THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

TAXREP 23/10

PROPOSALS FOR CONTROLLED FOREIGN COMPANIES (CFC) REFORM – DISCUSSION DOCUMENT

Memorandum submitted in April 2010 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales representing a second, detailed, response to the discussion document published on 25 January 2010. A first, high level, response was submitted in February 2010 and published as TAXREP 8/10.

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INTRODUCTION

1. We are writing to provide a second, more detailed, response to the discussion document published on 25 January 2010.

2. We published an initial, high level, response to the discussion draft on 19 February 2010. We have incorporated the points made in that initial response into the current response.

3. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

WHO WE ARE

4. 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.

5. 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.

6. 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.

GENERAL COMMENTS

7. We believe that the proposals in the discussion document represent a credible approach to a new CFC regime in the UK which it is proposed will be limited to the taxation of profits that have been diverted from the UK.

8. We do, however, feel that the government ought to consider whether there is a need for a CFC regime in the light of all the other measures that help to achieve the basic aim of the proposed CFC regime.

9. A major concern in relation to the current proposals is whether they will in practice achieve the stated objective of being compliant with the Treaty for the Functioning of the European Union (EU Treaty). We have set down some concerns with the current proposals in relation to this compliance issue.

10. Inevitably when more detailed proposals are available for comment other difficulties are likely to emerge. Overall the government must not lose sight of the need to maintain a competitive tax environment for business operating in the UK and the detailed proposals will need to be judged against that overall objective.

Is a CFC regime still necessary?

11. The first bullet point in Box 1.A states:

> 'There is a continuing need for CFC rules to protect the UK tax base from erosion through the artificial diversion of profits from the UK which is not countered through other measures.'

12. It is not immediately clear to many of our members why the existing transfer pricing regime, plus other international anti-avoidance measures, do not already provide sufficient protection to the UK tax base.

A welcome to the content of the discussion document

13. If there is to be an amended CFC regime then we welcome the opening statements in the discussion document which indicate, in general terms, what the new regime is intended to achieve.

14. We welcome in particular the following statements in Box 1.A

> The new rules will be targeted on artificial diversion of UK profit and not on taxing profits that are genuinely earned in overseas subsidiaries.
>
> An essential part of adapting a more territorial approach to the new rules will be moving from the current default presumption that all activities that could have been undertaken in the UK would have been carried out here, had it not been for the tax advantage of the overseas location.
>
> The new regime is not intended to increase the scope of the current CFC rules and any new regime must be compliant with EU law.'

Concerns about compliance with the EU Treaty

15. We welcome the explicit intention to ensure that the new regime 'must be compliant with EU law.'

16. But we have serious doubts as to whether that is going to be the case on the basis of the current proposals.

17. It seems clear from the ECJ judgment in the case of Cadbury Schweppes C-196/04 that if a company is genuinely established in an EU member state, and that will extend to the EEA area, and carries on commercial activities there then that company must fall outside any CFC regime if that regime is to be compliant with the EU Treaty.

18. The judgment paragraph in Cadbury reads:-

> 'Articles 43 EC and 48 EC must be interpreted as precluding the inclusion in the tax base of a resident company established in a Member State of profits made by a CFC in another Member State, where those profits are subject in that State to a lower level of taxation than that applicable in the first State, unless such inclusion relates ONLY to wholly artificial arrangements intended to escape the national tax normally payable. ACCORDINGLY, such a tax measure must NOT be applied where it is proven, on the basis of objective factors which are ascertainable by 3rd parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activity there.'
> [capitals added by ICAEW Tax Faculty in the above quote]

19. Our reading of this is that a permissible CFC inclusion is subject to a 2-part test viz it must ONLY relate to wholly artificial arrangements (which we accept would arguably be met in relation to the ending of swamping) but the second part of the test is that the CFC is NOT genuinely economically established (which in our view would not be met by the current proposals).

20. So in our view the current proposals in the discussion document will either have to be amended for companies established in the EU or EEA, or there will have to be amendments to the basic proposals themselves.

21. For instance in paragraph 2.9 there is an indication that the Government is considering a replacement to the current 'lower level of tax' test by a new test to exclude companies that operate in jurisdictions with (a) similar statutory rates and (b) similar tax bases to the UK. But in our view this test would have to include an effective presumption that all EEA states will be assumed to have complied with the requirement and that therefore so long as a company is genuinely established in an EEA member state and carries on commercial activities through its establishment in that member state, such that the arrangements could not be considered wholly artificial, construed in accordance with the ECJ judgments, it should be assumed that the similar rate and tax base conditions have been met. We accept that the exclusion from the CFC regime need not necessarily apply to the income generated by activities carried on by the EEA company outside the EEA .

22. There are similar concerns about paragraph 2.12 which we discuss in more detail below and where we welcome the proposal to extend the definition of trading activities. But we do not believe that the proposal to prevent the swamping of 'good' income can be compliant with the EU Treaty for the reasons we have set out below.

23. Equally in relation to paragraph 2.17 where under the proposed new motive test income would not be treated as artificially diverted from the UK if the overseas subsidiary can 'demonstrate the non-tax related commercial rationale for any specified transaction.' In order to be EU Treaty compliant it is the underlying rationale for the company's existence which determines whether it can be caught under an EU Treaty compliant CFC regime, at least as far as companies established in the EU and EEA member states are concerned.

Proposals that we welcome

24. We welcome the proposal in paragraph 2.8 to continue to exclude capital gains from the scope of the CFC regime, subject to the existing anti-avoidance provisions.

25. We also welcome the intent behind the proposal in paragraph 2.9 to seek to exclude from the new CFC regime subsidiaries operating in tax jurisdictions comparable with the UK.

26. Similarly we welcome the statement in paragraph 2.11 that 'to the extent that … intra-group transactions do not pose a risk to the UK tax base, it is proposed that the profits arising would be exempt from a CFC charge under the new regime.' This paragraph then goes on to suggest that as such transactions do pose a theoretical opportunity for tax avoidance that the rules in this area will have to be designed with care and that the design will benefit from a full discussion with business and organisations like our own. We wonder whether significant provisions are needed in relation to intra-group transactions as any Intellectual Property and Finance measures should take care of any potential problems in this area.

27. We welcome the proposal in paragraph 2.12 to extend the definition of trading activities to include genuine offshore group treasury operations and the active management of intellectual property. But at the end of that paragraph there is an indication that measures will be introduced to prevent swamping which is described in the discussion document as:

Artificially locating unrelated non-trading profits (typically intra-group interest income) alongside trading profits in order to shelter income from a CFC charge.

28. It is not clear how these anti-swamping proposals can be made to be compliant with the EU Treaty. If the company is established for bona fide commercial purposes the fact that it has some non-trading profits cannot change that basic purpose.

29. We welcome the proposal in paragraph 2.19 to suspend the application of the new rules for a period of time following the acquisition of a new sub-group overseas. But we believe that this would have to be put on a statutory basis of some sort if it is to avoid falling foul of the Wilkinson decision of being within the non statutory 'care and maintenance' powers of HMRC.

DETAILED COMMENTS

Question 2A: The Government welcomes views from business on how such an approach would work and whether it would be preferable to having a lower level of tax test and white list.

30. The suggestion in the discussion document is that if subsidiaries are operating in countries that have tax systems that are not too dissimilar from the UK regime then such subsidiaries should not be caught by the new CFC regime. So the suggestion is that there could be a short list of factors that would need to be satisfied in order to demonstrate that the overseas regime is comparable to the UK one rather than having a lower level of tax test and white list.

31. As we have noted above we believe that if a genuine commercial operation is set up in an EU or EEA country then it cannot be caught by an EU Treaty compliant UK CFC regime. So within the new CFC regime we believe there will need to be an appropriate carve out for subsidiaries in these countries.

32. As far as other countries are concerned we believe that the consequence of the new tests will be that there will be a de facto list of countries that satisfy these tests and it would provide greater certainty, and reduce compliance costs, if such a list was established.

Question 2B: The Government would like to discuss with business the level and type of intra group transactions undertaken to ensure that the new regime targets the artificial diversion of UK profits with minimum impact on commercial transactions.

33. We fully support the aim that intra-group transactions that pose no risk to the UK tax base should not be caught by the new CFC regime.

Question 2C: The Government is considering whether it would be possible to specifically exempt these and similar activities from the new regime, and would like to discuss this with stakeholders to see how such exemptions might be defined.

34. We do not believe that the structures described in paragraph 2.13, controlling non UK activities via a sub-holding company, should be caught by the new regime.

35. We reproduce in the next two paragraphs the comments from our original response which are also reproduced in paragraphs 25 and 26 above.

36. It is not clear how these anti-swamping proposals can be made to be compliant with the EU Treaty. If the company is established for bona fide commercial purposes the fact that it has some non-trading profits cannot change that basic purpose.

37. We welcome the proposal in paragraph 2.19 to suspend the application of the new rules for a period of time following the acquisition of a new sub-group overseas which we believe should be on a statutory basis for reasons set out in paragraph 29 above.

Question 2D:The Government would welcome views from business on whether this approach should be included in statute rather than guidance, and what would be an appropriate time period.

38. If an existing UK group acquires a new non UK sub-group from a third party as part of a commercial transaction then clearly there is no intent to 'divert profits from the UK' in respect of that newly acquired non UK sub group. The non UK sub-group should not be caught by the new CFC regime and newly acquired such sub groups need to be excluded from the regime and there should not be the need to restructure just to fit the parameters of a CFC regime.

39. A new motive test is proposed which would cover 'a subsidiary that is properly established overseas [and] is not engaged in activities intended to artificially divert UK profit'. In answer to question 2D we would certainly prefer a statutory approach rather than one which depends on guidance. But it seems clear to us that 'discussions with Customer Relationship Managers and HMRC's clearance procedures' as per paragraph 2.18 are likely to play a role in identifying more precisely what a statutory test means in a particular set of circumstances.

Question 3A: The Government invites comments on the necessary scope of a potential exemption for treasury operation companies and views on the level of substance required.

40. We welcome the proposal to exempt group treasury companies from the CFC regime.

Question 3B: The Government welcomes views on this approach, especially whether this strikes the right balance between operational simplicity and the ability for a group to manage its monetary assets in a way that supports overall competitiveness.

Question 3C: The Government would welcome views on these proposals, options for setting a suitable safe harbour ratio, along with appropriate comparables and views on the level of substance required.

41. If a foreign to foreign exemption were to be introduced then a separate finance company exemption would not be required subject to an appropriate safeguard for instances where the funding can be traced back to the UK.

Question 3D: The Government welcomes views on the relative merits of the proposed options, including comments on any practical issues for combined treasury and finance companies

42. We believe that rather than treating combined finance and treasury companies as finance companies the treasury and finance activities should be split out and dealt with separately.

Question 3E: The Government would like to discuss with business whether making provision for incidental or ancillary non-trading income would offer a suitable balance of flexibility and protection, and to discuss whether numerical measures should be considered.

43. We consider that all interest on surplus cash, and not just incidental or ancillary non-trading income, should be exempt provided it does not have a UK connection.

Question 4A: The Government would like to discuss with business (a) how this approach could be applied to find a workable and commercially equivalent solution, and (b) how to limit such a charge to those situations that are of specific concern.

44. The proposal is that there should be an additional charge if partially developed Intellectual Property is transferred from the UK at a value which may turn out to be inadequate.

45. We are concerned that if the transfer is to a company established in the EU or EEA areas then such a charge would constitute an exit charge and be contrary to the EU Treaty.

46. We are also concerned that this approach will discourage the development of Intellectual Property in the UK and will add rather than reduce complexity.

47. We also note that the value of the Intellectual Property could turn out to be less than the initial value put on it so any provision needs to provide flexibility and allow for a downward as well as an upward adjustment.

48. Finally this sort of issue could be covered in an APA (Advance Pricing Agreement).

Question 4B: The Government would like to discuss with business whether:
(a) using active management of IP conducted offshore is a workable approach, and if so,
(b) how best to measure and define the activities described, and
(c) which of these characteristics above are the right ones to consider.

49. We believe it would be easier to prove that there is not adequate management in the UK rather than 'active management conducted offshore'.

Question 4C: The Government welcomes views from business on the proposals for IP investment companies and whether focusing on the funding of these companies is a way of dealing with IP offshore.

50. We consider that an exemption should be available for IP not connected with the UK.

Question 4D: The Government also welcomes views on whether this approach could be used where it is difficult to distinguish between the profits derived from holding IP and those derived from managing it (removing the need to draw a distinction between the passive holding of IP and the active management of IP).

51. In the case of a company that holds IP as an investment which is partly or wholly derived from the UK, the CFC regime could apply to the extent of the UK connection and income would otherwise be exempt.

IKY
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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 (see http://www.icaew.com/index.cfm?route=128518).