Tax Representation

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Tax Faculty

TAXREP 35/06

CONTROLLED FOREIGN COMPANIES

Review of the current UK regime with recommendations for change to make a future regime EC Treaty compliant

Paper submitted to HM Treasury and HM Revenue and Customs - November 2006

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CONTROLLED FOREIGN COMPANIES

INTRODUCTION

1. The present paper has been prepared by a working party established under the auspices of the Large Business and International Tax Committee of the ICAEW Tax Faculty working under the chairmanship of Peter Cussons.

2. The intention of the working party, and of this paper, is to assist HM Government in its review of the existing controlled foreign companies (CFC) regime so as to develop a system that will meet the needs of business which is compliant with the EC Treaty and addresses the concerns of HM Government particularly in ensuring that the UK tax system remains, internationally, competitive.

3. The paper considers the background to the current CFC regime and reviews it in the light of the Judgment of the European Court of Justice (ECJ) in the Cadbury Schweppes case (C-196/04).

4. Information about the Institute of Chartered Accountants in England and Wales and the Tax Faculty is set out in Appendix 2.

OBJECTIVES FOR AN EC TREATY COMPLIANT CFC REGIME

5. We believe that a future UK CFC regime should be:

- objective and as certain as is possible;
- easy to comply with;
- not open to further EU challenges;
- a single system applying to CFCs established within the EU and CFCs established outside the EU (this would follow the precedent set following the ECJ judgment in *ICI v Colmer* when the relevant UK legislation was amended for all non resident companies); and
- designed with a view to keeping compliance costs to a minimum.

Changes may need to be introduced over a period of time to accommodate the arrival of relevant ECJ Judgments and to allow business to adapt from the existing regime;

BACKGROUND

6. On 12 September 2006, the ECJ gave its judgment in the Cadbury Schweppes case concluding that:

> ‘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.'

7. The case will now be referred back to the Special Commissioners, from whom the case was originally referred, to determine the implications of the Judgment in respect of Cadbury Schweppes.

8. The UK Government will also need to consider what changes are required to existing UK legislation to reflect the Judgment.

ANALYSIS OF EXISTING CFC SYSTEM

9. We consider in this section the extent to which the existing exemptions can and should be retained under a reformed, EC Treaty compliant, CFC regime.

Exempt Activities Test

10. The exempt activities test allows companies engaged in certain trading activities and particular types of holding company to fall outside the CFC rules on the basis that, as such, they can reasonably be assumed not to be used for reducing UK tax. To satisfy the exemption, a company must have proper 'substance' evidenced by adequate premises and sufficient employees in its territory of residence to carry on its business there.

11. However, a company which is engaged in one of the 'precluded' activities listed in the legislation is prevented from satisfying the exempt activities test even if it meets the substance requirements. Finance Acts 2000 and 2003 both expanded the precluded activities so that they now consist of investment business and dealing in goods for delivery to or from the UK or to or from connected or associated persons, as well as wholesale, distributive financial or service business where 50 per cent or more of gross trading receipts are derived directly or indirectly from, broadly, related persons or unrelated UK persons. This means, for example, that intra-group service companies, service and certain insurance companies deriving the majority of their income from UK customers and banks which receive non-interest income from UK customers amounting to more than 10 per cent of their total income are no longer able to satisfy the exempt activities test. Unfortunately, our experience has been that HMRC are normally unwilling to accept that these types of company can satisfy the motive test (see below).

12. We consider that on its own an exemption which does not apply to companies carrying on particular activities cannot be EC Treaty compliant hence it cannot be retained following Cadbury Schweppes since the sole test laid down in the ECJ's judgment is the requirement that the CFC is actually established in the host country and carries on genuine economic activities there. In addition, there is no permissible active versus passive test. The ECJ's judgment on the recently heard Columbus Container case will cover this issue (see paragraph 26 below).

13. ***We consider that the easiest way to create an EC Treaty compliant CFC regime following Cadbury Schweppes would be to amend the exempt activities test so that a company is no longer prevented from satisfying the test where it is carrying on one of***

the precluded activities. This would leave the existing substance requirements in the exempt activities test, which appear similar to those set out in the Cadbury Schweppes decision (given the ECJ's reference to a CFC needing to have 'staff, premises and equipment'), to be satisfied. The advantage of this approach is that substance would then be based on long established and well understood tests. In this case, the motive test could be left in place for companies that fail the exempt activities test but nevertheless are not in existence to avoid UK tax by a diversion of profits.

14. In addition to the above, there are a number of areas where we believe changes should be made to the existing legislation. These are covered in Appendix 1 to this paper.

Excluded Countries Regulations

15. This exemption was originally introduced to reduce the compliance burden for UK companies by giving them a relatively easy way of confirming that overseas subsidiaries are not subject to the CFC rules. Companies resident in a territory on an approved list of countries and deriving the majority of their income from local sources are able to fall outside the CFC rules on the basis that, as such, they are unlikely to be involved in UK tax avoidance. The exemption, originally set out in an HMRC press release of 5 October 1993, was given statutory basis in regulations following the introduction of corporation tax self assessment to give UK companies certainty when relying on it.

16. Following the 2004 Pre-Budget Report, a number of anti-avoidance provisions were included in the regulations as a result of perceived abuse of the exemption. The new 'motive' condition (set out in Regulation 4(A1) and (A2)), in particular, which is widely drafted has made it much more difficult for UK companies to be certain that the exemption applies in any given situation, which clearly goes against the original intention for having this exemption.

17. Given its importance in reducing the compliance burden for UK companies, we believe that the excluded countries regulations should be retained. However, ***we consider that the motive condition should be removed as it creates too much uncertainty for companies looking to rely on it.*** Where HMRC become aware of tax avoidance schemes which rely on the excluded countries regulations, we do not see a particular problem with the introduction of anti-avoidance provisions provided that they are properly targeted at the perceived abuse. If the motive condition is not removed, it is important that HMRC issue proper guidance, particularly on the difference in approach as compared to the motive test itself. ***In order to be EC Treaty compliant we also believe that all EU Member States should be included on the list of excluded countries***, otherwise the exemption breaches Article 12 EC Treaty (prohibition of discrimination on grounds of nationality).

Acceptable Distribution Policy

18. A company falls outside the CFC rules provided it distributes not less than 90 per cent of its 'net chargeable profits' during or within 18 months of the end of the particular accounting period. Although in form the acceptable distribution policy (ADP) test resembles the other exemptions, in substance it represents an alternative form of tax charge as it is only satisfied if the CFC pays dividends which are chargeable to tax in the hands of UK residents.

19. This forced distribution is in our view a breach of either the freedom of establishment or the free movement of capital, where the CFC is actually established in the member state concerned and carrying on genuine economic activity there. ***We believe that this exemption should however be retained in relation to CFCs not genuinely locally established*** as it does still provide some advantage as compared to suffering a CFC apportionment (even though this is limited following the 'ring-fencing' of ADP dividends for double tax relief purposes).

Public Quotation Condition

20. A company falls outside the CFC rules, broadly, if shares representing not less than 35 per cent of the voting power are held by the public, those shares have been listed on the official list of a recognised stock exchange during the 12 months before the end of the relevant accounting period and there have been dealings in the shares on a recognised stock exchange during that period.

21. ***We believe that this exemption should be retained, but would advocate that consideration be given to extending it to cover the subsidiaries of a qualifying quoted parent company.***

De Minimis Exclusion

22. Companies with chargeable profits of less than £50,000 per annum fall outside the CFC rules.

23. ***We consider that this exemption should be retained but that the 'de minimis' amount which has only been raised once since the CFC legislation was introduced in Finance Act 1984 should be raised to at least £100,000 per annum***.

Motive Test

24. In addition to all the above exemptions which can potentially take a company outside the scope of the CFC rules, there is also the motive test, although this is often seen as a last resort. Both legs of the motive test have to be satisfied. The first leg is that transactions which are reflected in the profits of the subsidiary company must not have achieved more than a minimal reduction in UK tax or the reduction must not be a main purpose of the transactions. The second leg is that it must not be a main reason for the company's existence to achieve a reduction in UK tax by a diversion of profits from the UK. Our previous experience of HMRC's approach to the motive test is that even if there are strong commercial reasons for establishing a company offshore to carry on one of the precluded activities set out in the exempt activities test, HMRC will normally argue that the reduction in UK tax, if it is significant, must have been one of the main reasons for the company's existence and that, therefore, the second leg of the test is not satisfied. In our view, the motive test and the way in which HMRC apply it is contrary to the ECJ's decision in Cadbury Schweppes as the focus is very much on tax motives.

25. If the exempt activities test is changed, as we have recommended above, ***then it might be possible to leave the motive test unchanged*** to allow companies which do not have the necessary substance but nevertheless are not in existence to avoid UK tax to fall outside the CFC rules. If the Treasury/HMRC decide not to change the exempt activities test to make the CFC rules EC Treaty compliant, we consider that ***the next best option would be to amend the motive test so that it is additionally satisfied where a company has sufficient substance to carry on its activities***. If this were done, it would be important for there to be objective criteria for establishing whether there was adequate substance in any particular situation, otherwise taxpayers would be faced with significant uncertainty. Our strong preference would be for these criteria to be set out in the legislation itself, rather than being dealt with in guidance issued by HMRC .

Distinction between Passive and Active Income

26. One possibility, which we have heard suggested, would be for a completely new CFC regime to be introduced which focuses on types of income rather than entities (similar to the US subpart F rules) so that only passive income would be potentially caught. However, we can see nothing in the Cadbury Schweppes judgment to suggest that such a regime would be EC Treaty compliant unless it targeted only 'wholly artificial arrangements'. This would mean that passive income could still not be taxed under the CFC rules if it was supported by the necessary substance. The German case of Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt (C-298/05), which was heard before the ECJ on 28 September 2006, should confirm this point (the Advocate-General's Opinion and ECJ Judgment will presumably be available some time in 2007). We believe that it is likely that the ECJ will conclude that Germany is not allowed, under EC law, to move from tax exemption to an ordinary tax credit due to a domestic anti-avoidance measure that applies to the low-tax passive foreign income of foreign Permanent Establishments.

Clearance Procedure

27. We believe that an ongoing clearance procedure for all material aspects of any revised CFC regime is highly desirable. We do not believe that the COP 10 regime in its current form, particularly with its limitation on advice on the effect of legislation passed in the previous four Finance Acts, is adequate. Accordingly, the existing CFC clearance procedure either needs to be given a statutory basis or there needs to be an undertaking from HMRC that it will be available for the long-term. We, therefore, welcome the proposals contained in the Varney Review Report published on 17 November 2006.

RECOMMENDATIONS

28. We have summarised below our recommendations for changes to be made to the CFC regime in the light of the Cadbury Schweppes judgment:

Exempt activities test

29. In order to ensure that the CFC regime is EC Treaty compliant

- the exempt activities test should be amended so that it can be satisfied regardless of the activities carried on, provided that the company in question satisfies the existing substance requirements set out in the legislation.

This would have the advantage of 'substance' being based on long established and well understood tests and could leave the existing motive test in place to be satisfied by companies which despite not having the necessary substance are not in existence to avoid UK tax.

Other exemptions

30. The other exemptions should be retained allowing taxpayers to rely on the exemption which is the easiest to satisfy in any particular situation. However, the following changes should be made to those exemptions:

- *Excluded countries regulations* – the new 'motive' condition should be removed and the list of excluded countries amended so that it includes all of the EU Member States.
- *Public quotation condition* – this exemption should be extended to cover the subsidiaries of a qualifying quoted parent company.
- *De minimis exclusion* – the 'de minimis' amount should be raised to at least £100,000 per annum.

Changes to apply not just to the EU Member States

31. The changes which are made should apply to both EU and non-EU subsidiaries. Otherwise, taxpayers will be faced with the added difficulty of having to apply two sets of CFC rules.

The need for an ongoing clearance procedure

32. Given the importance of having an ongoing clearance procedure for all material aspects of any revised CFC regime, the existing CFC clearance procedure either needs to be given a statutory basis or there needs to be an undertaking from HMRC that it will be available for the long-term. We, therefore, welcome the proposals contained in the Varney Review Report published on 17 November 2006.

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Recommended Changes to the Exempt Activities Test **APPENDIX 1**

We believe that the provisions introduced in FA 2003 (Section 200 and Schedule 42) and in particularly the 'habitually resident' point which, for example, catches Irish subsidiaries of UK banks which are prevented from doing business with the UK, constitute a constraint on the freedom to provide services within the EU. Accordingly, these provisions need to be removed from the legislation.

While it is helpful that holding companies are able to meet the exempt activities test, the relevant conditions can be difficult to satisfy in practice. In particular:

- A relatively small amount of 'bad' income can cause the 90 per cent income tests in Paragraphs 6(3), 6(4) and 6(4A) Schedule 25 to be failed. It would be more reasonable if the threshold was reduced to, say, 80 per cent.

- Paragraph 12(5) Schedule 25 means that the 90 per cent income test can be failed in purely commercial structures (particularly where there are a number of tiers of trading company, which is not uncommon). Paragraph 12(5) should be removed or at least amended to exclude dividends from non-trading income.

- The ability to treat a 40/40 joint venture company as controlled for the purposes of the holding and income tests is only allowed under Paragraph 6(ZA) Schedule 25 where the company in question is a CFC (i.e. subject to a lower level of taxation) and a trading company. This is unnecessarily restrictive. Paragraph 6(ZA) should treat any 40/40 joint venture company (whether or not it is subject to a lower level of taxation or trading) as controlled for the purposes of the holding and income tests.

APPENDIX 2

ICAEW AND THE TAX FACULTY: WHO WE ARE

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.

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.

The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations 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 ICAEW who pay an additional subscription.

To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at tdtf@icaew.co.uk or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.