

ICAEW REPRESENTATION

TAXREP 8/11

CORPORATE TAX REFORM: DELIVERING A MORE COMPETITIVE SYSTEM

Comments submitted on 22 February 2011 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to HM Revenue & Customs in response to the consultation document *Corporate Tax Reform: delivering a more competitive system* published in November 2010.

Comments were submitted, separately, on 9 February 2011 in relation to CFC Interim Improvements and Foreign Branch taxation (Parts IIIA and IIIB of the consultation document) which are to be included in Finance Bill 2011.

Contents	Paragraph
Introduction	1–4
Who we are	5–7
The Corporation Tax Roadmap	8 - 12
Controlled Foreign Company (CFC) Reform	13 - 32
Patent Box	33 - 39
Research and Development Tax Credits	40 - 54
The Tax Faculty's ten tenets for a better tax system	Appendix 1

CORPORATE TAX REFORM: DELIVERING A MORE COMPETITIVE SYSTEM

INTRODUCTION

1. In this document we present the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) on the consultation document *Corporate Tax Reform: delivering a more competitive system* published by HM Revenue & Customs (HMRC) in November 2010.
2. We are pleased to have the opportunity to respond to this consultation. We would be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Representatives of the ICAEW Tax Faculty attended the two open events on 13 December 2010 and 11 January 2011 which set out details of the proposals.
4. Information about the Tax Faculty and the ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

WHO WE ARE

5. The Institute 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 Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
6. 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.
7. 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.

THE CORPORATE TAX ROADMAP – PART 1A

8. We have welcomed the present government's stated policy objectives in creating tax policy and in response to the Consultation Document *Tax Policy Making: a new approach* which was published in June 2010 we wrote:

'We welcome the overall approach set out in the discussion document as to how tax policy should be made and kept under review. The approach that has been set out mirrors much of what we have said in many representations submitted to this and previous governments. Our own concerns about the current system are echoed at paragraph 1.3 of the discussion document in that under the current system there are the following concerns:

- a lack of clear strategy for the tax system;
- consulting too late (and over too tight a timescale) in the policy development cycle;
- the length and complexity of the tax code;
- uncertainty due to the volume and timing of tax changes; and
- inadequate Parliamentary scrutiny of tax legislation.'

TAXREP 38/10 – September 2010

9. We think that the principles set out in Box 2.A on page 11 are appropriate aspirations for the UK tax system in order to provide a system which demonstrates that 'Britain is open for business' and in working towards the Government's aim to create the most competitive tax regime in the G20.
10. We support the further aim to move towards a more territorial system in which the new CFC regime, to be put in place from 2012 following enactment of provisions in FA 2012, will play a crucial role.
11. We particularly welcome the Government's clear statement, paragraph 3.7, not 'to pursue significant changes to the UK's competitive regime for interest'.
12. As we have stated above a key element in improving the existing UK tax system will be creating a CFC regime which achieves the overall aims of the UK Government while at the same time providing a tax regime within which business is happy to operate.

CONTROLLED FOREIGN COMPANY (CFC) REFORM – PART IIA

General comments

13. We welcome the government's decision to drop the proposal for an earn-out charge (paragraph 3.9 of Part 11A).
14. We consider that if a Plc migrates from the UK then the provision in section 747(1B) ICTA 1988 which would treat that company as remaining resident in the UK is contrary to the EC Treaty, now the Treaty on the Functioning of the European Union (TFEU). The UK has given up its primary taxing rights via section 18 CTA 2009, so to treat the migrated Plc as continuing to be UK resident only for purposes of the CFC control test is in our view disproportionate, and incapable of justification in relation to the allocation of taxing rights (or coherence), which at the primary level have been given up via tax treaty. The EC case of Wielockx C-80/94 is in our view relevant in this respect.

Detailed questions

Chapter 2 – New CFC rules for monetary assets

Questions relating to the partial finance company exemption

Question 2A: Do you agree that our preferred option will deliver the best outcome for addressing monetary assets in the new regime? If not, what alternative approach do you favour that is consistent with the need to protect the UK tax base?

15. The overall approach seems reasonable. But it is not possible to answer the question properly without greater clarity as to what is the purpose of the legislation. If it is to encourage UK businesses to remain in the UK then an effective rate of tax on the CFC of less than 9%, which takes account of the minimum debt equity ratio, is probably a reasonable approach to attain that objective. It is less clear that such a regime would be sufficiently attractive to actually attract new Foreign Direct Investment in to the UK.
16. We are not yet clear how double tax relief will operate under the proposed new regime.
17. We are concerned that the proposals may not be in accordance with the ECJ judgment in the Cadbury Schweppes case and may, therefore, not be compliant with the EC Treaty. We do not consider that the view that an arrangement may be partially a "wholly artificial arrangement" is consistent with the ECJ Cadbury judgment, which in our view provides for a binary test. Nor do we believe that the SGI decision alters this analysis as the Belgian Transfer Pricing legislation

has a binary commercial purpose test before any Transfer Pricing adjustment can be made. We do however accept that even if a CFC is genuinely economically established, it could have profits in excess of the arm's length standard.

Question 2B: What would be the behavioural and tax impacts of such a change on your business?

18. As a representative body, we are not in a position to answer this question.

Question 2C: What are your views on the ratio proposed, bearing in mind the fiscal constraints and need to protect the UK's corporate tax base?

19. We think the ratio proposed is not unreasonable, albeit 3:1 would be preferable.

Questions relating to excess cash

Question 2D: Does this approach deliver a competitive and fair approach by applying the same tax treatment to finance income held offshore?

20. We believe that excess cash generated by 'good' offshore activity should not then subsequently be 'caught' by the CFC regime.

21. We are not clear when the 2:1 ratio would be measured. We suggest the test should be carried out at the time the capital is invested as this is the appropriate time to test 'motive'. This would also remove the requirement to continuously monitor for forex movements, accrual of interest etc.

22. We believe the treatment of interest free loans back to the UK should be considered. We believe these should not be viewed as a monetary asset of the offshore, potential, CFC if they are not loans to which the UK would want to make a Transfer pricing adjustment i.e. they are made to the UK at no interest and so there is no question of reducing the UK tax base.

23. We are also not clear how tiered companies would be treated.

Question 2E: Weighing up the additional complexity, do businesses support this proposal?

24. Whilst we believe that this looks like a reasonable proposal, we believe it needs a decent de minimis limit so that small sums don't risk dragging an otherwise compliant company into the CFC regime.

Question 2F: How should the debt and equity of a company be apportioned between the activities of a company that engage in both trading and financing transactions?

25. We do not think that this is necessarily the right approach. We do not believe that debt/equity should automatically be apportioned in such a situation. It should first be established whether or not the financing transactions are related to the trade. This could be done on a similar basis to the classification of loan relationship debits /credits as trading/non-trading. Only if some of the financing transactions are non-trade should a debt/equity approach then potentially be considered.

26. We appreciate the HMRC concern to deal with potential 'swamping' of bad income. We are concerned however that the measures will be very complicated to deal with in practice and will add significantly to the complexity of the new regime. We think that this area needs further consideration.

Chapter 3 – New CFC rules for Intellectual Property

Question 3A: Could the proposed option produce a workable set of new CFC rules?

27. In our view, it is not possible to answer this question until there is information about the more detailed proposals.

28. A key concern with the potential IP regime lies in the nature of the detailed proposals and their complexity. We need to see more of the detail before we can answer this particular question.

Question 3B: Does this provide more certainty and flexibility compared to the previous proposal to deal with real-life commercial situations?

29. Same answer as to Question 3A.

Question 3C: Could the compliance burden of this approach be reduced by applying the safe-harbours and carve-outs identified?

30. We welcome the fact that HM Treasury and HM Revenue & Customs are considering the use of safe harbours which we support.

Question 3D: What are appropriate measures to use for the safe-harbours identified and are there any others that could be included to minimise compliance costs without opening up a risk to the UK tax base?

31. There could be problems if a CFC also has to satisfy an overseas safe harbour which has been set by an overseas jurisdiction.

Question 3E: When the holding of IP as an investment is one of a range of activities carried on by a company how could a debt:equity approach discussed in paragraph 3.18 apply?

32. We believe that if you are able to trace the IP then you should be allowed to do so.

THE TAXATION OF INNOVATION AND INTELLECTUAL PROPERTY – PART IIB

PATENT BOX – CHAPTER 3

33. We welcome the decision to proceed with the announcement from the previous administration and to introduce a Patent Box regime from 2013 and we are keen to work with government in developing the implementation strategy.

34. Some of our members would have preferred a more extensive regime to encompass all types of IP but we believe that the current proposal represents a good initial approach and we would recommend that a review should be carried out after say 3 years to determine how successful the new regime has been and what changes might further improve the regime.

Question 3A: The Government welcomes views on appropriate conditions for patents to qualify for the regime, including the practicality of determining the date of initial commercialisation of a patent, and appropriate ownership criteria.

35. We agree that it is preferable to use the date of first commercialisation of the patent after 29 November 2010 rather than patents granted after that date.

Question 3B: The Government would like to discuss with business the proposed approach to determining patent income, and the challenges of practical implementation.

36. We welcome the Government's approach which will include within the patent box regime 'embedded' income included in the price of patented products. We also agree that it is going to be more practical to adopt a largely formulaic approach rather than adopting the OECD arm's length principle.

Question 3C: The Government welcomes views from business on whether the proposals are well aligned with commercial incentives to create profitable products.

37. We do believe that the proposal to give relief for the net patent income after associated expenses will best create a regime which can be aligned with commercial incentives. We also believe that the inclusion of embedded patents gives greater incentive for the relevant products to be both developed and manufactured in the UK.

Question 3D: The Government would like to discuss with business the most appropriate ways to prevent artificial tax avoidance or other types of abuse.

38. We welcome the opportunity to be part of the discussion as to how to create genuine incentives for innovation and development of patentable products in a way which limits incentives for artificial tax avoidance.

Question 3E: The Government welcomes any further general views on the Patent Box.

39. None at this stage.

RESEARCH AND DEVELOPMENT TAX CREDITS – CHAPTER 4

40. We fully support the statement at the beginning of this Chapter that ‘business is the main driver of economic growth and innovation’.

Question 4A: Are there any changes to the structure of the schemes that would significantly improve their impact in stimulating investment in R&D by UK companies, in the context of the wider corporate tax reforms?

41. We believe that there is merit in investigating a change in the nature of the incentive so that instead of an enhanced, tax deduction the benefit is provided by way of ‘an above the line’ credit. This is a similar system to that currently in operation in France and Ireland. The system could be redesigned at no additional cost to the Exchequer, it would be reasonably easy to administer and we believe would incentivise spending on R&D as the benefit would be reflected in the performance reports of the part of the entity actually involved in the R&D. This might well overturn the finding of the HMRC Research Report 101 Qualitative research into businesses’ R&D decision-making process (August 2010) which was that the current R&D incentives while increasing the overall amount of R&D activity within the UK have little, if any, effect on decisions to conduct specific R&D projects.
42. There is also some evidence that for larger companies the current rate of allowance, an additional deduction of 30%, may not be enough to create the desired effect. The effective rate of relief at a corporation tax rate of 28% is 8.4% and as the headline rate drops to 24% the rate of relief will also decline, to 7.2%. If the rate of relief were to be increased to 10%, which we believe will influence companies R&D decision making then this would suggest an increase in the additional deduction to just over 40%. Obviously if this increase is coupled with a change to an ‘above the line’ credit then the latter scheme would need to be amended accordingly.

Question 4B: Are there additional costs that should be eligible for relief under the schemes?

43. We believe that the 80:20 eligible staff costs rule that was abandoned in 2003 should be re-established and the relief for qualifying indirect activities should be withdrawn.
44. The 80:20 rule meant that if employees spent 80% or more of their time directly engaged in R&D their full salary costs were eligible but if an employee spent less than 20% of their time similarly engaged then none of their salary costs were eligible. When this rule was abandoned

complicated calculations were necessary to determine the precise percentage of an individual's time spent on direct R&D activities.

45. The overall impact of this proposed change would be to reduce the overall cost to the Exchequer, to simplify the regime but not to diminish the incentive to invest in R&D.

Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?

46. In addition to changes to the Qualifying Indirect Activities rules we believe the Government should review the externally provided workers (EPW) rules which are often hugely complex and are expensive to the Exchequer.

Question 4D: Is the R&D definition contained in the guidelines issued by BIS an effective definition for recognising genuine R&D activity through the R&D tax credit schemes?

47. We believe the current definition is effective in recognising genuine R&D activity and 80% of the respondents to the CBI 2009 survey Impact of the R&D tax credit were of a similar mind.

Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

48. We appreciate that this has caused a considerable amount of debate over the past couple of years.
49. We believe there is merit in allowing experimental production costs but deducting any income generated from the sale or other disposal of the experimental production items so that only the residual cost is eligible for relief within the R&D regime. A similar approach is currently used within the Canadian R&D regime.
50. We also believe it would be helpful to provide a clear Statement of Practice on how the new regime is going to operate with examples from real life as to what would, or would not, be included within this new regime.

Question 4F: What further enhancements would be most effective in promoting additional investment in R&D by the smallest companies, taking into account the risk of adding additional complexity to the schemes?

51. We believe that there would be merit removing the exclusion from SME relief of R&D activities which are viewed as having been done as a subcontractor or which are subsidised.
52. There would be a need to avoid duplication when one UK SME contracts R&D to another SME which could be achieved by only allowing a UK SME to claim SME R&D relief for work sub-contracted to it from large companies or companies outside the scope of UK tax.

Question 4G: Is VRR an effective intervention for incentivising research into drugs and vaccines for the prevention and treatment of disease prevalent in less-developed countries, or would it be more effective to deliver the support through other mechanisms?

53. We understand that the number of claimants is very low, only around 10 per year. If that is the case then it seems unlikely that the VRR regime is incentivising R&D into drugs and vaccines and consideration should be given to eliminating this special regime.

Question 4H: Are there improvements to the claims process that would make it more streamlined and certain for companies, particularly smaller companies with limited resources? Would there be

significant benefits from an external auditing process for claims or a more formal pre-clearance procedure of R&D projects with HMRC?

54. We understand that there is little appetite amongst business for pre-approval of R&D projects.

IKY/FH
22 February 2011

E ian.young@icaew.com

© The Institute of Chartered Accountants in England and Wales 2011
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is reproduced accurately and not used in a misleading context;
- the source of the extract or document, and the copyright of The Institute of Chartered Accountants in England and Wales, is acknowledged; and
- the title of the document and the reference number (*Corporate Tax Reform: Delivering a more competitive system* TAXREP 8/11) are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

www.icaew.com

APPENDIX 1

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.