



ICAEW TAX REPRESENTATION

CONTROLLED FOREIGN COMPANIES (CFC) REFORM

Comments submitted on 10 February 2012 by ICAEW Tax Faculty in response to the publication on 6 December 2011 of draft clauses *Controlled foreign companies (CFCs) reform* to be included in Finance Bill 2012.

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CONTROLLED FOREIGN COMPANIES (CFC) REFORM

INTRODUCTION

1. We are writing to comment on the draft clauses re *Controlled foreign companies (CFCs) reform* published on 6 December 2011.

The Gateway test

2. The key to the new CFC reform is going to be the Gateway test and because of its importance we submitted our comments on those elements of the proposals in a paper, TAXREP 70/11, submitted in December 2011. Those comments are reproduced in Appendix 1 to the present paper.

Further draft clauses – published 31 January 2012

3. On 31 January 2012 HM Treasury published a revised version of the draft clauses and an update. It has not yet been possible for ICAEW to give detailed consideration to these most recent changes so our present comments are based on the draft clauses published on 6 December 2011. We intend to review the additional changes as soon as possible and if we have comments on them we will submit a further paper.

CFC Open Day

4. Representatives of ICAEW attended the CFC Open Day on 11 January 2012 and it was very helpful to have reassurances that supervisory and governance control from the UK parent company and advisory roles would not be treated as an SPF (Significant people function).

WHO WE ARE

5. 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.
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.

DETAILED COMMENTS

Chapter 1 - Introduction

Section 371AE

8. We are concerned by the uncertain implications of the word 'reasonable' as what is reasonable to one person is not necessarily the same for someone else. This seems to us to be too subjective a test.
9. We believe the provisions should only apply to artificial arrangements.
10. This section contains the first of a number of TAARs and it was agreed at the 11 January 2012 Open Day that an exercise would be undertaken to look at each of the TAARs throughout the CFC provisions to decide whether all of them are absolutely necessary.

Chapter 2 – The CFC Charge

Section 371BB

11. We are not clear why an accounting period should end when (sub-section 3(d)) a company ceases to have a relevant interest in the CFC. It would seem more appropriate to craft the definition from the perspective of the owner of an interest in the CFC as is done for the loan relationship provisions in sections 381/385 Corporation Tax Act 2009 re the loan relationship regime.

Chapter 3 – The low profits exemption

Section 371CE

12. Conditions A and B are both subject to TAARs which are to be reviewed.

Section 371CG

13. This contains TAARs No 4 and 5.

Chapter 4 – The low profit margin exemption

Section 371DB

14. It is not clear why relevant operating expenditure should be excluded just because, for instance, it gives rise to income of a connected person if it is 'good' expenditure which would have been incurred in a purely arm's length situation.

Chapter 5 – The excluded territory exemption

15. At the Open Day on 11 January 2012 it was agreed that some of the conditions were going to be reviewed which we welcome.

Section 371EB

16. This contains TAAR No 6.

Section 371EE

17. We are concerned that the provision in sub-section 4 is very broadly drafted. For example, we wonder how this provision will operate in relation to all the other patent box regimes established in EU countries. ?

Chapter 6 – The Tax Exemption

18. This was previously the 'low tax exemption'. We welcome the comment at the Open day that HMRC are considering not requiring UK groups to include details of not low tax subsidiaries as not being CFCs.

Chapters 7 to 12 – the Gateway test

19. We submitted comments on the Gateway test in TAXREP 70/11 submitted before Christmas. Our comments are reproduced in Appendix 1 to the present document.
20. We note that section 371HK contains TAAR No 7.

Section 371HF

21. We have an additional point since we submitted our earlier paper, TAXREP 70/11. Subsection 3 extends the Premises exclusion to some OECD Permanent Establishment definitions but not to all of them. We believe the definition should be extended to dependent agents, services and offshore exploration activities.
22. A practical example of where the dependent agent definition is necessary would be where a CFC has no premises but employs a salesman to sell its product, the salesman having no office but staying in hotels. Similarly a CFC's only presence in its territory might be represented by consultants carrying out services for a client, or engineers carrying out offshore exploration activities.

Chapter 13 – Chargeable profits of a CFC – amounts to be left out

Section 371ME

23. In line 4 of sub-section 4 the word 'of' is omitted between 'proportion' and 'its'.

Chapter 16 – Apportionment of a CFC's chargeable profits and creditable tax

Section 371FC

24. We found these provisions particularly difficult to understand.

Chapter 17 – Loan relationships with connected companies

25. We found this chapter too compressed and we believe it would benefit from being expanded with a preamble to define the mischief it seeks to combat.
26. We note TAAR No 9 in section 371QD subsection 9.

Section 371QD

27. If bad income reduces good income then in our view it should become good income as is the treatment in equivalent circumstances in Canada.

Chapter 18 – Assumed taxable profits, assumed total profits and the corporation tax assumptions

28. TAARs 10 and 11 are contained in sections 371RL and 371RM.

Further contact

29. For any further enquiries please contact:

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BACKGROUND

The earlier attempt to introduce a new CFC regime

1. 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.
2. Those initial 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 for a separate consultation.

The importance of the CFC regime

3. 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.

OUR INITIAL COMMENTS ON THE GATEWAY TEST

4. We welcome the Government's positive approach to the most recent consultation over the course of the past summer/autumn and in particular its agreement to design a 'Cadbury' based "Gateway" exemption to eliminate the majority of UK controlled foreign subsidiaries from the new CFC regime.
5. We do not believe the current drafting or structure of the legislation will achieve that objective, nor will it make the new legislation easy to operate and it is almost certain to result in undue bureaucracy and significantly increased compliance costs, unless modified.
6. We set out below our understanding of the current Gateway test(s) and we include our comments on the tests.
7. First of all we think the structure of the legislation, and the way it is set out, should follow the helpful diagram on page 5 of the 'Response to Consultation' document as this clearly establishes the role of the Gateway in eliminating at the initial stage businesses that are not intended to be caught by the CFC regime. So what is currently Chapter 8 of the draft clauses, setting out the Gateway test, should feature towards the beginning of the statutory provisions probably immediately after the definition of a CFC and should be clearly labelled as the Gateway test .
8. Moreover, the Gateway should be an exemption rather than another category of chargeable profits ie "bad income". What is potentially CFCable income is defined in Chapter 7 section 371GA(2) as the total of Chapters 8 – 12 profits as adjusted by Chapter 13 'amounts to be left out'. So even if you do not have CFCable income under the sections 371HA – HK Gateway tests there are still categories of mainly finance income that remain CFCable ie Chapter 9 non-trading finance profits, Chapter 10 Trading finance profits, Chapter 11 Captives and Chapter 12 Solo consolidations. We accept that Chapters 10 and 12 are probably only of concern to banks and other financial traders. The Gateway is not therefore a true gateway, as in debt cap.

9. Under the provisions of step 2 section 371H in Chapter 8, if there are no UK Significant People Functions (SPFs) relevant to the economic ownership of the CFC's assets/the assumption or management of the CFC's risks then there are no Chapter 8 profits
10. While this would appear to be a relatively clear test we believe that it is hardly ever likely to be met in real life. Subsidiaries in groups are hardly ever completely autonomous, for obvious commercial reasons.
11. Step 4, as modified by s371HB via Step 5, then requires the provisional Chapter 8 profits, which come within the CFC regime, to be determined by taking out of the potential CFCable profits those that are attributable to UK SPFs where these are no more than the CFC's profits re its assets/risks attributable to non-UK SPFs.
12. Again, when deciphered, this looks like a generous exemption but will it require a full functional transfer pricing analysis for every CFC everywhere in the world? And will the analysis require an asset by asset/risk by risk assessment which would be incredibly onerous? We accept that other exemptions eg the Chapter 6 s371FA Tax Exemption (which we think should be called the Not Low tax or Designer rate Exemption) may apply but we thought the whole purpose of the Gateway was to screen out 90%+ of foreign subsidiaries, without the need to refer to the rest of the legislation.
13. There are then a number of further tests under Step 5 under which profits will be excluded from the CFC regime.
14. Apart from the exclusions already mentioned above, if there are UK SPFs but by having the CFC involved the group has generated 'substantial' non-tax value then even if the CFC uses the SPFs in relation to its assets and/or risks then there will be no Chapter 8 profits (section 371HC).
15. This is akin to a commercial purpose test but 'substantial' is undefined. Is it intended that this test will be similar to the 20% threshold that applies in the Substantial Shareholding Exemption (SSE) legislation? What evidence will HMRC require re valuation?
16. Inevitably because of valuation issues it is also going to be an extremely subjective test.
17. There is then an arm's length exclusion under section 371HD so that if there are UK SPFs but the arrangements would have been entered into on the same terms with a third party, in relation to the UK SPFs, then the CFC has no Chapter 8 profits.
18. Again, will it be necessary to carry out a full transfer pricing comparables exercise in order to self-assess this issue? What documentation requirements will there be?
19. Section 371HE is the final provision under which profits can be excluded from the CFC regime and it, in turn, has sections 371HF to HJ to explain what each of the provisions in s371HE actually means.
20. These provisions in effect reflect a trading income version of the 'Cadbury' let out but we are very concerned that they are terribly complicated and only very distantly related to Cadbury.
21. The various let outs are that the CFC:

- is genuinely established in terms of business premises (371HF);
 - no more than 20% of its trading income (excluding interest and income from goods made by the CFC in its residence territory sold to the UK) come from UK residents or UK PEs of non-UK residents (371HG);
 - no more than 20% of its management expenditure relates to UK based staff (371HH);
 - does not hold IP transferred out of the UK within the last 6 years as a result of which the value of IP held by group companies other than the CFC is significantly reduced (not taking account of the other trigger re the transfer of only parts of the IP) (371HI) and
 - no more than 20% of its trading income is in relation to goods exported from the UK (but excluding goods exported into the territory of the CFC) (371HJ)
22. The first requirement comes from the CJEU decision in Cadbury but there is no EU law basis for any of the other requirements. The SGI decision is of no relevance as Belgian TP has an inbuilt commercial purpose test.
23. Finally there is a TAAR for the gateway (371HK). We counted 6 TAARs **[on closer inspection we now believe there are 11 TAARs]** in the draft legislation. This is not going to assist in achieving legal certainty.

COMPATIBILITY WITH EU LAW

24. Amongst other things, Chapter 9 picks up interest on upstream loans to the UK (section 371D). We can fully appreciate why this was considered necessary from a UK policy perspective but we cannot see that there is any basis in the Cadbury Schweppes CJEU judgment for such a provision and we question whether it is compliant with EU law without a commercial purpose test.
25. We are also concerned that the fat cap test in Chapter 10 may not be EU law compliant. This may be based on the SGI judgment of the CJEU but as noted above that was by reference to Belgian transfer pricing rules which have an inbuilt commercial purpose test which the proposed new UK CFC rules do not have. So even if you come out from the CFC under the 'substantial' non tax value in paragraph 18 above you could still face CFCable income under Chapter 10 because there is no overall commercial purpose get out (see section 371GA(2)) which defines the new CFC charge as the total of Chapter 8 to Chapter 12 profits.

DRAFTING

26. Lastly, the drafting is appallingly dense. By comparison, the draft GAAR, or the King James Bible, or even arguably Spenser's Faerie Queene are more intelligible..

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>).