



ICAEW TAX REPRESENTATION

CONSULTATION ON CONTROLLED FOREIGN COMPANIES (CFC) REFORM

Comments submitted in August 2011 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to HM Treasury in response to the Consultation issued by HM Treasury and HM Revenue & Customs on 30 June 2011

Contents

	Paragraph
Introduction	1
Who we are	2 – 4
Background	5 – 7
Overall Impression and Timing	8 – 10
Compatibility with EU Law	11 – 17
Detailed Comments	18 – 77
Further contact	78
ICAEW and the Tax Faculty: who we are	Appendix 1
Ten Tenets for a Better Tax System	Appendix 2

CONSULTATION ON CONTROLLED FOREIGN COMPANIES (CFC) REFORM

INTRODUCTION

1. We set out below our comments on the proposals in the Consultation on Controlled Foreign Companies (CFC) Reform issued on 30 June 2011 by HM Treasury and HM Revenue & Customs. .

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 775,000 members worldwide. The Tax Faculty is the focus for tax within ICAEW.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter TAXline to more than 11,000 members of the Institute who pay an additional subscription, and a free weekly newswire.

BACKGROUND

The earlier attempt to introduce a new CFC regime

5. In mid 2007 a number of CT Reforms were put forward to be introduced as a single package. The reforms included a recasting of the CFC regime which was introduced in 1984 and has been subject to a considerable number of changes and modifications over the subsequent years.
6. The CFC reform proposals proved to be extremely contentious and the Government decided to go ahead with the balance of the package in 2009 and leave the reform of CFC to another occasion.

The importance of the CFC regime

7. It could be argued that the CFC regime goes to the very heart of the international tax regime for UK based business and if the UK is to achieve its objective to have the most competitive corporate tax regime amongst the G20 countries then this latest consultation is of fundamental importance to achieving that goal.

OVERALL IMPRESSION AND TIMING

The proposed new CFC regime – will it do the job?

8. We have to say at the outset that while the current proposals are a considerable improvement compared to the 2007 proposals they are still disappointing and leave a lot of subjectivity and will create what we believe will be a considerable amount of uncertainty for business and its advisers.

9. We are also very concerned that there is now very little time left for the proposals to be put into acceptable form in order to be published in draft before the end of the year for inclusion in Finance Bill 2012 next Spring. We are worried that once the proposals are in draft legislative form it will be that much more difficult to make meaningful changes.
10. We believe that the Government may need to take extra time to get the CFC regime right rather than rush to amend the current unsatisfactory arrangements.

COMPATIBILITY WITH EU LAW

11. The European Commission issued a reasoned opinion on 18 May 2011 in relation to the current CFC regime and the UK Government had 2 months to respond.
12. Annex I to the Consultation Document provides a summary of the Government's understanding of the relevant ECJ case law in the area of CFC legislation.
13. We do not consider that Cadbury Schweppes and later ECJ cases are support for the contention that it is possible to split activities of an offshore subsidiary between activities that are genuine economic activities and those that are wholly artificial arrangements and so introduce an EU compliant CFC regime which targets just those wholly artificial arrangements. This may be a position the ECJ arrives at in relation to CFCs in the future, but in our view this has not yet happened.
14. In particular, having regard to paragraphs 86 and 87 of the ECJ's decision in Thin cap GLO (C-524/04) and paragraphs 71 and 73 in Société de Gestion Industrielle (SGI) (C-311/08), we do not accept that a transaction that only takes place in a controlled situation is automatically artificial. If this were the case, no dealings between Permanent Establishments (PE)/head offices/other PEs would ever be recognised, which is not the position taken by the OECD.
15. We are also concerned by the proposal in paragraph 8.7 that the Territorial Business Exemption will not apply in relation to Intellectual Property that has been transferred from the UK within the last 6 years. This seems to us to be an arbitrary cut off and could be held not to be compliant with EU law particularly if, because of UK business connections, the General Purpose Exemption (GPE) is also not available.
16. Finally we are concerned by the proposals in relation to upstream loans in paragraphs 6.30 and 6.31. We are concerned that these proposals may breach State Aid rules. The proposals are similar to the Dutch 7% regime which has had to be abandoned for State Aid reasons. Similar considerations arose in the Spanish rules for the writing off of goodwill which was only permitted in relation to overseas, and not domestic, acquisitions or the Hungarian 75% exemption for cross border interest but not for domestic interest. These last two regimes were also held to be contrary to EU state aid rules.
17. If the proposed UK regime is not EU compliant then it will only be a matter of time before a complaint is made by another EU member state or in the Code of Conduct Group.

DETAILED COMMENTS

Chapter 2 – Overview of Regime

Question 2A: Do the proposals strike the right balance to deliver a more competitive corporate tax system while providing adequate protection of the UK tax base?

18. We welcome the proposed default that the new CFC rules will be targeted at artificial diversion of profits from the UK.

19. We are concerned that in paragraph 2.2, which sets out the underlying principles for the new CFC regime, the last sentence of the final bullet point 'Maintaining a level playing field..' does not accurately reflect EU law and the decision of the ECJ in the Cadbury Schweppes case. A company which sets up a genuine subsidiary in another EU member state to take advantage of a lower tax rate, in other words a tax motivated location, cannot in our view be caught by a CFC regime in the parent company host state. That's what the ECJ decided in Cadbury.

Question 2B: Do you have any views on how the rules should be administered, and in particular how the clearance process could be improved?

20. We agree that a non-statutory clearance procedure together with real time working with large business should provide greater certainty for business.

Chapter 3 – Defining a Controlled Foreign Company

Question 3A: Which of the options for defining control would be preferable and why? Or would a combination be preferable?

21. At the present time our members don't have an absolute preference for any one of the three options set out. Some favour a principles approach while others believe that a more mechanical approach may be preferable although it would be a concern if this had to be coupled with complex anti-avoidance protection, as suggested in paragraph 3.9.
22. Our members do have a concern about the treatment of joint venture companies and it is recognised in paragraph 3.9 that there may need to be supplementary rules for these .We acknowledge that the accounting test may exclude most joint ventures.

Question 3B: Are there other options for the calculation of the lower level of tax which would ensure that the UK measure of tax would broadly reflect the figure calculated under the existing rules? Can the chargeable profits approach be simplified?

23. We think that the simplest approach is to have an actual rate which on the 75 per cent test could be 17% by reference to the UK headline rate in 2014 onwards. However, we believe that the rate could be set at a lower level, by reference to 50% of the UK headline rate, which would reduce the threshold rate for the new CFC regime to 11.5%.

Chapter 4 - Low Profits, Excluded Countries and Temporary Period Exemptions

24. In relation to the proposal in paragraph 4.10 to introduce a TAAR to protect against fragmentation of profits we note that there is no such provision under the existing CFC regime and we think it unlikely that business would seek to exploit the new regime in such a way, not least because of the cost involved in undertaking the fragmentation.

Question 4A: Which option for the low profits exemption is preferred? The Government would welcome views from groups on the options outlined, and the proportion of their CFCs that could potentially qualify under each option.

25. We note that the equivalent threshold under the US Sub-part F regime is \$1.5 m which is £0.92m currently ie circa £1 m and this makes the proposed limits under all the options seem relatively ungenerous.

Question 4B: The Government would welcome views on the suggested percentage of group turnover for option B, including data on the proportion of CFCs which could potentially benefit from this approach.

26. Under Option B we recommend that the lower limit should be £500,000 rather than the £200,000 proposed.

27. We have no data on the proportion of CFCs which would benefit from this approach.

Question 4C: The Government welcomes views from business about whether they would prefer a single accounts based exemption, or an option to apply a UK chargeable profits basis despite the anticipated additional compliance burden.

28. We would welcome this optional approach.

Question 4D: Which of the proposed options for an excluded countries exemption would be the easiest to operate and is preferred?

29. We believe that all EU member states and countries in the EEA should be in the Category 1 list

Question 4E: The Government welcomes views on what the appropriate limits should be for the general conditions set out in paragraph 4.14, and on what basis they should be applied.

30. We do not object to the general condition set out in the third bullet point re branch income in another territory with a lower tax charge but we do not consider the conditions in the first two bullet points to be relevant. The transfer pricing rules should be used if transactions with the UK are being 'abused' to divert profits from the UK and there are a number of other provisions targeting finance and royalty income.

Question 4F: Is the scope of the temporary period of exemption in Finance Bill 2011 sufficiently wide to cover the majority of commercial acquisitions and reorganisations?

31. While three years is likely to be sufficient for the majority of cases we recommend that there should be a possible extension when three years is not sufficient. So the provision could be 'three years or such longer period as is appropriate in the particular circumstances of the case.'

Question 4G: Are the anti-avoidance rules (which focus on transactions with the UK) included in Finance Bill 2011 for the temporary period of exemption sufficiently well targeted?

32. The third condition (new paragraph 15E (4) (c)) is not Cadbury Schweppes compliant as it is not restricted solely to situations when wholly artificial conditions are present.

Question 4H: Are specific rules needed to deal with circumstances where an overseas subsidiary is transferred from one UK group to another, for example a third party sale during a period of exemption?

33. We do not believe that specific rules are required.

Chapter 5 – Territorial Business and Sector Specific Exemptions

Question 5A: Would the proposed safe harbour be effective at removing CFCs that make a low level of profit and pose a low risk to the UK tax base?

Question 5B: The Government invites views on the preferred basis and limit for this safe harbour, and is particularly interested in the impact of different rates and bases on the number of CFCs that would qualify for this exemption.

34. We are concerned that any distribution company is unlikely to be able to benefit from the 10% safe harbour profit level. We also do not believe that all related party business expenditure should be excluded from the calculation which smacks of a retention of an aspect of the present regime.

Question 5C: Are there specific situations where a different safe harbour could be useful?

35. No comment.

Question 5D: Would the proposed manufacturing TBE be useful to remove manufacturing CFCs from the rules? How many CFCs would it apply to?

36. We are concerned that contract manufacturing potential CFCs would not be covered by this exemption as they are often likely to be using UK IP.

37. There is a need for a clear understanding as to what is meant by manufacturing. Is assembly the same as manufacturing?

38. More fundamentally do you have to change the underlying nature of the materials involved in the process for there to be manufacturing? What would be the position of a contract assembly and test operation, for example?

Question 5E: If a CFC currently qualifies for the exempt activities test is it likely to qualify for this exemption? If not, why not? Please distinguish between the changes which address "swamping" and other aspects of the rules. If the failure is marginal or a minor adjustment to the TBEs would result in exemption please provide details.

39. The exclusion of CFCs performing activities to a substantial extent relating to ex-UK IP mean this exemption is unnecessarily restrictive in our view.

Question 5F: Would setting a minimum value of assets leased under an operating lease at £10 million per asset provide a reasonable approach to identifying business activity for this purpose?

40. We do not have a firm view on a minimum value but we are concerned that there are State Aid implications for these proposals.

Question 5G: The Government would be interested in views on how adequate protection of the UK tax base could be provided against such tax driven arrangements without introducing rules which would have a disproportionate effect on supply chains, procurement companies and intra-group service provisions.

41. We believe that the tax risks that are identified here are best dealt with using the Transfer Pricing regime and should not be a part of a new CFC regime.

Question 5H: The Government invites views on the options for defining incidental finance income set out above.

42. If the foreign subsidiary has been capitalised in an appropriate way then we cannot see the need for the proposed limitation.

Question 5I: The Government welcomes views on the preferred option to define incidental investment income more generally, and how that should interact with the incidental finance income definition.

43. No comment.

Question 5J: Does the proposed treatment of holding companies raise any issues? Would an alternative approach to this be preferred and, if so, what would the advantages be?

44. We are concerned that this, and other proposals, do not uphold the basic principle of the new CFC regime which is to target 'profits artificially diverted from the UK' and not surplus income that arises overseas

Question 5K: Could a principles-based approach to drafting the TBE offer an alternative to the more mechanical TBE proposals? The Government welcomes early views on this.

45. Only if the principles are fully Cadbury compliant i.e. they only target artificial diversion from the UK.

Question 5L: Is the proposed approach a reasonable starting point for drafting the exemption? Or would a different approach be preferred (please provide details)?

46. Yes, provided paranoia re ex-UK IP is overcome.

Question 5M: Alternatively would there be advantages in using both mechanical and principles-based approaches to design the TBEs?

47. The overriding principle is to 'prevent the artificial diversion of profits from the UK' and all the provisions should be interpreted accordingly and any mechanical proposals should also uphold that principle.

Chapter 6 – Finance Company Rules

48. We welcome the introduction of a finance company partial exemption which from 2014 onwards should give an effective UK corporation tax rate of profits from overseas intra-group financing of 5.75%.

49. We believe the Government ought to consider the potential State Aid implications of the proposals in paragraphs 6.8 to 6.31 and share their conclusions with those bodies involved in these consultations on the new CFC regime.

Question 6A: Do business prefer the simplest option, one of the more flexible options (as outlined in Annex D) or an alternative approach? Would the benefits of the simplest option outweigh the cost of any intra-group debt restructuring where required?

50. We prefer the more flexible option for Finance Company Partial Exemption (FCPE) and believe Method C in the Appendix should be followed.

Question 6B: Do businesses agree that the proposed treatment of companies that carry out both treasury and finance company activities is a satisfactory approach? If not, do businesses consider that it would be practical to separately identify the profits from treasury and finance activities?

51. Businesses should have the option of separating out the 2 activities.

Question 6C: Do businesses agree that applying the GPE to treasury companies is an appropriate approach to exempt them from the rules?

52. We agree provided the final form of the GPE is reasonable.

Question 6D: Bearing in mind the need to deliver an affordable regime, what circumstances and qualifying conditions should the Government consider when determining when a full exemption might apply?

53. The test should be on the capitalisation of the CFC and there being no artificial diversion of profits from the UK.

Question 6E: Do the circumstances above in which upstream loans can arise cover the majority of the instances where funds are lent to the UK for genuine commercial reasons?

54. There could also be Foreign Exchange reasons.

Question 6F: Would using the worldwide debt cap approach to short term lending produce a workable solution to allow short term upstream loans in these circumstances while protecting the UK tax base?

55. We believe the worldwide debt cap approach would produce a workable solution.

Question 6G: Based on the design options available, do you think that the finance company rules should apply to mixed activity companies, despite the added complexity? If so, what would be the most appropriate way to identify the profit arising from each activity?

56. If the CFC is fully equity funded we cannot see why the rules should apply to such mixed activity companies.

Question 6H: Would any practical issues arise if the design option chosen meant that intra-group debt had to be restructured? How long would it take to restructure such arrangements?

57. We consider that this situation should be avoided..

Question 6J, 6K and 6L

58. We have no comment on the final three questions in this chapter.

Chapter 7 – General Purpose Exemption

Question 7A: The Government welcomes views on applying principles based on those set out in Article 7 to apply the GPE, and any alternative methods for the calculation of “commensurate with activities” profits.

59. It doesn't seem to us to necessarily be a step forward replacing the existing motive test with what is in essence a transfer pricing test to be applied in the context of CFCs.

Question 7B: The Government welcomes views on the likely compliance impacts of adopting this approach, and any situation in which this attribution may significantly increase compliance burdens.

60. We believe the proposed approach would be unduly burdensome for business.

Question 7C: Does the GPE provide a suitable and effective replacement for the motive test that can be applied to any CFC to determine whether and to what extent profits have been artificially diverted from the UK?

61. We believe that this exemption is too mechanical .

62. We wonder whether it would not be better to seek to identify what is 'bad' i.e artificial diversion in the activities/profits of the CFC and tax that.

Chapter 8 - Treatment of Intellectual Property

Question 8A: The Government welcomes views on ways to distinguish high risk from low risk licensing for the purposes of defining the term “transfer”.

63. We believe that the automatic removal from the exemption from the exploitation of any IP which has been transferred from the UK within the last 6 years raise serious questions as to whether such a provision can be compatible with EU law.

Question 8B: The Government welcomes views on the indicators described in Annex E that may indicate whether a transfer of IP has given rise to an artificial diversion of UK profits or not, and whether inclusion of such indicators in guidance would be helpful in assisting with interpretation of the CFC rules as they relate to IP.

64. We believe the indicators are fair and reasonable and could helpfully be included in guidance.

Question 8C: The Government welcomes views on whether the above proposals are appropriate to deal with CFCs where IP is held as a passive investment.

65. We believe there will need to be a let out for activities that are not artificial to comply with EU law, at least in respect of EU member states.

Questions 8D: Is the pure income profit approach to determining whether IP is held as an investment workable?

66. Yes, but even if it's an investment, it's not necessarily artificial diversion.

Question 8E: Is there a case for the tapering charge? Are there sufficient instances to which a tapering charge could fairly be applied to justify the additional rules that would be needed?

67. We believe that a taper charge could be workable.

Question 8F: The Government invites views on these proposals and whether in practice tax is paid on IP transfers sufficiently frequently to merit the additional complexity that relieving rules would introduce.

68. The proposal does avoid double jeopardy and double taxation.

Question 8G: The Government welcomes comments on the examples in Annex F and analysis provided, and would also welcome any other practical examples which might assist with the development of the CFC rules for IP during the next stage of consultation.

69. The examples provided in Annex F appear reasonable. We will investigate whether our members can provide other examples to assist in the development of the CFC rules for IP.

Question 8H: The Government welcomes views on an appropriate transitional provision, setting out its purpose and justification.

70. No comment.

Chapter 9 – Foreign Branches

Question 9A: Is the local management requirement proposed for the CFC regime appropriate for foreign branches?

71. We think it is probably likely to be appropriate but it may be difficult to satisfy in the context of branches where there is likely to be less local management.

Question 9B: The Government is keen to hear the views of businesses on the application of the banking and insurance exemptions to exempt foreign branches and to see examples of how the capitalisation tests might apply to the foreign branch or UK company in practice.

72. No comment

Question 9C: Do you see any issues with the proposed approach to the application of the sector specific TBEs to exempt foreign branches?

73. No comment

Question 9D: Do you foresee any issues with the application of the general purpose exemption to foreign branches?

74. If the situation is wholly commercial then we do not see why there should be the need for a Transfer Pricing analysis.

Question 9E: Are there any other issues that should be considered to ensure that the CFC reform and proposed exemptions apply in a workable way to exempt foreign branches?

75. No comment.

Annex A – Property and Leased Tangible Assets

Annex B – Insurance Exemption

Annex C – Banking Exemption

Annex G – Charging Mechanics

Annex H – Tax Impact Assessment

76. We are not providing answers to the additional questions in these five Annexes with the exception of the one question shown below.

Question A1: It is not intended that the property investment exemption will apply to rental income received by owner occupiers. Instead activities in relation to rental to owner occupiers will be treated as non-investment activities. Will this approach raise any practical issues?

77. We do not see why if property is occupied by persons who are connected or associated with the CFC this should automatically be treated as investment activity.

Further contact

78. For any further enquiries please contact:

Ian Young International Tax Manager, ICAEW Tax Faculty Email: ian.young@icaew.com Tel: +44 (0)207 7920 8652	
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APPENDIX 1

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>).