-up . . . . .	13
3. Inter-corporate Dividends . . . . .	14
4. Surtax on Undistributed Earnings of Closely Held Corporations . . . . .	14
Chapter II. Profits Tax . . . . .	15
A. In General . . . . .	15
B. Taxable Profits . . . . .	15
C. Resident and Non-Resident Corporations . . . . .	16

/...

Table of Contents (continued)

	<u>Page</u>
Part Two. Principles of Taxation of Income from Foreign Activities and Investments . . . . .	17
Chapter I. Introduction . . . . .	17
Chapter II. Residence . . . . .	17
A. In General . . . . .	17
B. Rules against Company Emigration . . . . .	18
Chapter III. Income from Foreign Activities and Investments . . . . .	19
A. In General . . . . .	19
1. Foreign and Domestic Income . . . . .	19
2. Concept of Foreign Income . . . . .	20
B. Foreign Income Taxed when Remitted to the United Kingdom . . . . .	20
1. Income to which Remittance Basis May Apply . . . . .	20
2. Situations in which Remittance Basis Applies . . . . .	21
3. Taxable Income where Remittance Basis Applies . . . . .	22
4. Conclusion . . . . .	23
C. Foreign Income Taxed on the Arising Basis . . . . .	23
1. In General . . . . .	23
2. Deductions . . . . .	23
(a) Foreign Mining Operations . . . . .	24
(b) Foreign Plantations . . . . .	24
(c) Depreciation Allowances . . . . .	24
(d) Foreign Income Tax . . . . .	25
(e) Annual Interest, etc. . . . .	25
D. Overseas Trade Corporations . . . . .	25
E. Foreign Currency and Blocked Income . . . . .	27
1. Foreign Currency . . . . .	27
2. Blocked Foreign Income . . . . .	27
<u>Part Three.</u> Relief from International Double Taxation: Credit for Foreign Taxes . . . . .	29
Chapter I. Credit under International Agreements and under United Kingdom Law . . . . .	29

/...

Table of Contents (continued)

	<u>Page</u>
Chapter II. Scope of Credit . . . . .	31
A. Persons Entitled to Credit . . . . .	31
B. Foreign Taxes which are Creditable . . . . .	31
C. United Kingdom Taxes against which Credit is Allowable . . . . .	32
D. Credit for Tax Paid Directly or Indirectly . . . . .	32
Chapter III. Computation of Credit . . . . .	33
A. Credit for Tax Paid Directly . . . . .	33
1. In General . . . . .	33
2. Limit on Credit . . . . .	33
B. Credit for Tax Paid Indirectly . . . . .	38
1. When Available: Credit to Shareholders for Foreign Tax Paid by Corporation . . . . .	38
2. Limit on Credit . . . . .	39
<u>Part Four.</u> Effects of Form of Foreign Business Operations on Taxation . . . . .	44
Chapter I. In General . . . . .	44
Chapter II. Foreign Branch . . . . .	45
Chapter III. Subsidiary Controlled in the United Kingdom (Resident Subsidiary) . . . . .	46
Chapter IV. Subsidiary Controlled Abroad (Non-Resident Subsidiary) . . . . .	48
Chapter V. Overseas Trade Corporation . . . . .	49
Chapter VI. Direct Ownership of Resident Foreign Trading Corporation . . . . .	51
Chapter VII. Direct Ownership of Non-Resident Foreign Trading Corporation . . . . .	52
Chapter VIII. Conclusion . . . . .	53
APPENDIX I. List of General Income Tax Agreements to which the United Kingdom is a Party	
APPENDIX II. List of the Countries of the Commonwealth with a System of Direct Taxation	

## Part One

### GENERAL SURVEY OF TAXES ON INCOME AND PROFITS

There are two distinct taxes on income and profits in the United Kingdom: the income tax, which affects both individuals and corporations, and the profits tax, which is imposed on corporations only. Residents - including resident corporations regardless of the place of incorporation - are taxable on their worldwide income, but credit is given for foreign tax on their foreign income; non-residents pay tax on income derived from sources in the United Kingdom only.

## Chapter I

### Income Tax

The law of income tax is laid down in the Income Tax Act of 1952 as amended; the tax is imposed annually by the Finance Acts at the rates provided in those Acts.

The law provides for two sets of rates of income tax equally applicable to all types of taxable income, namely the standard rate and the surtax rate. The income tax may be thus thought of as composed of two taxes, the flat-rate standard tax and the progressive surtax. The term "income tax" is often used where the standard tax alone is meant; in this paper the term will include both standard tax and surtax.

#### A. Taxpayers and Rates

##### 1. Standard Tax

Standard tax is levied at a flat rate (currently 42.5 per cent).<sup>1/</sup>

In the case of individuals, however, the first £140<sup>1/</sup> is deductible from income by way of personal allowance. Further reliefs include allowances in consideration of the taxpayer's family status, small income allowances, life insurance premium allowances, etc.: a special deduction is given for earned income and a special allowance is given to those who are more than 65 years of age. Finally, provision is made for reduction of the tax on the lowest £360 of taxable income remaining after allowances, with the result that the effective rate on individuals is graduated at the lower level.

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<sup>1/</sup> These are the rates and allowances in force for the year ended 5 April 1958.

Standard tax is imposed at the full 42.5<sup>1/</sup> per cent rate on the income of corporations, but shareholders in effect receive a credit for this tax against the tax they may owe on dividends received from a corporation which has paid the tax (section G below).

## 2. Surtax

Only individuals are subject to surtax: this tax is levied on individual incomes of more than £2,000 but as from 1957/8 certain personal allowances are deductible in arriving at the net income to be taxed. The tax is a graduated tax, the rates of which progress from 10 per cent on the first £500 above £2,000 to 50 per cent on the amount of income above £15,000. There are certain differences in the definition of taxable income subject to surtax and taxable income subject to standard tax, so that the two taxes must be separately computed. Neither tax is deductible from income in computing the other. The aggregate rate of income tax on any slice of income above £2,000 will therefore be the sum of the standard rate and of the surtax rate applicable to that slice. The top aggregate rate is thus 42.5 per cent plus 50 per cent, or 92.5 per cent on the excess of income over £15,000.

## B. Taxable Income

Calculation of the tax base for the purpose of standard tax and surtax, as well as determination of the period with respect to which income is computed in order to determine the amount subject to tax, is highly complex. Sections B - G set forth the basic principles and concepts, in so far as they are relevant to the subsequent discussion of the taxation of income from foreign investments.

### 1. Scope of Income Concept

The term "income" is nowhere defined in the statutes and is but loosely defined in the court decisions. Instead, the law lists in so-called "schedules"<sup>2/</sup> certain described types of income (interest, rents, annuities, etc.) and income from certain designated sources (trades, professions, employments, securities, etc.) which are subject to tax. Thus, not all benefits which might be considered

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<sup>2/</sup> The "schedules" serve only to provide the rules for defining and computing different categories of taxable income: as noted above, the rates are the same for all categories of income, and the tax is calculated for all income as a whole.

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as income, in a generic sense, are subject to tax, but only the types of income set out in the schedules. The schedules are discussed in section E below.

Capital gains are in principle not subject to income tax. With but a single exception (proceeds of the sale of patent rights), neither gain realized nor loss sustained through the sale or exchange of capital assets otherwise than in the course of a trading activity will be taken into account in computing taxable income. This applies even to gains made on the sale of fixed business assets in excess of their original cost (section F below). Yet in practice the effect of this principle is somewhat limited by the fact that dealing in property may be considered as "trading" for tax purposes in a number of situations in which the taxpayer would not be considered as engaged in the business of dealing in such property in the ordinary sense of the word.

## 2. Net Income

It is not a general principle of the law of income tax that only net income is taxable. It is rather the theory that the tax is imposed on the full amount of the income defined in the schedules, with such deductions as are expressly or implicitly allowed by the statutes. A general allowance for expenses is provided only in the case of income from business and professions (section F below) and, though within narrower limits, in the case of income from employment.

## C. Tax Year and Basis Period

### 1. Tax Year

The income tax is imposed annually by the Finance Act and is charged on the income for a designated "year of assessment" (herein called "tax year"). Each tax year begins on 6 April and ends on the succeeding 5 April, and all material determinations of time are made by reference to that year. Thus rates are applicable to that period and any change of rate takes effect on 6 April; the determination of whether an individual was married or single, whether an exemption for dependents is available, etc., is made by reference to the status as it existed during the 6 April - 5 April period. The tax year is usually identified by reference to the two calendar years which it encompasses, viz. the 6 April 1955 - 5 April 1956 tax year is referred to as the 1955-56 year.

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## 2. Basis Period

The basis period is the year (or other period) with reference to the income of which the tax liability is determined. Certain categories of income are taxable on the "current year basis", that is by reference to the amount earned during the current tax year, and other categories are taxable on the "preceding year basis", that is by reference to the amount earned in the preceding tax year. The categories of income which are the subject of this paper are all taxed on the preceding year basis except income from employment. In the case of business income it is not normally necessary to determine the income earned between the 6 April - 5 April dates, because, if proper books are kept, the income for the accounting period of the business ending within the preceding tax year is used. In all other cases where income is taxed on the preceding-year basis, tax is measured by the actual income for the period 6 April - 5 April which immediately precedes the current tax year.

Since assessment on the preceding-year basis would prevent any tax from being assessed in the year in which income is first received, the assessment of income normally taxed on the preceding-year basis is made on the current year basis in the first year in which the taxpayer earns income from the source in question. There are complex provisions (the so-called commencement provisions) for effecting the transition to the normal preceding-year basis; this transition is completed by the third year. A similar problem exists when income ceases, since it has been held that income cannot be assessed on the preceding-year basis in a year where the taxpayer no longer possesses the source of that income. Again special provision is made to assess the income of the last year and in certain circumstances the penultimate year on the current year basis instead of on the preceding year basis. As a result of the commencement provisions, all or part of the income of one accounting year may enter into the basis of assessment for more than one tax year, while in the case of discontinuance, all or part of the income of one or more accounting years may not enter into the basis of assessment at all.

These provisions are of more than purely technical significance: due to their operation, the timing of starting a business, of the dissolution of a corporation, the discontinuance of a business or the disposition of an investment have material tax consequences; these consequences extend i.a. to the availability of credit for foreign taxes (Part Four, Chapter III).



D. Taxation at Source

For reasons of administrative convenience and for the security of the revenue, certain types of income are not subject to direct assessment in the hands of the recipient. Instead tax is deducted at source. Upon payment of annual interest, rents, annuities and certain other annual payments the law gives the payer the right to deduct income tax at the standard rate when he makes the payment. (For the special treatment of dividends see Section G below.)

In some cases, the payor is required to withhold standard tax from the payment and to remit the tax withheld to the Government. In other cases substantially the same result is achieved through a different procedure; the payor is not allowed to deduct the payments from his income for standard tax purposes, even though these payments are otherwise in the nature of deductible expenses;<sup>3/</sup> the payor has, however, the right to reimburse himself for his resulting extra tax by deducting and retaining standard tax from the payment. In both cases the payment is not charged to standard tax in the hands of the recipient, who may in fact be entitled to a refund on account of family and related allowances which are deductible from standard tax.<sup>4/</sup>

Broadly speaking, under this system of taxation at source, the tax burdens ultimately sustained respectively by the payor and the recipient of the income are the same as if the payments had been charged solely in the hands of the recipient. Thus, the payor's right to deduct tax at standard rate from the payment has the same result as if the payment were deducted from his taxable income subject to standard tax. As to the recipient, the payments are treated as his income, but of course at their original gross amount before deduction of the standard tax.

The emphasis in this paper will be on the tax finally borne, and the method of collection, whether at source or otherwise, will be noted only where it is necessary to an understanding of the provisions under discussion.

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<sup>3/</sup> He may however deduct the payments for surtax purposes.

<sup>4/</sup> In effect the recipient is in the same position as if he were credited with the amount of the standard tax already paid on the income, so that - depending on his family status and total income level - he will either receive a refund from the standard tax pre-paid or owe surtax in addition.

Side by side with the above "taxation at source" rules, which are of old standing, there is a set of more recent provisions under which the standard tax of employees is withheld from wages and salaries and paid to the Government on a current basis. The tax withheld under this "pay as you earn" system, however, is not at the flat standard rate, but is calculated closely in accordance with each wage earner's standard tax obligation as determined by his total income, family status, etc. This withholding system does not affect the allowance of wages as deductible expenses from the employer's taxable business income.

E. The Schedules

For income to be subject to tax, it must be of a type described in one of five "schedules" set forth in the Income Tax Act. The rules which are applicable in the taxation of any particular type of income are determined by reference to the schedule within which that type falls. These rules relate to the taxable year in which the income will be assessed, the person upon whom the assessment will be made, availability of deductions for expenses, losses, etc., and other matters material to determination of tax liability. It is thus necessary in considering any tax question to determine first whether the income falls within any of the five schedules, and, if so, to determine which schedule applies. The rate of tax is uniform under all schedules.

The five schedules and the six "cases" into which Schedule D is subdivided may be summarized as follows:

- Schedule A Income from the ownership of real property in the United Kingdom
- Schedule B Income from the occupation of restricted classes of immovable property in the United Kingdom
- Schedule C Income in the nature of interest, annuities, etc., paid in the United Kingdom by a domestic or foreign Government
- Schedule D The schedule is divided into six cases which encompass the following classes of income:
  - Case I Profits of trades and businesses
  - Case II Profits of professions and vocations
  - Case III Interest, annuities, royalties and other periodic payments
  - Case IV Income arising abroad from secured obligations

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Case V     Income arising abroad from all other property  
              and from all transactions and activities (other  
              than employment) deemed to have a foreign source

Case VI    Casual and miscellaneous profits

Schedule E   Income from employment.<sup>5/</sup>

Only Schedules D and E are of importance for this study: income from foreign business and investments is included in Schedule D<sup>6/</sup> and income from foreign employment in Schedule E. It should be noted that, in spite of its general language, Case V of Schedule D includes only a very limited range of foreign business activities: all foreign income derived from a trade or business managed and controlled in the United Kingdom is included under Case I (Part Two, Chapter III).

F.    Business Income

1.    Accounting Period

Income from business is normally assessed on the basis of the profits of the accounting year ending within the preceding tax year, and any fiscal year of twelve consecutive months adopted by the taxpayer will be taken as the accounting year (Section C.2 above).

2.    Accounting Method

Income and expenses of trades and businesses are generally accounted for on an accrual basis and are determined in accordance with generally accepted principles of commercial accounting.

3.    Deductions

In general a deduction is allowed for "any disbursements or expenses ..... wholly and exclusively laid out or expended for the purpose of"<sup>7/</sup> earning the profits of the business, provided the expenditure does not bring into existence a capital asset.

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<sup>5/</sup> This Schedule is divided into three cases which however serve mainly to differentiate between the tax treatment of income from domestic and from foreign employment (Part Three, Chapter III, B).

<sup>6/</sup> Except that interest from foreign government securities (payable in the United Kingdom) is classified under Schedule C.

<sup>7/</sup> Schedule D, Section 137 of the Income Tax Act of 1952.

Depreciation of industrial buildings and structure is allowed at the rate of 2 per cent per annum of the expenditure on the asset ("straight line method"). Depreciation of machinery and equipment used in a business is allowed at a rate determined by the asset's estimated useful life; normally this depreciation is calculated as a percentage of the expenditure reduced by depreciation already taken ("declining balance method"), although the straight line method may be used if the taxpayer so chooses. Correspondingly, where the price received for the asset shows that the depreciation was excessive or insufficient, a balancing item in the corresponding amount will be charged or allowed against the tax liability of the year of disposition of the asset. Consistent with the principle of non-taxability of capital gains, however, the excess of the price realized over the sum of the written-down value plus the depreciation previously allowed or allowable will not be taxed.

Depreciation allowances are also available in other cases, including scientific research facilities, patents, mineral exploration and development expenses. Provision is also made in certain cases for accelerated depreciation and for investment allowances which are granted in addition to full depreciation. Depreciation allowances are generally available on equal terms for domestic and foreign assets (except for special allowances in connexion with overseas mineral deposits).

#### 4. Losses

Business losses may be set off against profits earned during the same basis in another business operated by the same taxpayer or against income from any other source whatsoever which is assessed for the same or the next succeeding tax year with respect to which the loss was incurred. Alternatively, losses may be carried over into succeeding years until exhausted, but only against profits of the same business (not against any other income).

### G. Corporate Profits and Dividends

#### 1. In General

Resident corporations are subject to standard tax on their income. This tax is deemed to satisfy all standard tax liability with respect to the corporate earnings (though dividends remain includible in income subject to surtax). Shareholders receiving dividends from resident corporations are thus not charged

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to standard tax thereon and may be entitled to refunds on account of family and other allowances. The result is substantially the same as if the recipient included the gross dividend in his income subject to standard tax and then received credit for the amount of tax which the corporation was entitled to deduct from its dividend payment. It should be understood that the rate of standard tax thus "credited" to the stockholder is not necessarily that which the company actually paid on its own income, but rather that which prevails in the year the dividends are distributed and which is actually deducted from them; these rates may of course differ, where a dividend is paid out of past profits earned in a year where a different rate prevailed. The actual income tax paid by the company affects the stockholder's standard tax liability, only where the company has paid less than standard tax, due to the deduction of a credit for foreign taxes against its United Kingdom tax on foreign profits. In that case the stockholder, while continuing to gross-up his dividend by the full amount of the prevailing standard rate, can nevertheless not secure a refund (on account of personal and other allowances) in excess of the income tax actually paid by the company since otherwise the Government would in effect "refund" tax money received not by it but by the foreign Government.

Dividends received by a resident of the United Kingdom from a corporation not resident in the United Kingdom are subject to standard tax (and in the case of individual recipients also to surtax), since the non-resident corporation normally does not bear standard tax. However a United Kingdom shareholder who received an ordinary dividend from a non-resident company out of profits which have borne United Kingdom income tax, may claim relief on the "appropriate fraction" of such dividend. The "appropriate fraction" is that fraction of the profits (out of which the dividend is deemed to be paid) on which United Kingdom income tax has been paid. The relief does not operate to reduce the shareholder's total income and accordingly has no application to surtax.

## 2. Grossing-up

A resident corporation may deduct the standard tax from its declared dividend and pay it out "with tax deducted" or it may declare a dividend "free of tax", in which case the shareholder is paid the full amount of the dividend declared.

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In either case the dividend deemed to have been received by the shareholder is the "grossed-up" amount of the dividend, i.e. the sum which, after deduction of standard tax at the current rate, leaves an amount equal to the net dividend he actually received.<sup>8/</sup> The grossed-up dividend is included in income subject to surtax; it is also used to determine eligibility for refunds on account of the standard tax in the case of individuals who owe less than the full rate due to entitlement to personal allowances or other reliefs.

### 3. Inter-corporate Dividends

Since corporations are not subject to surtax, the fact that dividends from resident corporations are not charged to tax in the hands of the recipient results in corporations' owing no income tax at all on the dividends received from resident corporations.

### 4. Surtax on Undistributed Earnings of Closely Held Corporations

As a rule, shareholders are not liable to surtax on the earnings of corporations unless these earnings are distributed to them in the form of dividends. The Income Tax Act, however, seeks to prevent the avoidance of surtax providing that unreasonable accumulations of profits by closely held corporations may be apportioned to the shareholders and assessed to surtax accordingly. This assessment is made on the shareholders, but if any shareholders do not pay the tax, the corporation must pay it without right of recoupment from the shareholders.

These provisions apply to corporations incorporated in the United Kingdom which are controlled, directly or through other corporations by not more than five persons, unless the ordinary shares of such corporation are quoted and traded on a stock exchange in the United Kingdom and at least 25 per cent of the voting power is held by the general public.

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<sup>8/</sup> Thus a net dividend of 57.5 when grossed-up represents taxable income of 100, on which standard tax of 42.5 has been paid. The formula for grossing-up is  $\frac{100}{100 - r} \times N = G$ , where  $r$  is the tax rate,  $N$  the net amount to be grossed-up and  $G$  the gross-up amount.

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## Chapter II

### Profits Tax

#### A. In General

Only corporations are subject to the profits tax which, when it assumed its present form in 1947, was said to be designed to serve three main purposes: to raise revenue to replace the disappearing excess profits tax; to encourage companies to plough back profits rather than distribute them; and to do rough justice in an inflationary situation as between persons living on fixed interest bearing securities whose incomes might have fallen, and equity shareholders who had not suffered that disadvantage. To this end the basic tax rate of 30 per cent is reduced, by so-called "non-distribution relief", to 3 per cent on the undistributed portion of the profits. The tax is imposed on profits from trade or business, but this term includes also the operations of investment and finance companies. Exemption is granted when the profits, including investment income, do not exceed £2,000 and an abatement which is given by way of a deduction from the chargeable profits is granted where the profits, including investment income, are less than £12,000.

The profits tax had its origin as the National Defence Contribution in the Finance Act, 1947. It was then a flat-rate tax on profits excluding investment income. Major modifications which increased the rate of tax, provided for relief in respect of undistributed profits and brought investment income within the charge, were introduced by the Finance Act, 1947.

#### B. Taxable Profits

Profits tax is normally charged on the profits of the twelve-month accounting period adopted by the corporation. The charge is at 30 per cent, but relief is given in respect of so much of the chargeable profits as are not distributed. In determining what profits have been distributed the general rule is to attribute to an accounting period such dividends (declared within six months after the end of the accounting period) as are expressed to be paid in respect of that period. Other dividends or distributions are related to the accounting period in which they are paid. Special rules apply on cessation of trade or in liquidations. Non-distribution relief is withdrawn by a distribution charge whenever the distributions related to a chargeable accounting period exceed the profits chargeable for that period.

The profits subject to profits tax are determined largely in the same manner as is business income subject to income tax (Chapter I, section F.2-4 above). The taxable profits include investment income except for so-called "franked investment income", i.e. dividends received directly or indirectly from corporate bodies which are themselves subject to profits tax. The result is that ordinarily dividends received from resident corporations are not charged to profits tax.

Income tax is not deducted in determining profits for profits tax purposes; nor is profits tax deductible from income subject to income tax. Thus, the basic 3 per cent profits tax is due on the total profits (before deduction of income tax). The additional 27 per cent profits tax on distributed profits, however, is payable only on that part of the profits which is allocated to gross dividends, before deduction of income tax, or other relevant distributions. To illustrate, a company earning profits of 100 will owe income tax of 42.5 and basic profits tax of 3; if any part of the remaining 54.5 is to be distributed as dividends, the additional 27 per cent profits tax will be calculated on the gross amount of these dividends (including income tax). In the instant case, the maximum amount of net dividend that could reach the stockholders out of the 54.5 would be 37.1, since the remaining 17.4 are absorbed by the grossed-up<sup>9/</sup> profits tax (27 per cent on 64.5, the amount corresponding to 37.1 at the 42.5 per cent income tax rate).

C. Resident and Non-resident Corporations

Resident corporations pay profits tax on their world-wide profits, except that established Overseas Trade Corporations are exempt from profits tax on their trading profits (Part Two, Chapter V). Corporations which are not resident in the United Kingdom pay the tax on profits from business carried on in the United Kingdom. In view, presumably, of the anti-inflation function of the tax, for which foreign distributions are not directly relevant, and of the provisions of double taxation agreements, non-resident corporations benefit from the reduced 3 per cent rate on all such profits regardless of distribution. This benefit is extended to resident corporations, one half of whose voting power is controlled by a non-resident corporation.

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<sup>9/</sup> Section 2 above.

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## Part Two

### PRINCIPLES OF TAXATION OF INCOME FROM FOREIGN ACTIVITIES AND INVESTMENTS

#### Chapter I

##### Introduction

This part discusses the general rules of taxation of income which persons resident in the United Kingdom derive from activities and investments outside the country; it does not deal with such special rules as those applicable to resident insurance companies doing business abroad or to international shipping and air transport enterprises.

The basic pattern of United Kingdom taxation of foreign income of residents is that a resident of the United Kingdom is taxable on all income, whether derived from activities carried on inside or outside the United Kingdom and from foreign as well as domestic investments. The income of a resident derived from abroad is taxable whether or not remitted to the United Kingdom, except for the limited cases of taxation on a remittance basis discussed in Chapter III, B below.

If a resident derives foreign income which is earned in foreign currency and which is unremittable because of exchange restrictions, the taxpayer may elect to defer tax on this income until such time as it becomes remittable (Chapter III, D, below).

#### Chapter II

##### Residence

###### A. In General

Residence in the United Kingdom is the sole factor which causes the taxpayer to be taxable on his total world income. Other factors, such as domicile or citizenship are irrelevant for this purpose.<sup>10/</sup> The rules for determining residence, as they relate to the principal classes of taxpayers, may be summarized as follows:

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<sup>10/</sup> But these factors may determine whether certain foreign income is to be taxed only when remitted to the United Kingdom (Chapter III, B, below).

An individual is resident in the United Kingdom if he maintains an abode there and visits the country (unless he is in full time overseas employment etc.) during the year or if he is present in the country for six months in the tax year, or if he makes habitual visits of substantial duration.

A corporation is resident wherever its central control and management are located. The situs of control and management is determined primarily on the basis of the place where the directors meet and do business, rather than the place of shareholders' meetings or the place of incorporation.

Financial control is thus not a decisive criterion, so that subsidiary corporations, even if wholly owned, are not necessarily resident in the place where the parent corporation resides. A foreign subsidiary of a corporation resident in the United Kingdom will be considered as non-resident if it has its own board of directors (or even if it shares directors with its parent) by whom the central control and management is exercised at meetings held overseas. If, however, the facts are such that it can be shown that the central control and management is exercised other than at such meetings a subsidiary may in certain circumstances be held to be resident in the United Kingdom.

#### B. Rules against Company Emigration

Since 1951 it has been unlawful for a resident corporation without Treasury authorization to engage in certain transactions which result in changing its status to that of a non-resident corporation.<sup>11/</sup> This prohibition is intended to prevent those "company emigrations" which are designed to avoid United Kingdom tax on foreign income rather than to serve legitimate business purposes.

The following transactions are unlawful without approval, and severe penalties are imposed on any person who knowingly participates therein without such approval:

1. Any transaction which causes a resident corporation to become non-resident, such as the transfer of the central management and control abroad.
2. The transfer of any part of the trade or business of a resident corporation to a non-resident individual or corporation.
3. The issue of shares or debentures by a non-resident corporation over which a resident corporation has control.

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<sup>11/</sup> Section 468 of the Income Tax Act of 1952.

4. The transfer by a resident corporation of shares or debentures which it holds in a controlled non-resident corporation.

The Treasury may give its consent to these transactions upon application and has published general consent to a number of classes of transactions which it regards as not promoting tax avoidance. For example, a new corporation which is formed for the purpose of carrying on a new business may be incorporated in the United Kingdom and so organized that its central management and control will be situated abroad, without obtaining special Treasury consent, while an existing foreign business which is resident controlled cannot be transferred to foreign control without such consent.

### Chapter III

#### Income from Foreign Activities and Investments

##### A. In General

##### 1. Foreign and Domestic Income

Residents are taxable on their world income. There is no special schedule for foreign income in the law: different types of foreign income are included in different schedules and are treated in accordance with this classification. It is true that Cases IV and V of Schedule D deal exclusively with income from foreign investments and from certain activities carried on abroad, and that such income is subject to special rules (e.g. for taxation on remittance basis, see section B below); but Cases IV and V do not by far include all income which might be considered as of foreign origin in a general sense. In particular, Case I of Schedule D covers all income from a business managed and controlled in the United Kingdom, and thus includes income from operations conducted entirely abroad by such a business and involving assets located exclusively abroad. This Chapter thus deals with all income which might be called foreign income in a general sense by reason of its being derived from foreign investments and activities; it does not limit itself to income from foreign sources in the technical sense of being included in Cases IV and V of Schedule D.

## 2. Concept of Foreign Income

The concept of taxable income is the same for foreign income as for comparable domestic income (Part One, Chapter I,B). Consequently, capital gains and repatriation of capital from abroad are not taxable. The distinction between capital and income from foreign sources is the same as that made with respect to domestic transactions. As an exception, dividends from foreign sources are treated as income even though declared out of capital or even though the declaring corporation may have had no income from which the dividend could be paid: such dividends paid by a resident corporation would represent non-taxable capital receipts. On the other hand, distributions usually received in liquidation of a foreign corporation or in redemption of part of its shares are not taxable, except in the hands of a financial dealing concern.

### B. Foreign Income Taxed when Remitted to the United Kingdom

In most cases income from a foreign source is taxed as it arises whether it is remitted to the United Kingdom or not. Such income is said to be taxed on the arising basis. Profits tax is always charged on the arising basis.

In certain situations, however, income from foreign sources is taxed on the remittance basis, that is, only the amount remitted to the United Kingdom is subject to income tax. This applies only to foreign source income included in Cases IV and V of Schedule D and in Schedule E, and even then only in a restricted number of situations.

#### 1. Income to which Remittance Basis May Apply<sup>12/</sup>

(a) The remittance basis applies when it can be shown that the business of an individual or a partnership is carried on wholly overseas. The business will be regarded as so carried on if not only the trading operations but also the central management and control are situated outside the United Kingdom. If on the other hand the management and control is exercised in the United Kingdom the profits are assessable under Case I of Schedule D even though the day-to-day transactions take place wholly abroad.

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<sup>12/</sup> The income under (a) and (b) is chargeable under Case I, II, IV or V of Schedule D; the income under (c) is chargeable under Schedule E.

It will be noted that in these cases the taxpayer's relation to the business was such that the income was more in the nature of investment income derived from a foreign enterprise than of business income.

(b) Investment income in the form of dividends from corporations not resident in the United Kingdom; interest from a non-resident debtor; and rent from real property situated abroad.

(c) Compensation for services wholly rendered abroad (including services as director of a corporation).

## 2. Situations in which Remittance Basis Applies

(a) The remittance basis is applicable to the types of income listed under 1 (b) above in the following two situations:

(i) the recipient of the income is a British subject or a citizen of the Republic of Ireland who, though resident in the United Kingdom, is not "ordinarily resident" there. A "British subject" is a person who is a subject of the United Kingdom or a citizen of any of the Commonwealth countries. The definition of "ordinary residence" is elusive. It has been contrasted with "casual" or "occasional" residence and "extraordinary residence" and has been said to mean "according to the way in which a man's life is usually ordered." As a practical matter it would appear that one could be resident without being ordinarily resident whenever his residence was based solely on the existence of the formal conditions listed in Chapter II.A above, e.g. if without living in the country he maintained an abode in the United Kingdom which he visits very infrequently or if, without maintaining an abode, he was present in the country for six months during the particular tax year.

A corporation will generally be both resident and ordinarily resident in the country where its central control and management are situated.

(ii) the recipient, though resident in the United Kingdom, is not domiciled in the United Kingdom. The domicile of an individual is determined in accordance with the general common law rules: domicile of origin is established at birth by reference to the domicile of the father; domicile of choice is the place where one resides with the intention of remaining there permanently. A person may be resident in the

United Kingdom but domiciled abroad if he maintains a residence abroad with the intention to remain there permanently but visits the United Kingdom during a year in which he maintains an abode there or, without maintaining an abode in the United Kingdom, remains in the country for six months during the tax year or habitually visits the country for periods of substantial duration.

A corporation has in one case been held to be domiciled in the country under the laws of which it is organized. Consequently a corporation organized abroad but resident in the United Kingdom because controlled there would be taxed on its investment income only when it is remitted to the United Kingdom, but its business income would be taxed as it arose.

(b) Income from services rendered abroad /1 (c) above/ is taxed on the remittance basis (in so far as here important) in the following three situations:

- (i) the recipient is both resident and ordinarily resident in the United Kingdom /2 (a) above/, but he performs the duties of his office or employment wholly outside the United Kingdom (where the duties are performed partly inside and partly outside the country, the remittance basis does not apply and the emoluments are entirely taxed on the arising basis).
- (ii) the recipient is resident but not ordinarily resident and performs services either wholly outside the United Kingdom or partly within and partly outside the country ; in this case the emoluments in respect of the services rendered abroad are taxable on the remittance basis.
- (iii) the recipient is not domiciled in the United Kingdom and the employer is resident outside the United Kingdom and not resident in the United Kingdom: in this case the emoluments are taxable only if the recipient is resident in the United Kingdom and then on the remittance basis only.

### 3. Taxable Income where Remittance Basis Applies

Where the remittance basis applies, only income which is actually received during the base year by the taxpayer or his nominee in the United Kingdom is

subject to tax. In general no deductions are allowed since the amounts of income remitted to the United Kingdom will presumably be already net of expenses.

In addition to income remitted directly to the United Kingdom, foreign income used to repay abroad a debt incurred in the United Kingdom, or to repay a sum borrowed outside the United Kingdom and transmitted to the United Kingdom, is in certain cases treated as received in the United Kingdom.

#### 4. Conclusion

From the above it will be seen that the remittance basis applies only to a very limited group of taxpayers and to restricted types of income. The remittance basis is perhaps most often applied to income from services. Investment income potentially eligible for taxation on the remittance basis is not uncommon, but such income must be received by taxpayers belonging to the small group described under 2 (a) above in order actually to qualify. Business income practically never qualifies; such income is therefore taxable on the arising basis whether derived from operations within or outside the United Kingdom.

### C. Foreign Income Taxed on the Arising Basis

#### 1. In General

In the normal case, foreign income is taxed on the arising basis. Foreign income is usually assessed on the basis of the income earned in the year preceding the tax year (or, if it is business income, in the accounting year ending within that preceding year), but income from employment is taxed on the current year basis. Profits tax is ordinarily assessed on the profits earned in the corporation's accounting year. Foreign taxable income is determined and allocated to the applicable basis period in accordance with rules applicable to comparable types of domestic income (Part One, Chapter I, C and F; II, B). The deductions allowed in computing taxable income are the same for foreign income as for similar domestic income, subject to the special rules noted below.

It follows that the taxable foreign income of a resident taxpayer (remittance basis and blocked income aside) is determined in every respect in the same way as would income of the same type earned in the United Kingdom. Thus, where a resident carried on a business partly inside the United Kingdom and partly abroad, the income from the foreign and the domestic operations would be assessed together,

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without distinction between the two; and the income from a business carried on wholly abroad but managed and controlled in the United Kingdom would be assessed like the income of a business operated exclusively inside the country.

## 2. Deductions

Where foreign income is taxable on the arising basis the same deductions and allowances are generally available with respect thereto as are available with respect to comparable types of income from a domestic source, except for the following special rules:

- (a) Foreign mining operations: Where the income is derived from mining operations carried on abroad, or from the working of foreign mineral deposits generally, the following allowances, not granted with respect to the working of deposits in the United Kingdom, are available: The cost of acquiring rights to foreign mineral deposits may be amortized each year in the proportion that the mineral output for the year bears to the total estimated future output. A similar allowance is granted with respect to the capital cost of land used in connexion with foreign mineral deposits. Finally, capital expenditures for various employee facilities established primarily for the use of the employees of the enterprise may be written off at the rate of 10 per cent per year. The amortization is limited to contributions toward facilities that are likely to become valueless on cessation of the mining operation and which do not result in the acquisition of assets by the contributor. This relief, and that for the capital cost of land, was introduced in 1952, their purpose being primarily to aid United Kingdom enterprises operating in under-developed countries.<sup>13/</sup>
- (b) Foreign Plantations: Buildings in use for the working of a foreign plantation (i.e. land abroad used for husbandry or forestry) normally qualify for allowances as industrial buildings (Chapter I.F.3.).
- (c) Depreciation allowances: In the case of assets which are used in producing income subject to foreign income tax, depreciation allowances may be postponed where, due to the difference between the United Kingdom and

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<sup>13/</sup> Finance Act, 1952, Sections 21 and 22 followed on the recommendations of the Committee on the Taxation of Trading Profits (Report, paragraphs 241 and 242, Command Paper 8189, April 1951).



the foreign depreciation provisions, foreign tax credit would otherwise be lost. Thus, the foreign tax law may permit only straight line depreciation, while United Kingdom depreciation is being claimed on the declining balance method, with higher annual allowances in the initial years and lower allowances in subsequent years. Since, in effect, credit for foreign taxes is given only to the extent that the foreign tax does not exceed the allocable United Kingdom tax on the foreign income, the granting of United Kingdom depreciation allowances in some years in excess of, and in other years below, those granted abroad would result in loss of credit by reducing the United Kingdom tax below the foreign tax in the first years, and increasing it above the foreign tax in the latter years (Part Three, Chapter III).

(d) Foreign income tax: Foreign income tax may be deducted from foreign income. In those cases where the foreign tax may be credited against the United Kingdom tax on the foreign income (Part Three), the taxpayer must elect either to take the credit or to deduct the tax. In most cases the former course of action will result in a greater tax saving, the principal exception being the case where domestic losses exceed the foreign income, so that no United Kingdom tax remains due; thus, while a credit would be wholly lost, the deduction of the foreign tax from foreign income would increase the total loss available for carry-over against the profits of other years.

(e) Annual Interest, etc.: For income assessable under Case IV or Case V a deduction is allowed for any annual interest or any annuity, etc. payable out of the foreign income to a person not resident in the United Kingdom.

#### D. Overseas Trade Corporations

Under the Finance Act of 1957 foreign business income derived through so-called Overseas Trading Corporations is tax exempt, unless and until it is distributed. This incentive to foreign trade and investment activities by resident United Kingdom companies is based on a majority recommendation of the Royal Commission on the Taxation of Profits and Income.<sup>14/</sup>

In order to qualify for the tax relief, the Corporation must be wholly engaged either directly or through qualified subsidiaries in foreign business

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<sup>14/</sup> Final Report, Command Paper 9474, June 1955, paragraphs 673-677.

operations through an overseas permanent establishment (mining, petroleum, agriculture, manufacturing, processing, public utilities, distribution, including exportation of United Kingdom merchandise, but excluding shipping and banking, insurance or other financial activities). The Corporation must draw its entire trading income from qualified foreign activities. Where the foreign operations consist in the exportation of United Kingdom merchandise, the Overseas Trade Corporation must purchase the goods f.o.b. United Kingdom ports so that its profits would be derived solely from the foreign sales and not from the domestic production of the goods.

A company may qualify as an Overseas Trade Corporation if it is the non-trading principal (i.e. owns more than one-half of the ordinary share capital) of a subsidiary company which is an Overseas Trade Corporation, and which is carrying on a trade outside the United Kingdom; it cannot qualify, however, if it has a subsidiary which is resident in the United Kingdom and is not itself an Overseas Trade Corporation. Overseas Trade Corporation status is not affected by the principal company's having or not having non-resident subsidiary companies or minority interests in non-resident companies or in other Overseas Trade Corporations. It is confirmed that under the Overseas Trade Corporation scheme profits may be switched from one Overseas Trade Corporation to another by means of a dividend paid by one subsidiary to its parent and by a loan from the latter to a second subsidiary. It should be noted, however, that this facility exists only where all three companies are Overseas Trade Corporations, and that, for example, the loan by an Overseas Trade Corporation parent to a non-resident subsidiary might impose a tax liability upon the parent as being a distribution out of exempt trading income.

The tax benefits granted to a qualified Overseas Trade Corporation are twofold: its overseas trading profits are exempt from profits tax and it pays no income tax on its trading income until it is distributed, when income tax is charged on such an amount as will after deduction of tax at the standard rate equal the net amount paid to the shareholder.<sup>15/</sup> Thus, reinvested trading profits will be wholly freed from United Kingdom tax liability. Income from participations, however (other than in Overseas Trade Corporation subsidiaries), is considered as

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<sup>15/</sup> United Kingdom parent companies will of course pay profits tax upon such dividend income.

investment rather than trading income and is not entitled to those tax benefits. By segregating its foreign operations in an Overseas Trade Corporation, a United Kingdom company can secure substantially the same tax benefits through a resident subsidiary as could otherwise be obtained only through a non-resident subsidiary (Part Four, Chapter IV). This constitutes a considerable advantage in view of the obstacles which ordinarily lie in the way of establishing the latter, specially the difficulties in transferring control to a non-resident board of directors and the provisions against company emigration (Chapter II, above).

#### E. Foreign Currency and Blocked Income

##### 1. Foreign Currency

The taxable amount of income in foreign currencies must be determined by converting the foreign currencies into pounds sterling. Income which is taxable only when remitted to the United Kingdom is converted at the rate of exchange prevailing on the date of remittance. Income which is taxable on the arising basis is generally converted to sterling at the mean rate applicable over the period in which it arose. The Board of Inland Revenue issues tables of mean rates for this purpose. If the income is derived from foreign business operations the Government will accept a determination of the taxable profits in pounds sterling under either the "balance sheet method" or the "profit and loss method", provided the method selected is followed consistently. In substance, the balance sheet method involves the conversion of net current assets into their sterling equivalent at the beginning and at the end of the taxable accounting period. The difference between the two sterling amounts so arrived at, plus any remittances made during the period, constitutes the profit or loss for the period. Under the profit and loss method the profit or loss for the accounting period is determined in foreign currency and then converted into sterling at either the mean exchange rate or the rate prevailing at the end of the period.

##### 2. Blocked Foreign Income

Where foreign income is taxed on the arising basis, blocked currency ("unremittable overseas profits") may, upon written notice to the Commissioners of Inland Revenue, be excluded from taxable income, provided the blocking results from a foreign law or executive action or from the factual non-availability of

foreign exchange for the remission of the income. If the notice is filed, the amount of unremittable profits does not become taxable until such time as the Commissioners of Inland Revenue determine that the income can be remitted. At the time the income is determined to be remittable it is converted into sterling at the current rate of exchange, the amount of such foreign income is then treated as having been earned during the original period with respect to which the election was made, and the tax liability for that period is revised accordingly.

Where foreign income is taxed on the remittance basis, a taxpayer who receives such income in the United Kingdom which was earned in earlier years but which could not be remitted earlier because it was blocked may elect to be taxed on that income as if it had been remitted when earned, and the tax liability for earlier years will be revised accordingly.

Part Three

RELIEF FROM INTERNATIONAL DOUBLE TAXATION: CREDIT FOR FOREIGN TAXES

Chapter I

Credit under International Agreements and under United Kingdom Law

The imposition of United Kingdom tax on the foreign income of residents, which normally is also taxed in the foreign country of its origin, raises the problem of double taxation. Relief from such double taxation has been provided chiefly through the so-called tax credit: subject to the requirements and limitations described below, United Kingdom residents may deduct from United Kingdom income and profits taxes on their foreign income, foreign income and profits taxes imposed on such income by the country from which it is derived. These taxpayers may elect to deduct the foreign tax from their income instead of taking this credit against tax, but in most cases the credit will result in a greater tax saving (Part Two, Chapter III C 2). The taxpayer who elects to claim the credit may not deduct the foreign tax for which credit is allowed, but must include in his taxable income the total foreign income - before such foreign tax.

Credit provisions are found both in the United Kingdom statutes<sup>16/</sup> and in international agreements or arrangements for the avoidance of double taxation of income which have been concluded between the United Kingdom and other countries and territories.<sup>17/</sup> The credit to be given under such agreements and arrangements

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<sup>16/</sup> The credit provisions in the statutes serve in part to regulate in detail the credit to be granted under the treaties (Income Tax Act of 1952, Schedule 16) and in part to give credit where no treaty exists (Ibid., Schedule 17).

<sup>17/</sup> The countries or territories with which the United Kingdom has treaties and other arrangements providing for credit for foreign income taxes are listed in the Appendix. Full information on their status is published periodically in the "World Guide to International Tax Agreements"; the latest issue (Volume V, Revised, of International Tax Agreements) is slated for publication in the fall of 1957. The texts of all agreements concluded since 1936 are reproduced in International Tax Agreements (Volume I, United Nations Publications Sales No. 1948.XVI.2; Volume II, Sales No. 1951.XVI.1; Volume IV, Sales No. 1954.XVI.1; Volume VI, Sales No. 1956.XVI.1; Volume VII is scheduled for publication in the fall of 1957).

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is commonly referred to as "treaty relief" (herein termed "treaty credit") and the credit which is available where no treaty exists is called "unilateral relief" (herein termed "non-treaty credit"). There is no fundamental difference between the two, either in the conditions upon which the credit is granted or in the computation of the amount of the credit.<sup>18/</sup> The instant discussion applies to the general principles applicable to both treaty credit and non-treaty credit, but significant differences between the two are noted.

Treaty credit is often more liberal, in particular in granting credit to dividend recipients for foreign tax paid, not only on the dividends, but also on the company profits from which the dividends were distributed; in the absence of a treaty the latter tax may be credited only in certain limited cases (Chapter III B below). Treaty credit, on the other hand, is sometimes more restrictive than non-treaty credit with respect to the foreign taxes eligible for credit and to the United Kingdom taxes against which the credit may be claimed (Chapter II B and C below). The existence of a treaty, however, does not diminish any non-treaty credit available, except that non-treaty credit is not allowable in respect of any income if any treaty credit is allowable for the same overseas tax on it (proviso (b) to paragraph 1, Part I, 17th Schedule, Income Tax Act, 1952). With this exception where the non-treaty credit is broader, the taxpayer may claim that broader credit. Apart from the differences between treaty-credit and non-treaty credit, there are differences of detail among the credit provisions included in the various treaties, though they do follow a standard pattern. The following pages therefore will serve only as a general guide to the determination of treaty and non-treaty credit. Precise determination in each case can be made only after examination of the applicable

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<sup>18/</sup> Provisions applicable to the Republic of Ireland differ from those generally applicable and are not discussed here.

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sections of the law and of the treaty, if any, with the foreign country or territory involved.<sup>19/</sup>

## Chapter II

### Scope of Credit

#### A. Persons Entitled to Credit

Credit for foreign taxes is in principle available only against the United Kingdom tax liability of resident persons and corporations. There are exceptions in certain restricted circumstances in paragraph 1, Part II, 17th Schedule, Income Tax Act, 1952.

#### B. Foreign Taxes which are Creditable

Each treaty specifies the foreign taxes to which it relates and for which credit is allowed.<sup>20/</sup> Generally, the specified foreign tax is one which is in some measure comparable to the United Kingdom income tax or profits tax. Taxes imposed by political subdivisions of a foreign country or territory are generally not creditable under the treaties.<sup>21/</sup>

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<sup>19/</sup> It should be noted that under the tax treaties, United Kingdom taxpayers may secure not only a reduction in the United Kingdom tax (through the foreign tax credit), but also a reduction or elimination of the foreign tax imposed on certain classes of foreign income: business profits not arising through a "permanent establishment", shipping and air transport profits, patent and copyright royalties, interest, professional and employment earnings derived during a temporary business visit are usually among the classes of income exempt from tax in the co-contracting country from which they are derived, while foreign dividends are generally granted either a reduction in the tax or an exemption from surtax or complementary tax. Such relief from the foreign tax, however, will actually reduce the over-all tax burden of the United Kingdom taxpayer only to the extent to which the full foreign tax would have exceeded the corresponding United Kingdom tax and could thus not have been absorbed by the tax credit.

<sup>20/</sup> For a complete listing of the taxes covered by each of the income tax treaties concluded by the United Kingdom, see "World Guide to International Tax Agreements," *op. cit.*, footnote 17, above.

<sup>21/</sup> E.g. state and municipal income taxes imposed in the United States are not creditable (Article I 1a). However, Swiss cantonal tax is creditable and Norwegian communal tax is also creditable up to a maximum of half the tax (Article I 1(b) of the Swiss Agreement and Article XVI (1) of the Norwegian Agreement.

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Non-treaty credit is granted generally for foreign taxes on income or profits which correspond to the United Kingdom income tax or profits tax. The credit is limited to national (central government) taxes in the case of taxes levied by non-Commonwealth countries. Similar taxes levied by Commonwealth countries or territories or by any province, state or subdivision of a Commonwealth country or territory, but not those levied by or on behalf of a municipality or other local body, are eligible for credit.<sup>22/</sup> There is no authoritative statement as to what foreign taxes correspond to United Kingdom income tax or profits tax.

C. United Kingdom Taxes against which Credit is Allowable

Credit for foreign tax is applied against profits tax and income tax (standard tax and surtax).

D. Credit for Tax Paid Directly or Indirectly

In principle a taxpayer may claim credit only for foreign tax which he bears himself. Under certain conditions, however, a taxpayer who has received dividends from a corporation resident abroad may claim credit not only for the foreign tax levied on such dividends (whether charged directly or by deduction) but also for the foreign tax paid by the corporation on the profits from which the dividends are distributed. Foreign tax borne by the taxpayer is referred to as "direct" tax and tax paid by the foreign corporation in which the taxpayer is a shareholder as "indirect" tax. Credit for "direct" tax is discussed in Chapter III, A and credit for "indirect" tax in Chapter III, B.

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<sup>22/</sup> The Royal Commission on the Taxation of Profits and Income recommended that in the case of all foreign countries and territories, credit be given for all income taxes regardless of the political level at which they are assessed (op. cit., paragraph 701).



### Chapter III

#### Computation of Credit

##### A. Credit for Tax Paid Directly

###### 1. In General

Credit for foreign tax paid by the person who is claiming the credit is computed in accordance with the following principles.

The income which has borne the foreign tax to be credited must be the same income as is taxed in the United Kingdom. It is immaterial that the amount of such income is computed differently under the foreign law or that the foreign tax may be levied with respect to a different taxable period. Thus, credit will not be forfeited solely as the result of the fact that the law of the foreign taxing country provides for accounting rules, deductions, exemptions and exclusions, or for a basis period, different from those provided by the United Kingdom law. However, a difference, e.g. in accounting rules, may have the result of increasing the foreign tax on the amount of foreign income which is taken into account for United Kingdom purposes to an amount higher than the United Kingdom tax at the effective United Kingdom rate with resultant loss of credit (2 below). The taxpayer, however, has an option to prevent differences in the rules on depreciation allowances in certain circumstances from having this result (Part Two, Chapter III, C.2.b).

Credit is allowed in principle for foreign tax only if paid to the country where the taxed income arose,<sup>23/</sup> for example, where a foreign country taxes the world income of a United Kingdom enterprise the credit will be limited to that portion of the foreign tax which is allocable to income arising in that country.

###### 2. Limit on Credit

The objective of the foreign tax credit is to avoid double taxation by limiting a taxpayer, total tax liability on his foreign income to an amount equal to the higher of the United Kingdom tax or the foreign tax on the income. Treaty

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<sup>23/</sup> Income Tax Act 1952, Schedule 17, Part I, Section 1.

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credit as well as non-treaty credit is therefore limited by a number of rules which are designed to assure that the amount of the foreign tax deducted from United Kingdom tax on the foreign income does not exceed the United Kingdom tax attributable to that income. This maximum credit is in principle equal to that share of the United Kingdom tax on the taxpayer's total - foreign and domestic - income which corresponds to the share of the foreign income in such total income, i.e. by applying to that foreign income the taxpayer's over-all effective United Kingdom tax rate.<sup>24/</sup> The amount of foreign income entered into these calculations is the grossed-up foreign income (i.e. before deduction of foreign tax relieved by credit),<sup>25/</sup> since, where credit is claimed for the foreign tax, the taxpayer may not also deduct the foreign tax from the foreign income he reports.

This determination of the credit limit is not too difficult where the foreign tax rate is no higher than the over-all effective United Kingdom tax at the effective rate on the United Kingdom measure of the income and can therefore be fully credited. The mechanics of the calculation in such a case may be illustrated by the following example:<sup>26/</sup>

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<sup>24/</sup> The explanations and calculations of the credit limit here given do not follow precisely the procedures outlined in the statute. They do, however, reach the same result, and are intended merely to bring out the principles and rationale of the statutory methods. For fuller details on the latter see paragraphs 347, 348, Income Tax Act, 1952, Schedules 16 and 17; Simon's Income Tax, second edition, Volume III, Part XVI(B), (Butterworth and Company, London, 1952); Spicer and Pegler's Income Tax and Profits Tax, twenty-first edition (edited by H.A.R.J. Wilson), Chapter 10 (H. Foulks Lynch and Co., London, 1954); C.A. Newport and H.G.S. Plunkett, Income Tax, Law and Practice, twenty-sixth edition, Chapter 18 (Sweet and Maxwell, Ltd., London, 1954). The explanations also ignore certain complications which arise in the case of a limited company which is liable to United Kingdom profits tax.

<sup>25/</sup> For an explanation of grossing up, see Part One, Chapter I G 2.

<sup>26/</sup> For computation of United Kingdom tax, see Part One, Chapter I.A.1 and 2.

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Taxpayer is a single individual resident in the United Kingdom. His income consists of £800 from domestic sources and £200 from foreign sources. He is therefore subject to standard tax only. Foreign income has borne foreign tax of £40.

i. Effective rate of United Kingdom tax: 26/

Domestic income	£800	
Foreign income (before foreign tax)	<u>200</u>	
World income (for effective rate purposes)		£1,000
Earned income allowance	222	
Personal allowance	<u>140</u>	
Net taxable income		<u><u>362</u></u> <u>638</u>
Tax on first £360		93
Tax on £278 at 42.5 per cent		<u>118</u>
Tax for effective rate purposes		<u>211</u>
Effective rate: £211 ÷ £1,000		21.1%

ii. United Kingdom tax and credit

Total United Kingdom tax on foreign and domestic income		211
Foreign tax available for credit	40	
Maximum credit limit: United Kingdom tax on foreign income (21.1 per cent of £200)	42.2	
Foreign tax credit allowed: lower of the two preceding amounts		<u>40</u>
United Kingdom tax due after foreign tax credit		<u><u>171</u></u>

Where the foreign tax rate is higher than the United Kingdom tax at the effective rate, the amount of the foreign tax which is in excess of the allowable credit and can therefore not be deducted from the United Kingdom tax, may instead be deducted from the foreign income.

This facility provides no additional relief where the applicable United Kingdom rate is strictly proportional since the decrease in the foreign (and thus in the total) income will not affect the United Kingdom tax payable on the recipient's other income. In this case a computation of credit limited by reference to the final United Kingdom gross measure of the income would be quite

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complicated. While the effective United Kingdom rate which limits the amount of foreign tax allowable for credit depends on the amount of foreign (and domestic) income, this amount in turn depends on the excess foreign tax which may be deducted from the foreign income; this excess over the credit limit in turn cannot be known until that limit, i.e. the over-all effective United Kingdom rate, has been determined.

In order to avoid the necessity of resorting to complex mathematical formulae, the law provides an abbreviated computation method: The effective United Kingdom tax rate is determined in the usual way (taking into account the full grossed-up foreign income) and continues to provide the measure for establishing the maximum tax credit. The law provides that the excess foreign tax is to be deducted from the foreign income, and the effect of this is that where there is excess overseas tax the final United Kingdom gross measure of the income may (if the United Kingdom profits tax is not involved) be calculated on the basis of grossing it up at the - lower - effective United Kingdom rate, thus reducing the total (foreign and domestic) taxable income. The foreign tax calculated at this lower (i.e. United Kingdom) rate on this reduced foreign income can then be fully credited against the lower United Kingdom tax on the reduced total income. On balance, the abbreviated method substantially achieves the purpose of the law by reducing the amount of foreign tax accepted for credit, but reducing as well the amount of over-all United Kingdom tax due on the total income. This method is illustrated by introducing a higher foreign tax rate in the earlier example:

Taxpayer is a single individual resident in the United Kingdom. His income consists of £800 from domestic sources and £200 from foreign sources. Foreign income has borne foreign tax of £50.

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i. Effective rate of domestic tax:		
Domestic income	£800	
Foreign income (before foreign tax)	<u>200</u>	
World income for effective rate purposes		£1,000
Earned income allowance	222	
Personal allowance	<u>140</u>	<u>362</u>
Net taxable income		<u>638</u>
Tax on first £360		93
Tax on £278 at 42.5 per cent		<u>118</u>
Tax for effective rate purposes		<u>211</u>
Effective rate:		
£211 ÷ 1,000		21.1%
ii. Taxable income for purposes of United Kingdom tax:		
Domestic income	800	
Foreign income (at the United Kingdom effective rate (21.1 per cent) which gives a lower figure than the foreign tax) $150 \times 100/78.9$	<u>190</u>	
Taxable income		990
iii. United Kingdom tax and credit:		
Taxable income		990
Earned income allowance	220	
Personal allowance	<u>140</u>	<u>360</u>
Net taxable		<u>630</u>
Tax on first £360		93
Tax on £270 at 42.5 per cent		<u>114</u>
United Kingdom tax		<u>207</u>
Credit - (£190 x lower effective rate of 21.1 per cent)		<u>40<sup>27/</sup></u>
Net United Kingdom tax		<u>167</u>

27/ The foreign tax for which no credit is given is £10. Taxable income is £10 less than total income (£1,000 - £990). Thus, foreign tax in excess of the creditable amount has been deducted from foreign income.

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The computation of the limit on the tax credit must be made separately with respect to the income derived from, and tax paid to, each foreign country. If the credit allowed with respect to income from any particular country is less than the foreign tax thereon, the unused credit may not be applied against United Kingdom tax due with respect to income from a different foreign country, nor can it be carried forward to a subsequent year. The total of all allowable credit cannot exceed the net tax otherwise payable by the taxpayer on his total income for the taxable year, less any tax which he is entitled to receive by deduction from any other person.

B. Credit for Tax Paid Indirectly

1. When Available: Credit to Shareholders for Foreign Tax Paid by Corporation

In certain cases a resident shareholder of a non-resident corporation may be entitled, not only to credit for the foreign tax he paid on the foreign dividend (so-called direct credit or credit for "direct" tax), but also to credit for that portion of foreign tax paid by the corporation which is attributable to the profits distributed to him as a dividend (so-called indirect credit or credit for "indirect" tax).

Under the statute such "indirect" tax credit is available only if the recipient shareholder is itself a company which controls at least one-half the voting power of the foreign company distributing the dividend, and only for the tax which the distributing company pays to its country of residence. If, however, the foreign taxing country is a Commonwealth country, credit for "indirect" tax is available both to individual and corporate shareholders without regard to the extent of voting control. In that case, however, the dividend must be on an ordinary share, except that in the case of a participating preference share, so much of the dividend as is in excess of the fixed rate thereon is treated as an ordinary dividend.

Finally, indirect credit will also be available in all cases in which there is a tax treaty providing for such credit. Treaty credit, of course, will be given only within the limits of the treaty provisions. However, any portion of the "indirect" tax which is not allowable for credit under the treaty may be allowed under non-treaty credit if any of the above conditions for non-treaty credit are met and where any treaty provides for credit of indirect tax on any

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class of dividends the credit is extended to all classes of dividends paid by an overseas company to a United Kingdom company which controls not less than half of its voting power. Some treaties provide for indirect credit of the same scope as the non-treaty credit allowed for Commonwealth taxes.<sup>28/</sup> A few treaties limit the credit to controlling corporations but do not distinguish between preference and ordinary dividends.<sup>29/</sup> The treaty with Greece is the only treaty with a non-Commonwealth country which is silent with respect to credit for "indirect" tax.<sup>30/</sup>

## 2. Limit on Credit

Where indirect credit is available, in addition to direct credit, the sum of "direct" and "indirect" tax may not exceed the over-all limit set on the maximum allowable foreign tax credit, i.e. an amount equal to the United Kingdom tax allocable to the foreign income (see A.2 above). In addition to the "direct" tax, the amount of the "indirect" tax must therefore be determined. This requires as a first step identification of the profits from which the dividends were paid. Here the rule is that unless the dividends are paid for a specified period or out of specified profits they will be deemed to have been paid out of the profits of the most recent complete accounting period. If the dividends exceed the profits of the appropriate period, the excess is deemed to have been paid out of the profits of the preceding period, then the next preceding period, and so on. In each case the amount of the profits is determined in accordance with United Kingdom law.

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<sup>28/</sup> This is the case with respect to treaties with Australia, Burma, Canada, Ceylon, Denmark, Federal Republic of Germany, the Federation of Rhodesia and Nyasaland, Finland, Israel, New Zealand, Norway, Sweden, and the United States.

<sup>29/</sup> Treaties with Austria, Belgium, France, the Netherlands, and Switzerland are in this category.

<sup>30/</sup> The Royal Commission on the Taxation of Profits and Income recommended that unilateral credit for "indirect" tax be given to all resident shareholders of non-resident companies, wherever located, regardless of control and regardless of the existence of a treaty (op. cit., paragraph 708).

The next step is the determination of the rate of foreign tax borne by these profits. This rate is in principle obtained by dividing the paying company's total profits during the appropriate period into the total taxes paid by it to the foreign country for that period. Special calculation is necessary where the foreign country taxes the income of the corporation from a third country, since the United Kingdom will grant credit only for taxes paid with respect to income arising in the taxing country.<sup>31/</sup> By first grossing up the amount actually received by the shareholder as his net dividend at the rate of the "direct" tax levied on the dividend and by then grossing up the resulting sum at the rate of the "indirect" tax levied on the profits of the paying corporation, one arrives at the share of these profits represented by the dividend; thereby one obtains the over-all effective foreign tax rate which was imposed on this share of the profits so as to reduce it to the net dividend received by the shareholder.

The following example may illustrate this calculation: the taxpayer received an ordinary dividend of sixty which had borne "direct" foreign tax of  $33\frac{1}{3}$  per cent; the rate of the "indirect" foreign tax on the profits of the paying corporation is 25 per cent.

Net dividend	60
Gross dividend:	
(60 grossed up at $33\frac{1}{3}$ per cent direct tax)	90
Share of profits allocable to the dividend 90 grossed up at 25 per cent profits tax)	120
Effective foreign tax rate on the dividend (60:120)	50 %

The calculation of the limit of the foreign tax credit requires a comparison between this effective foreign tax rate and the over-all effective United Kingdom rate on the recipient's total foreign and domestic income. As in the case of the "direct" tax credit, this calculation is based on the final United Kingdom gross assessment would become quite complex, especially where the foreign rate exceeds the United Kingdom rate; in that case the excess of the foreign tax which cannot be

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<sup>31/</sup> Section A.1 above.



credited is deducted from the foreign income - which in turn requires a recalculation of the United Kingdom rate. In addition, it was felt that taxpayers deriving dividends from several foreign countries should be able to calculate the relief due them on any one dividend, even before they had been able to ascertain the "indirect" tax paid on all dividends.<sup>32/</sup> An abbreviated procedure has therefore been devised, somewhat along the lines of the direct credit calculation. Under this procedure only the dividend distributed (i.e. gross of "direct" tax) is included in total income for the calculation of the effective United Kingdom rate, while the "indirect" tax is ignored at this step of the computation.<sup>32/</sup> The total income actually subject to tax is then recalculated by grossing up the net dividend at only the lower - foreign or United Kingdom - rate, the foreign rate at this stage including both the "direct" and the "indirect" tax. The amount by which the dividend is thus grossed up can then be fully credited against the United Kingdom tax on this income. The following example illustrates the different steps of this procedure:

A corporation resident in the United Kingdom, with £800 of business profit, received a net ordinary dividend of £180 from a corporation resident in Country A. The foreign corporation had declared a dividend of £200 from which it had withheld Country A tax at 10 per cent. Its earnings for the period with regard to which the dividend was paid were £2,000. Country A tax on those earnings was £400.

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<sup>32/</sup> Royal Commission on the Taxation of Profits and Income, op. cit., paragraph 730.

i.	Profits from which dividend was paid:	£2,000
ii.	Effective rate of foreign tax on profits: £400 ÷ £2,000	20%
iii.	Effective rate of foreign tax attributable to dividend:	
	Gross dividend £200	
	£200 grossed up at 20 per cent (£200 x 100/80)	£250
	Less gross dividend	200
	"Indirect" foreign tax	50
	"Direct" foreign tax	20
	Total foreign tax	70
	Effective foreign rate on dividend (70 ÷ 250)	28%
iv.	Effective rate of domestic tax:	
	Business income	800
	Dividend income	180
	"Direct" foreign tax	20
	Income for effective rate purposes	1,000
	United Kingdom tax on above <u>33/</u>	425
	Effective rate: 425 ÷ 1,000	42.5%
v.	Taxable income for purposes of United Kingdom tax:	
	Domestic income	800
	Foreign income (£180 grossed up at lower 28 per cent effective rate) $180 \times \frac{100}{72}$	250
	United Kingdom taxable income	£1,050
vi.	United Kingdom tax and credit:	
	Taxable income	1,050
	United Kingdom tax on £1,050 (42.5 per cent)	446
	Credit (250 x lower effective rate of 28 per cent)	70
	Net United Kingdom tax	£376

33/ The profits tax has been ignored for this example. Note also footnote 24.

Where the profits from which the dividend is paid have borne tax in a third country, i.e. a country other than that of the paying company's residence, separate credit is allowed under the same conditions for such third country's tax attributable to the dividend, if both the second and third country are either a Commonwealth country or a country which has entered into a tax treaty with the United Kingdom which provides for indirect credit. The income will be traced back through each additional country which has subjected it to tax until the chain is broken by the intervention of a taxing country which is neither a treaty country nor a Commonwealth country.

If the profits from which the foreign dividends are paid were derived from sources within the United Kingdom and have been subject to United Kingdom tax, relief is also provided for the portion of the United Kingdom tax attributable to the dividend received by a resident shareholder from the foreign company - not, however, as a foreign tax credit, but as an extension of the rule that shareholders receive relief for the United Kingdom standard tax levied on the company paying the dividend (Part One, Chapter I G 1).

As in the case of "direct" tax credit, the computation must be made separately with respect to the income derived from, and tax paid to, each foreign country. Unused credit cannot be applied against United Kingdom tax due with respect to income from a different foreign country, and cannot be carried forward. The total credit cannot exceed the net tax otherwise payable by the taxpayer on his total income for the taxable year.

## Part Four

### EFFECT OF THE FORM OF FOREIGN BUSINESS OPERATIONS ON TAXATION

#### Chapter I

##### In General

Selection of the appropriate form for the conduct of foreign business operations by an enterprise owned by a United Kingdom resident requires consideration of a multitude of factors in addition to the effect of the form upon United Kingdom tax liabilities. Discussion here is limited to identification of the major features of United Kingdom tax law bearing upon selection of an appropriate form. The following discussion is limited to the cases where ownership of the foreign operation is vested either in a United Kingdom corporation or in its stockholders.

The following principal forms exist for conduct of the foreign enterprise:

- foreign branch of United Kingdom resident corporation;
- separate resident corporation (i.e. corporation controlled in the United Kingdom) conducting the foreign operations; special case: Overseas Trading Corporation;
- separate non-resident corporation (i.e. corporation controlled outside the United Kingdom) conducting the foreign operations.

If a separate corporation is to be employed, its shares may be held by the United Kingdom parent corporation or by its shareholders. The place of incorporation of the foreign enterprise is generally immaterial from the viewpoint of the United Kingdom tax law, since United Kingdom taxation of corporations operating abroad depends upon the place of residence - that is, where the central management and control are situated.<sup>34/</sup>

Discussion here is confined to the above choices. However, others exist, such as a foreign branch of a corporation controlled abroad, or a foreign subsidiary of a corporation controlled abroad (especially of a foreign holding

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<sup>34/</sup> However, the place of incorporation is material for the application of provisions designed to prevent avoidance of surtax by unreasonable accumulation of profits in closely held corporations (Chapter IV below and Part One, Chapter I, G.4 above), and for the taxation on a remittance basis of corporations resident, but not domiciled in the United Kingdom (Part Two, Chapter III, B.2 (a) (ii)).

company). It should be noted that qualification of a corporation as a non-resident, that is, as "foreign controlled", may present practical difficulties, since a United Kingdom enterprise may find it impracticable or impossible to assign control of its foreign operations to a separate board of directors meeting abroad. Account should also be taken in this connexion of the rules against company emigration (Part Two, Chapter II).

## Chapter II

### Foreign Branch

If the effective foreign tax rate on the branch profits (measured under United Kingdom tax rules) is no higher than the effective United Kingdom rate on those profits, the combined domestic and foreign tax burden will be the same as though the branch operated in the United Kingdom. Full credit will be given for the foreign tax, with the result that the combined foreign and domestic tax liability will be at the United Kingdom effective rate. The full liability for the excess of domestic over foreign tax will be incurred as the foreign profits are earned, whether or not they are remitted to the United Kingdom, unless they are in unremittable foreign currency (Part Two, Chapter III, D).

If the effective foreign rate is higher than the effective domestic rate, the tax burden will be at the higher foreign rate, and no United Kingdom tax liability will be incurred with respect to the foreign earnings.<sup>35/</sup>

Foreign branch losses may be set off against domestic income, or carried forward, in the same manner as domestic losses (Part One, Chapter I, F.4). However, a difference between the foreign and domestic treatment of losses may result in loss of foreign tax credit. For example, if the nominal United Kingdom rate is higher than the nominal foreign rate, but the foreign country allows no loss carry forward or requires a carry back of losses, while the loss is carried forward for United Kingdom tax purposes, the effective United Kingdom rate in the year to which the loss is thus carried forward may be reduced below the effective foreign rate for that year. In the case of differences in the depreciation rules

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<sup>35/</sup> However, the inclusion of the foreign income in domestic income may tend to decrease the rate at which the domestic income is taxed, because the effective profits tax rate decreases where total profits increase without a corresponding increase in the dividend distribution.

of the two countries, however, special provisions have been made for allowing deferral of depreciation charges in order to avoid similar loss of credit (Part Two, Chapter III, C.2 b).

### Chapter III

#### Subsidiary Controlled in the United Kingdom (Resident Subsidiary)<sup>36/</sup>

In important respects the same tax results as those of a foreign branch may be achieved with a subsidiary corporation controlled and managed in the United Kingdom (resident subsidiary) which is created to conduct the foreign operations of its parent. This is so especially in the treatment of losses and of profit distribution due to the operation of the following rules on interrelated corporations:

For income tax purposes, a parent company may reduce its profits by the losses of a subsidiary by means of contributing a corresponding amount to the subsidiary: under certain conditions this contribution will be deductible from the parent's taxable income, while it will constitute income to the subsidiary.

For profits tax purposes, as well, parent and subsidiary companies may under certain conditions elect to be treated as a "group", consolidate their profits and losses and have profits tax assessed on the consolidated amount.

The members of such a group may also disregard distributions among each other when claiming non-distribution relief, with the result that the distribution rate of profits tax will be charged only on distributions to persons outside the group.

A subsidiary of a resident corporation, if controlled in the United Kingdom, will be taxed on its foreign earnings by both the United Kingdom and the foreign country, with credit against United Kingdom tax for foreign taxes computed in the usual way. Should the subsidiary sustain a loss, under the above rules this loss may, in general, reduce the parent's tax liability to the same extent as would a branch loss.

If the subsidiary operates at a profit, it will pay income tax and profits tax on its foreign profits in the same manner as would the parent. The parent

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<sup>36/</sup> This Chapter deals only with the general case of the resident subsidiary; resident subsidiaries qualified as Overseas Trading Corporations are discussed in Chapter V below.

corporation may withdraw profits from the subsidiary (in the form of dividends) without attracting additional income tax (Part One, Chapter I G 3), and the subsidiary would not have to pay profits tax at the distribution rate on these profits if group treatment is secured.

Thus, assuming that a proper choice is made for such group treatment and for inter-company loss contributions and effective advance planning has assured compliance with the strict statutory requirements, the tax results of operations through a domestically controlled subsidiary will be largely similar to those of a branch operation. Conversely, if the parent is closely held, the unreasonably accumulated income of a resident subsidiary incorporated in the United Kingdom may be apportioned among the parent's shareholders for surtax purposes (Part One, Chapter I G 4).

A difference will persist, however, in the early and final years of the foreign activity. Since the opening and closing of a branch will generally constitute mere extension or contraction of the existing domestic business, the profits of the branch will be taxed, along with the domestic profits, on the preceding-year basis. The profits of the first year's operation abroad by a branch will be subjected to tax in the year following that in which earned, and profits of the final year will be taxed in the year following cessation of the foreign operation (Part One, Chapter I C 2).

A subsidiary, however, will automatically become subject to the commencement provisions, so that the special basis of assessment will apply to it for the first three years of its operation. This will result in taxation of the first year's income on the current basis, while that year's income, if earned by a branch, would not become taxable until the second year. Furthermore, the commencement provisions may result in one year's income's forming the basis of assessment for two, or even three, successive tax years. It is the Government's practice to allow credit for foreign tax paid with respect to that year's income only in one of the tax years, and to permit deduction of the foreign tax as an expense in the others. Upon discontinuance of the business the current year basis is substituted for the preceding year basis, and one year's income is

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therefore omitted from assessment. The result is that credit for foreign tax levied on that year's income is not available.<sup>37/</sup>

#### Chapter IV

##### Subsidiary Controlled Abroad (Non-resident Subsidiary)

If the central management and control of a subsidiary are situated abroad, the corporation is a non-resident and does not come within the ambit of United Kingdom taxation (except on profits derived from United Kingdom sources), irrespective of the place of residence of its shareholders or the place of its incorporation. The foreign income of such a subsidiary will not be subject to United Kingdom tax until distributed in the form of dividends to the parent, and if accumulated until completion of the venture and distributed on dissolution or sale of the subsidiary, such income will be received by the parent as tax-free capital profits.

Accumulated earnings of a non-resident subsidiary may not be apportioned for surtax purposes among the shareholders of the parent unless the subsidiary was incorporated in the United Kingdom (Part One, Chapter I G 4).

Dividends paid to the parent will be taxed to it as income from foreign investment. Unlike dividends from a resident subsidiary, even dividends paid out of capital profits of a non-resident subsidiary will be taxed as income to the parent (Part Two, Chapter III A 2). Credit for foreign "direct" and "indirect" tax attributable to dividends received by the parent will be available to the parent.

In the absence of dividend distribution, the level of taxation of foreign profits will be determined entirely by the foreign rate: thus, tax incentives offered by the foreign country of operation will fully redound to the advantage of the foreign subsidiary, while this is not necessarily the case for a foreign branch or an ordinary resident subsidiary: here, the reduction in the foreign tax will merely reduce the available foreign tax credit and thus increase

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<sup>37/</sup> The Royal Commission on the Taxation of Profits and Income has put forward specific recommendations to remedy this situation chiefly by bringing the great bulk of overseas profits and income taxed under Schedule D on to a current year basis of assessment (op. cit., paragraphs 742-4).

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pro tanto the United Kingdom tax remaining due (except in so far as the foreign tax rate exceeded the United Kingdom rate - and thus the maximum credit). On the other hand, group treatment of the parent and subsidiary for profits tax purposes (Chapter III above) is not available when the subsidiary is non-resident, nor may losses of either the parent or the subsidiary be set off against the profits of the other or be eliminated by a contribution from one to the other.

Formation of a non-resident subsidiary to carry on the foreign business of an existing resident subsidiary requires prior government approval under the rules against "company emigrations" (Part Two, Chapter II, B). These rules are not applicable to incorporation of a foreign branch or to the commencement of a new foreign activity.

The profits derived by a parent from transactions with a subsidiary are subject to adjustment to the profit which would have been earned if the two companies were dealing at arm's length as independent enterprises.

## Chapter V

### Overseas Trade Corporation

The Overseas Trade Corporation, a concept introduced by the Finance Act of 1957,<sup>38/</sup> is, in effect, a resident subsidiary with many of the tax advantages of a non-resident subsidiary: its trading profits are exempt from profits taxes; dividends paid out of such profits however are not franked investment income and are included in the computation of the profits of the recipient parent company, unless it in turn is also an Overseas Trade Corporation. The investment income of an Overseas Trade Corporation is chargeable to income tax but its trading income is exempt so long as it remains undistributed. Since income tax is payable only on distributions, not on current profits, the special provisions governing the assessment of corporate income at the beginning and end of its existence also are not applicable to an Overseas Trade Corporation (Part One, Chapter I, (2)).

A non-resident stockholder will normally be entitled to repayment in respect of the tax deducted from the part of a dividend which is regarded as paid out of exempt trading income; the repayment will be limited to the company's net

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<sup>38/</sup> Part Two, Chapter III, D.

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United Kingdom rate of tax. In this way, the non-resident stockholder will be substantially in the same position as he would be with respect to dividends from a non-resident company.

Grouping between an Overseas Trade Corporation and a resident company which is not an Overseas Trade Corporation is permitted for profits tax purposes, i.e. the profits from the investment income of the Overseas Trade Corporation are grouped with the whole profits of the resident non-Overseas Trade Corporation, but, as in the case of a non-resident subsidiary, there is no such grouping for income tax purposes.

Where the Overseas Trade Corporation is held directly by individual shareholders, its trading profits will suffer no profits tax, even after distribution, just as in the case of a directly held non-resident corporation. The difference in the availability of indirect credit which exists between a company-owned and an individually owned non-resident company, does not exist in the case of an Overseas Trade Corporation (Part Four, Chapter VII). Resident stockholders may see a disadvantage in the fact that they may normally obtain credit for the foreign income tax paid by a non-resident corporation, while the Overseas Trade Corporation will itself claim this advantage, though it must ultimately redound to the stockholders' benefit. A corporate stockholder may obtain credit against its profits tax liability with respect to dividends received from an Overseas Trade Corporation for any balance of foreign tax which has not been relieved by credit against the income tax liability of the Overseas Trade Corporation itself.

The dissolution of an Overseas Trade Corporation or the sale of its shares will not give rise to any charge to tax on the parent company. Where, however, a company which is or has been an Overseas Trade Corporation is wound up, tax will be payable by the liquidator out of the funds of the Overseas Trade Corporation on so much of the assets distributed to members as may be regarded as paid out of exempt trading profits. It will be recalled that in the case of the sale or dissolution of a non-resident subsidiary, its accumulated profits will be received by the parent as tax-free capital profits (Chapter IV above).

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## Chapter VI

### Direct Ownership of Resident Foreign Trading Corporation

Where a resident company which is closely held contemplates extension of its activities to the foreign field, it may be feasible for the foreign operation to be owned directly by its shareholders, rather than as a subsidiary of the company. If the foreign operation is to be carried on by a separate corporation resident (i.e. controlled) in the United Kingdom the following are the principal factors relative to corporate versus direct ownership of its shares:

Group treatment for profits tax purposes (Chapter III above) is available only if the resident foreign operating company is a subsidiary of a United Kingdom resident corporation. Common ownership of the shares of both corporations by the same shareholders is not sufficient for this purpose.

Losses of one of the corporations cannot be eliminated by contribution from the other (Chapter III above) unless the parent-subsidiary relationship exists.

Credit for foreign taxes against United Kingdom taxes is available only to the company carrying out the foreign operations. Therefore, it is immaterial whether the dividends of that company are paid directly to individual shareholders or are first channeled through a parent corporation.<sup>39/</sup>

Dividends paid to a parent company and by the latter to its shareholders are subjected to standard tax but once (Part One, Chapter I G 3). Similarly there is no duplication of profits tax where the income passes through several resident corporations (Part One, Chapter II B). Therefore, there is but a single United Kingdom standard tax and profits tax on the foreign earnings whether the subsidiary or direct ownership form is used.

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<sup>39/</sup> Note that the differences between a subsidiary and a directly held corporation for purposes of the profits tax and of inter-company loss contributions may produce differences in the effective United Kingdom tax rate in any particular year. Such differences may result in differences of allowable foreign tax credit between the two forms.

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## Chapter VII

### Direct Ownership of Non-resident Foreign Trading Corporation

If the foreign trading corporation is to be controlled abroad, the following are the principal factors relative to corporate versus direct ownership of its shares:

Group treatment for profits tax purposes (Chapter III above) is not available under either form. However, dividends paid by a non-resident subsidiary to its resident parent corporation are subject to profits tax in the hands of the parent. The earnings of a non-resident corporation distributed directly to individual shareholders, on the other hand, escape profits tax entirely.

Mitigation of the adverse effects of losses on the allowable foreign tax credit through inter-company contributions is not possible under either form of ownership.

The form of ownership of the shares may produce a marked difference in the allowable foreign tax credit (Part Three, Chapter III B 2): if operations are to be conducted in a treaty country, credit for "indirect" tax may be allowed in all cases or it may be reserved to a controlling corporate shareholder but denied to individual shareholders, depending on the particular treaty involved. If operations are to be in a non-treaty country, or if the treaty does not provide for indirect credit for individual shareholders, indirect credit will nevertheless be available if the foreign tax is imposed by a Commonwealth country, whether the foreign dividends are paid to a United Kingdom company or to individual shareholders. If a non-Commonwealth, non-treaty country is involved, indirect credit will be available only if the recipient is a United Kingdom resident corporation which owns at least one-half of the voting power of the foreign operating company. However, if the shares are so owned, the benefit achieved in terms of foreign tax credit would be curtailed by the subjection of the foreign dividends to profits tax in the hands of the parent. Whether the profits tax detriment would counterbalance the indirect credit benefit would depend upon the facts of each particular case.

Dividends of the foreign corporation would be subject to United Kingdom standard tax but once, whether paid directly to individual shareholders or through a United Kingdom parent corporation.

## Chapter VIII

### Conclusion

The preceding analysis indicates the principal forms in which foreign operations may be carried on, each form differing from the others in some of its tax features. In many situations, however, the choice of forms is restricted by practical considerations. Thus, direct ownership of a resident or non-resident foreign trading company by the stockholders of the parent enterprise is practical only in case the parent company is closely held; widely-held companies must carry on their foreign operations through their own branch or subsidiaries. On the other hand, where there is a free choice of forms, as between foreign branches and ordinary resident subsidiaries, their tax regimes can be largely assimilated through the possibilities of group treatment and loss contributions.

Until the introduction of the Overseas Trade Corporation in 1957, the most important alternatives were the foreign branch and the foreign (non-resident) subsidiary. The use of the latter form offers considerable advantages: current profits are not taxed unless they are distributed in the form of dividends to the parent; and if profits are allowed to accumulate, they may be repatriated as tax-free capital profits upon the partial or total sale or dissolution of the subsidiary. If the profits are currently returned as dividends, such dividends will have to be included in the parent's income grossed up at the effective foreign ("direct" and "indirect") tax rate or at the United Kingdom tax rate, whichever is the lower (Part Three, Chapter III B 2). To this extent the United Kingdom tax on the repatriated foreign profits will be substantially the same whether they were earned through a foreign branch or a non-resident subsidiary (though a difference may result where the foreign tax varies depending on whether or not the foreign operation is locally incorporated and sends dividends out of the country. It may be noted that this constitutes a limitation on the advantages of non-resident subsidiaries over foreign branches under United Kingdom as against United States law: under United States law, in the case of a foreign subsidiary, only the dividends distributed (net of "indirect" tax) are includible in the taxable income of the United States parent corporation, although credit is given for both the

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"direct" and the "indirect" tax falling on such dividends.<sup>40/</sup> Another difference lies in the greater ease with which United States law will recognize a subsidiary as being non-resident. On the other hand, the above-mentioned possibility of repatriating accumulated profits as tax-free capital profits is a definite advantage of the United Kingdom law as against the United States tax of 26 per cent, which is in principle payable on the liquidation gains from foreign subsidiaries.<sup>41/</sup>

The principal advantage of a foreign branch lies in the possibility of deducting its losses from the domestic profits of the enterprise, thus reducing United Kingdom tax on the latter. While this may favour the use of the branch form during the early years of foreign operations, when losses may be expected, the foreign subsidiary would become more advantageous once this initial period is past: yet the provisions against company emigration (Part Two, Chapter II B) may exclude the possibility of transforming at this point a branch into a foreign subsidiary, so that the loss-deduction benefits of the branch could be secured only at the cost of retaining this form permanently.

With the introduction of the Overseas Trade Corporation (Part Two, Chapter III D) this difficulty, however, has become somewhat academic, since it is now possible to secure for a qualified resident subsidiary most of the tax advantages otherwise available only through a foreign subsidiary. While this is more important under United Kingdom than under United States law (where mere foreign incorporation, without a need for government consent, suffices to establish a foreign subsidiary), it is a definite advantage to obtain these tax benefits without abandoning domestic residence - an advantage not available under United States tax. It may therefore be concluded that the resident Overseas Trade Corporation subsidiary with its complete tax exemption for reinvested foreign profits constitutes the most advantageous business form for qualified foreign operations available under United Kingdom tax law.

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<sup>40/</sup> United States Income Taxation of Foreign Private United States Investment in Latin America, Chapter II B 1 a iv, at p. 20 (United Nations Publications Sales No. 1953.XVI.1, including Supplement, 1956).

<sup>41/</sup> See Sec. 367 U.S. Internal Revenue Code of 1954 regarding the possibility of tax-free liquidations.

# Appendix I

## LIST OF GENERAL INCOME TAX AGREEMENTS TO WHICH THE UNITED KINGDOM IS A PARTY

The United Kingdom has concluded agreements for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income with the following:

### (a) Commonwealth countries and territories

Aden Colony	Fiji	St. Christopher and Nevis
Antigua	Gambia	St. Lucia
Australia	Ghana	St. Vincent
Barbados	Gilbert and Ellice Island Colony	Sarawak
Basutoland Protectorate	Grenada	Seychelles
Bechuanaland Protectorate	Guernsey	Sierra Leone
British Guiana	Isle of Man	Singapore
British Honduras	Jamaica	Swaziland
British Solomon Islands Protectorate	Jersey	Tanganyika
Brunei	Kenya	Trinidad and Tobago
Canada	Mauritius	Uganda
Ceylon	Montserrat	Union of South Africa
Cyprus	New Zealand	Virgin Islands (British)
Dominica	Nigeria (including Cameroons under UK trusteeship)	Zanzibar
Falkland Islands	North Borneo	
Federation of Malaya	Pakistan	
Federation of Rhodesia and Nyasaland		

### (b) Other countries

Austria	Germany (Fed. Rep.)	Norway
Belgium	Greece	Sweden
Denmark	Ireland	Switzerland
Finland	Israel	Union of Burma
France	Netherlands <sup>42/</sup>	United States

<sup>42/</sup> This agreement has been extended to the Netherlands Antilles.

Appendix II

LIST OF THE COUNTRIES OF THE COMMONWEALTH  
WHICH HAVE A SYSTEM OF DIRECT TAXATION

Aden	Jersey
Antigua	Kenya
Australia	Malaya (Federation of)
Barbados	Malta
Basutoland	Mauritius
Bechuanaland Protectorate	Montserrat
British Guiana	New Zealand
British Honduras	Nigeria (Federation of)
British Solomon Islands Protectorate	North Borneo
Brunei	Pakistan
Canada	St. Christopher and Nevis
Ceylon	St. Lucia
Cyprus	St. Vincent
Dominica	Sarawak
Falkland Islands	Seychelles
Federation of Rhodesia and Nyasaland	Sierra Leone
Fiji	Singapore
Gambia	South Africa (Union of)
Gibraltar	Swaziland
Gilbert and Ellice Islands	Tanganyika
Ghana	Tonga
Grenada	Trinidad and Tobago
Guernsey	Uganda
Isle of Man	Virgin Islands
Jamaica	Zanzibar

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