



ICAEW TAX REPRESENTATION

FINANCE (NO.3) BILL

CLAUSE 47 and 48 Schedules 12 & 13: CONTROLLED FOREIGN COMPANIES AND PROFITS OF FOREIGN PERMANENT ESTABLISHMENTS ETC

Parliamentary briefing submitted at Public Bill Committee stage in May 2011 by ICAEW Tax Faculty setting out comments and concerns in relation to the clauses and schedules covering CFCs and the taxation of foreign branches

Contents

	Paragraph
Introduction	1 - 2
Comments and recommendations	3 - 19
Further contact	20
ICAEW and the Tax Faculty: who we are	Appendix 1
Ten Tenets for a Better Tax System	Appendix 2

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CLAUSE 47 and 48 Schedules 12 & 13: CONTROLLED FOREIGN COMPANIES AND PROFITS OF FOREIGN PERMANENT ESTABLISHMENTS ETC

Introduction

1. Clauses 47 and 48 and Schedules 12 and 13 cover interim changes to the CFC regime and the introduction of a new regime for the taxation of foreign branches. These are the latest changes to the law as part of the rewriting of the taxation of foreign profits.
2. We understand the government will publish a consultative document at the end of May 2011 with proposals for a fundamental rewriting of the CFC regime to be included in FB 2012 and to come into effect some time next year.

Comments and recommendations

Controlled Foreign Companies

3. Overall we welcome the government's efforts to introduce temporary easing measures to the CFC regime prior to the new regime to be put in place in 2012.
4. We welcome the introduction of the statutory exemption 'grace period' of up to three years for foreign subsidiaries that, as a consequence of a reorganisation or change of UK ownership, come within the scope of the CFC regime for the first time.
5. We do not believe that cash and finance income that is derived from previous 'good' overseas income should potentially come within the CFC regime. It would be possible to pay this income up to the UK parent by way of dividend and then reinvest as equity to the potential CFC subject to any possible Fat Cap provisions. But we do not see why there should be a need to do that and it could also be expensive if the local jurisdiction operates a withholding regime.

Revisions to s 748 ICTA 1988

6. There is a proposal for new s 748 (1)(da) to increase the de minimis limit from £50,000 to £200,000. We suggest that, as an alternative, there should also be a de minimis based on group turnover.

New s 751AB ICTA 1988

7. We found it extremely difficult to read and understand the provisions in this new section. We understand that new s 751AB is intended to allow partial CFC relief claims similar to s 751A/AA/B, where the provisions of new s 748(1)(ba) or (bb) are failed.
8. Section 751AB(2)(a)(i) then addresses the situation where the new s 748(1)(ba)/Part 2A trading company relief is not applicable by virtue of UK-related gross income or expense being > 10% but ≤ 50%. Section 751AB(2)(a)(ii) then appears to allow partial trading company relief where > 5% of a CFC's gross income is either finance income or relevant intellectual property income, but the relevant intellectual property income itself is ≤ 5% of the CFC's gross income.
9. When we submitted our comments on the draft Finance Bill clauses in February 2011 we asked whether the above was the correct interpretation of these new provisions? Irrespective of the detailed implications of these provisions we continue to recommend that the provisions should be redrafted to make them clearer to understand.
10. We recommend that the limit on intellectual property income below which no apportionment will apply should be 10% rather than 5% (s 751AB(2)(a)(ii)) for consistency/accessibility of the new exemption.

11. Our general concern is that if these exemptions are made too complicated then business will revert to, and rely on, the existing motive test.

Amendments to Schedule 25 ICTA 1988

12. We are concerned by the provision in para 12D which requires the CFC company not to have 'to a substantial extent' non-exempt activities. Without a more precise definition of substantial we are concerned by the uncertainty that this particular provision may create. We understand that this is to be based on the substantial shareholding exemption practice of interpreting substantial as 20% or more, but would be grateful for confirmation of this. However, we believe that it should be statutorily defined.
13. The measures in new paragraph 12 H et seq are more demanding than the proposed 3:1 Fat Cap ratio considered for the new, post 2012, CFC regime and outlined in paragraphs 3.17 and 3.18 of Chapter 3 of part IIA of the Corporate Tax Reform document. There is some lack of clarity here as the Fat Cap concept is applied to situations where the intellectual property is held as an offshore investment. Is there to be a distinction between passive and active intellectual property? If this is the intention, why should passive intellectual property be easier to deal with by way of a simple ratio concept?
14. We believe that in para 12L(2)(a) IP income from unrelated persons should be specifically excluded.

Profits of foreign permanent establishments

15. We welcome the change, from the December draft clauses, to allow potential relief for investment companies.
16. The election under new section 18F is irrevocable.
17. We do not believe it is realistic to expect a company to be able to commit itself irrevocably. It would seem more appropriate for the initial election to be for a minimum period of say four years and for there to be a facility to bring the election to an end by giving a minimum period of advance notice of say one or two years' such notice not to be effective before the end of the initial four year period.
18. There would appear to be no potential relief for terminal losses for which relief would need to be given to keep the UK legislation EC Treaty compliant on the principles established by the Marks & Spencer ECJ judgment. Equally, if on the closure of the foreign branch there was a foreign exchange loss on the branch 'investment' then not to give loss relief to the UK 'parent' would be contrary to the ECJ judgment in the case *Deutsche Shell GmbH v. Finanzamt für Grobunternehmen in Hamburg* (C-293/06).
19. We are also concerned by new s 18F (1) (b) CTA 2009 under which the election to exclude certain profits and losses will apply 'to all accounting periods of the company following that in which it is made.' This would mean that for companies with a calendar year end, the election could not be validly made until after Royal Assent in July 2011 and so branch exemption would only apply for the accounting period beginning on 1 January 2012. Companies with a June year end would be even worse off and would only be able to elect into the new system for accounting periods beginning on 1 July 2012. We believe that the election should commence at the very least with effect from 1 April 2011, as was the original intention, with split accounting periods. We recommend that consideration is given to backdating the effective date of the new election to 1 January 2011 as was done in Finance Act 2004 on the introduction of the Interest and Royalty Directive (see now ss 757 – 767 ITTOIA 2005).

Further contact

20. For any further enquiries please contact:

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ICAEW AND THE TAX FACULTY: WHO WE ARE

1. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
2. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
3. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including *TAXline*, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see <http://www.icaew.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx>).