

Tax Representation



TAXREP 8/07

**CONTROLLED FOREIGN COMPANIES (CFCs)
WRITTEN SUBMISSION TO THE PAYMASTER-GENERAL AND HM REVENUE
AND CUSTOMS ON DRAFT GUIDANCE AND DRAFT CLAUSES PUBLISHED ON
6 DECEMBER 2006 FOR INCLUSION IN FINANCE BILL 2007**

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INTRODUCTION

1. On 6 December 2006, at the time of the Pre-Budget Report, HMRC published draft guidance and draft clauses for inclusion in Finance Bill 2007 and asked for comments, on the draft guidance only, to be submitted by 28 February 2007.
2. We comment below not only on the draft guidance but also on the draft clauses.
3. The proposed changes to the UK CFC legislation come as a result of the ECJ Judgment in the case of *Cadbury Schweppes* C-196/04.
4. The draft guidance states that the Government is satisfied that existing UK CFC legislation is compatible with the EC Treaty but there may be some elements at the margins where this is not clear. In particular paragraph 6 of the draft guidance states:

‘The Government is satisfied that the UK’s CFC legislation is compatible with European law as interpreted by the ECJ in *Cadbury Schweppes*. But the Government recognises that there may be circumstances at the margins where it may not be entirely clear.’

5. Prior to the Pre-Budget Report ICAEW Tax Faculty presented its own recommendations for change to the existing CFC regime to make it compatible with the ECJ Judgment in *Cadbury Schweppes*. This document, TAXREP 35/06, is published on our website at <http://www.icaew.com/index.cfm?route=143710>.

EXECUTIVE SUMMARY

6. We do not believe that the current proposals will make the UK CFC legislation compatible with the EC Treaty. We also believe the proposals are contrary to the transfer pricing principles of OECD to which the UK fully subscribes.
7. We are concerned that if the draft clauses are enacted without change this will merely lead to further litigation.
8. We can see no reason why taxpayers should have to apply for the new relief as the CFC rules are otherwise self-assessment provisions.
9. We do not see the need for amending the ‘effectively managed’ condition in the exempt activities test for EU/EEA CFCs.
10. The public quotation condition is a long established and important exemption and its abolition will cause considerable additional work for a number of our members for no good effect. If there is avoidance in this area then appropriately targeted anti-avoidance provisions should be introduced.

DETAILED COMMENTS

The Cadbury Schweppes Judgment

11. Paragraph 56 of the Judgment states:

‘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 controlled foreign company 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 third parties, that despite the existence of tax motives that controlled company is actually established in the host Member State and carries on genuine economic activities there.’

12. In relation to the existence, or otherwise, of wholly artificial arrangements, paragraphs 63 and 69 are particularly relevant.

13. Paragraph 63 states:

‘As stated by the applicants in the main proceedings and by the Belgian Government and the Commission, the fact that none of the exceptions provided for by the legislation on CFCs applies and that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions between the latter and the resident company does not suffice to conclude that there is a wholly artificial arrangement solely to escape that tax.’

14. Paragraph 69 states:

‘On the other hand, as pointed out by the Advocate General in point 103 of his Opinion, the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.’

15. HMRC draft guidance seeks to put an emphasis on diversion of profits, which is clearly contrary to the ECJ Judgment in paragraph 69, and to draw a distinction between profits that arise from labour and profits that arise from capital. There is no support for this distinction in the ECJ Judgment.

16. In particular at paragraphs 16 and 17 the draft guidance sets out the distinction between ‘genuine economic activities’ and what, in HMRC’s view, would reflect what the ECJ referred to as ‘wholly artificial arrangements’:

‘16. The ECJ gave broad guidance on what it meant by ‘genuine economic activities’, which concentrated more on what they were not (e.g. activities that

'do not reflect economic reality' or activities that involve 'practices which have no purpose other than to escapetax') than what they were.

17. The distinction is in essence one between the creation of profits in another Member State and the diversion of profits to another Member State from elsewhere. And the distinction within a CFC is, in essence, between profits that arise from labour and those that arise from capital. Profits from labour tend to be created where the activities are located. Profits from capital are mobile and have no automatic link with where the activities take place and can be (and often are) diverted elsewhere.'

17. In our view the statement in the first sentence of paragraph 17 'The distinction is in essence one between the creation of profits in another Member State and the diversion of profits to another Member State' is merely an assertion which is not supported, and indeed is contradicted by the ECJ Judgement, see paragraphs 63 & 69 which we have quoted above.

18. The next sentence in paragraph 17 states 'And the distinction within a CFC is, in essence, between profits that arise from labour and those that arise from capital'. This is again an assertion which is not supported by the ECJ Judgment itself. We develop both of these points below.

Reduction in chargeable profits – section 751A

19. The potentially chargeable profits of the CFC can be reduced by 'net economic value' created directly by qualifying work.

20. The guidance at paragraphs 15 to 17 suggests that the ECJ Judgment indicates that only profits that arise from 'genuine economic activities' are to be excluded from apportionment and this is in essence saying that only profits that arise from labour can be excluded and not those profits that arise from capital.

21. Paragraph 19 goes on to posit that not only will profits from capital rarely constitute profits from 'genuine economic activities' but any intra group profits are always to be excluded as 'they simply move value from one part of the group to another.'

22. The Judgment in Cadbury Schweppes draws no distinction between income from labour and income from capital and, indeed, the movement of both labour and capital is specifically permitted within the EU under the EC Treaty.

23. In addition the prohibition on recognition of intra-group profits is contrary to the OECD approach to transfer pricing between associated companies, a principle to which the UK completely subscribes as a member of OECD.

Application for exemption

24. We do not see any reason why taxpayers should have to apply for the new relief, particularly as this does not accord with the other CFC provisions which are applied on a self-assessment basis.

25. We also believe that the twelve month time limit for making the claim, under new section 751A, conflicts with the exemption for the Acceptable Distribution Policy

(ADP) exemption which applies to distributions made within 18 months of the year end (ICTA 1988 Schedule 25 paragraph 2(1)).

26. The section 751A claim is only available if no other exemption applies and at the time the claim has to be made it will not be known whether the ADP exemption is going to be satisfied.

Amendment to the exempt activities test

27. We do not see the need for amending the 'effectively managed' condition in the exempt activities test for EU/EEA CFCs given that the existing condition is well established and understood. If HMRC believes that such a change is necessary then HMRC guidance should spell what are the differences with the existing conditions and illustrate this with appropriate examples.

Public quotation condition

28. This is an important and long established exemption and a number of our members, who are listed companies, will be seriously disadvantaged by the proposed elimination of this exemption. They will be required to undertake a significant amount of additional work in order to demonstrate that they remain unaffected by the CFC regime. If there is a problem with avoidance schemes which exploit this exemption then targeted measures should be introduced.

lky/12 February 2007

WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute.