

TAXREP 37/06

PRE BUDGET REPORT 2006

SUBMISSION OF WRITTEN EVIDENCE TO TREASURY COMMITTEE

*Text of written evidence submitted in December 2006 by the Tax Faculty of the
Institute of Chartered Accountants in England and Wales in response to
an invitation issued in December 2006 by the Treasury Committee*

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PRE BUDGET REPORT 2006

SUBMISSION OF WRITTEN EVIDENCE TO TREASURY COMMITTEE

FOREWORD

On 1 December 2006 the Treasury Committee announced on its website at http://www.parliament.uk/parliamentary_committees/treasury_committee/tc011206pn12.cfm that it would be undertaking an inquiry into the 2006 Pre-Budget Report which was to be issued on Wednesday 6 December. The Committee invited written evidence, to arrive no later than 12noon on Monday 11 December.

This memorandum reproduces the text of the written evidence submitted on 7 December 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales.

LH/FJH/PCB
21.12.06

Tax Representation

Institute of Chartered Accountants in England and Wales

Submission to Treasury Committee on the 2006 Pre Budget Report



Section One- Broad Issues

1. Measures to Improve UK Productivity (Leitch, Barker and Eddington)

- The ICAEW welcomes the Leitch, Barker and Eddington Reports

2. Improving the UK Tax System

- The need to keep UK corporation tax rates globally competitive
- Ensuring UK taxation on foreign profits does not disadvantage UK companies compared to those in the EU
- The need for real progress on simplifying the UK tax system

3. Delivering Efficient and High Quality HMRC Services

- Transition without investment in HMRC is resulting in poorer tax services

4. Regulation & the Administrative Burden

- Government must act to address the cost of new regulation on the smallest businesses

Section Two- Specific Issues

5. Missing Trader Intra-Community Fraud (MTIC)

- The fundamental incentive for fraud has still to be addressed

6. Controlled Foreign Companies (CFC)

- CFC changes should be EC Treaty compliant

7. Six year limitation period for all Direct Tax claims

- The retrospective nature of the legislation and the way it pre-empts a legal ruling is of concern

8. Managed Service Companies

- We welcome the consultation on these changes, as safeguards are needed for workers

9. Construction Industry Scheme (CIS)

- Lack of evidence for revenue raising from small construction operators

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1. Measures to Improve UK Productivity (Leitch, Barker and Eddington)

The ICAEW warmly welcomes the publication of the Leitch, Barker and Eddington Reports. As our own Enterprise Survey Report 2006 demonstrated, UK business is experiencing a unique challenge from increasingly global competition as well as unique opportunities. Tackling core barriers to UK productivity growth, particularly skills, is essential to equipping business to compete on a global scale. Improving the UK tax system and dealing with regulation are however areas where we would have liked to see a similar level of progress in this PBR.

2. Improving the UK Tax System

The ICAEW welcomes the Government's determination (paragraph 5.102 of the PBR Book) to maintain the overall competitiveness of the UK tax system. We also welcome the Government's announcement that next year it will consult with business on a wider package of reform. However, we believe there were a number of lost opportunities for improvement in this PBR.

We have welcomed the recent proposal in the Varney review 'Links with large business' which do make a significant contribution on the issue of uncertainty. The recommendations are ambitious but will require investment in appropriate resources. However, the Varney proposals still do not address the fundamental complexity of the UK tax system. Complexity is a significant factor in the investment decisions of multinational businesses. For small business it impacts upon such decisions as expansion and taking on their first employees.

The Global Competitiveness of the UK Corporate Tax System

We believe that PBR could have gone significantly further to maintain and improve the UK's competitive position. The ICAEW believes there are two particular initiatives that the PBR should have included:

- Reducing the headline rate of corporation tax. The UK's level of 30% is now looking expensive relative to European Union neighbours over whom we would wish to maintain our competitive edge.
- Improving way in which the UK taxes foreign profits so that UK companies operating abroad are not at a relative disadvantage to EU companies operating here. The UK's credit method system results in a far higher ratio of business compliance costs to the revenue raised by government, than the exemption system of most other EU countries. The UK Government has been considering the issue but it is now time for open consideration of the advantages to UK business from moving to an exemption system.

Addressing, as well as consulting on the above two concerns in 2007 would help address the increasing belief of business that the UK tax system is becoming less competitive.

Potential Measures to Address the Complexity of the UK Tax System

The ICAEW has consistently drawn attention to the increase in volume of tax legislation, doubling in the past ten years. Finance Acts are now three times longer than they were in the 1980s. Complexity, like regulation (see further section) has a much greater impact

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proportionately on the smallest businesses and tackling this is of key importance for the UK's enterprise economy.

The Government has sought to examine the particular burdens faced by business in complying with the tax system, for example in the Admin burdens project published earlier this year. But initiatives to reduce the burdens on smaller businesses appear to be stalled, for example the work of the Small Business Review, launched in 2001, has yet to be taken forward.

We believe that action is required in a number of areas:

- The Government needs to move forward with the Small Business Review and bring forward proposals to reduce some of the key burdens that small businesses face, for example taking on your first employee.
- The Government needs to make a formal policy commitment to tax simplification and set a timescale for implementation. We appreciate that the Tax Law Rewrite Project has produced benefits and made the UK's tax rules clearer, but it does not address tax simplification, which was the original intention of the legislation which gave rise to this project. The use of an independent committee, including representatives from business and the tax profession, should be considered to help achieve consensus on a long-term programme.

3. Delivering Efficient and High Quality HMRC Services

We welcome the Government's aim to create world-class tax services through sustained investment and far-reaching reform. In principle, we support the Government's drive to make public services more efficient and therefore freeing up resources for frontline services. We will work with HMRC to help build a tax system that is fit for the 21st century.

Nevertheless, we are concerned that the ambitious cost-cutting proposals, and consequent reductions in staff numbers, are resulting in far-reaching reform now without the level of investment necessarily needed to improve services. In any event, technological improvements take time to feed through to real improvements in the tax system, as they need to be designed, built and tested thoroughly to ensure that they work properly and are implemented efficiently.

The result is that, on the ground, services have deteriorated with the closure of local offices and the increased reliance on call centres. HMRC's local support structure has been dismantled but no mechanisms have been put in place to replace it, let alone lead to improvements. These developments have led to considerable frustrations for taxpayers and their agents and advisers, and are probably the largest single cause for complaints that we receive. Given the year-on-year budget reductions faced by HMRC, it looks inevitable that services will get worse in the short-term, calling into question the benefit of any longer-term improvements.

Our recommendations for improvement are as follows:

- If customer services are to be improved, there needs to be greater transparency about HMRC's reorganisation and restructuring and how existing services will be maintained and improved. This process needs input from tax professionals and its customers. Whilst returning to the former 'District' structure may no longer be possible, practical

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steps can be taken to improve local dialogue and accountability. HMRC is working on a number of initiatives, for example by nominated staff 'owning' particular issues and by the nomination of named staff as a contact point for tax agents, but this needs to be translated into sustained action on the ground and a willingness to work more closely with agents.

- There also needs to be recognition that year-on-year reductions in department budgets may not be realistic if services are to be improved. A year on year budget reduction of 5% may not reflect the longer lead-time needed for investment in new technology to lead to cost savings. A commitment to a savings in the medium term would focus attention on the necessary investment required to feed through to improvements rather than short-term cost-cutting.

4. Regulation & Administrative burdens

The ICAEW understands the Administrative Burdens Project Reports quantifying the administrative impact of current Government regulation will soon be released, together with details of a 25% across the board reduction target. Though they were not made available with the Pre-Budget Report, this project has been cited regularly in Budgets and PBR statements. Together with the implementation of the Hampton Review, these will make a substantial contribution to improving current regulation and its enforcement as well as to wider culture change.

The ICAEW still finds, however, that the cost of new regulation remains unabated and has actually risen to £7.7billion this year, with 74% of that impact falling upon businesses with less than 10 employees (ICAEW Enterprise Survey Report 2006). The regressive nature of regulation is perhaps the most troubling aspect of the regulation agenda due to its impact on UK entrepreneurs. The ICAEW also believes this is the issue least dealt with in the regulatory agenda and again has not been addressed in the PBR.

To help ensure the forthcoming publications of the Administration Burdens Reports have the greatest impact on the UK regulatory culture, Treasury Committee may wish to consider the following timely recommendations:

- The figure for the total sum of annual administrative burden should be published together with the individual reports.
- The proportion of the administrative burden falling upon different sizes of business should be made clear.
- That the 25% reduction in administrative burden should focus most on the smallest business currently realising the bulk of the burden.
- That new administrative burden should not be 'grandfathered' into the targets i.e. burden should be 25% less than now even if new regulations have come forward.
- That Government widen its Better Regulation Agenda to include the tackling of the regressive nature of the cost of new regulation on the smallest businesses.

Section Two - Specific Issues

5. Missing Trader Intra-Community Fraud (MTIC)

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We welcome the Government's announcement of the measures it is introducing to tackle the fraud and that more staff are being deployed to help tackle this pernicious attack upon the tax system. We remain committed to assisting the Government in its fight against MTIC.

Nevertheless, we remain concerned that the proposed measures do not address the root cause of the problem and that unless co-ordinated action is taken at the EU level to address this issue, MTIC will remain a serious threat to the UK's tax system. As we said in our PBR submission, the UK Government needs to work with other Member States and combat MTIC fraud by addressing the incentive for fraud. The proposed derogation to impose a reverse charge mechanism is in our view only a short-term fix and in any event there remains the possibility that the derogation will not be obtained, which would take the UK back to square one. The UK needs to consider other possible solutions to reduce MTIC. Our recommendations are:

- The imposition of a limit on the amount of input tax that each VAT-registered business could reclaim in an accounting period. It would be set at an amount that in the normal course of events the business would not reach, with a fast-track clearance procedure for abnormal transactions such as a property purchase;
- In the longer term, national VAT systems need to be changed so that VAT is charged on cross-border transactions between registered traders. We recognise that this may inhibit cross border trade and will require fundamental changes to the current VAT systems, but operationally we see such a system as most likely to end the fraud.

6. Controlled Foreign Companies (CFC)

The UK has been required to amend its existing CFC rules to make them EC Treaty compliant.

On 12 September 2006, in the *Cadbury Schweppes* case, the European Court of Justice held that the UK CFC regime is prima facie contrary to the freedom of establishment provisions of the EC Treaty. However, the breach may be justified provided the regime applies only to 'wholly artificial arrangements' which do not reflect economic reality. In other words companies which carry on genuine economic activities in the EEA (the European Union plus Iceland, Norway and Switzerland) should not be caught by the UK CFC rules once they have been made compliant with the EC Treaty. It is this case that has resulted in the requirement to change the rules.

A company is a CFC if it is resident outside the UK and is controlled by UK residents and is subject to less than 75 per cent of the tax that it would pay if it were UK resident. Any UK resident company that has an interest in the CFC and to which, with connected persons, at least 25% of the chargeable profits would be apportioned, must pay tax on the apportioned profit of the CFC. There is no such apportionment if one of several exemptions applies.

The first of the PBR proposals is that companies which have an EEA business establishment, which comes within the CFC rules, may apply to HMRC to exclude from an apportionment that part of the chargeable profits of the CFC which represents the net economic value created by work carried out by individuals working for the CFC in business establishments within the EEA.

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The second main proposal in the PBR is a change to the exempt activities test. Currently a CFC satisfies the exempt activities test if it has a business establishment in its territory of (overseas) residence, its business affairs in that territory are effectively managed there, and it does not undertake certain types of (non-exempt) business. This rule is to be amended so that a CFC resident in an EEA territory will only be treated as effectively managed in that territory if there are sufficient individuals working in that territory who have the competence and authority to undertake the company's business.

The two proposals are likely to give rise to the apportionment of profits of CFCs which go beyond profits attributed to 'wholly artificial arrangements which do not reflect economic reality'.

We submitted a paper to HM Treasury and HM Revenue and Customs in November 2006 setting out amendments to the existing CFC rules which we believe are proportionate and would make the UK regime EC Treaty compliant.

We recommend the UK Government amend the CFC rules along the lines proposed in our paper (Appendix 1).

7. Six year limitation period for all Direct Tax claims

New provisions will be introduced in FA 2007 which will amend section 32 in respect of any direct tax action involving mistake of law brought before 8 September 2003 except where a claimant is subject to a final judgment given by the Courts before 6 December 2006.

The House of Lords recently determined in the case of *Deutsche Morgan Grenfell* that the company had paid CT earlier than it need to have done [because it should not have been subject to ACT accounting] under a mistake of law (paragraph 143 of the decision) and that the mistake could be held to have been discovered only when the ECJ gave its Judgement in the *Hoechst* case in March 2001. The fact that the early payment represented a mistake of law meant that section 32 of the Limitation Act 1980 was in point and section 32 provides that the period of limitation, for making a claim, only starts when the mistake is discovered.

The effect of the proposal will be to deprive claimants which have commenced litigation to benefit, in restitution (or damages), from the rectification of their earlier mistake of law. In these cases the litigation is a civil law procedure under common law, and not a Taxes Act claim.

In the context of EU law, the ECJ has held that limitation periods cannot be reduced without allowing an adequate period after the enactment of the legislation for lodging the claims for repayments which persons were entitled to submit under the original legislation. The current proposal does not give effect to this and in our view is itself therefore a new and inexcusable breach of the EU law principle of effective remedy.

The Treasury Committee may wish to ask HM Treasury what other alternatives to this drastic action were considered and the reasons for their rejection.

8. Managed Service Companies

Managed Service Companies (MSCs) are corporate structures through which workers provide labour services. The current proposals seek to differentiate MSCs from Personal Service Companies (PSC), which will continue to be dealt with by the IR35 legislation.

MSC structures are most commonly used by persons working in construction, information technology, teaching and health workers, but could be used by any sector. The workers are not usually managing their own businesses, but are performing in the same capacity as an employee doing the same work, with the management of the umbrella company being undertaken by a corporate provider. It is this lack of control which distinguishes workers in MSCs from those in PSCs and which be most difficult to define in legislation.

MSCs are used to reduce income tax and national insurance liabilities by paying each of the workers within it using dividends rather than using a salary. However, it is important to stress that another key reason for using these structures is to cut costs by trying to deny the worker employment rights. In most cases this succeeds because of the practical difficulties of having to go through the employment tribunal process to gain redress.

We understand the difficulties associated with trying to use the IR35 legislation against MSCs and support the Government's attempts to tackle this problem without disturbing the vast number of PSCs. However, we are concerned that the workers employed by MSCs do not usually have a choice when they accept work, about how the engagement is structured. Indeed many will not even realise that they are involved in MSCs.

We are pleased that these proposals are going to be the subject of wide consultation and believe there should be adequate safeguards to protect vulnerable low paid workers who could otherwise be those hurt most by this legislation.

9. Construction Industry Scheme (CIS)

The standard deduction rate for the new CIS is set at 20%. The equivalent rate for deduction under the current scheme is 18%.

The new CIS comes into operation on 6 April 2007 and will operate very differently from the current one. The existing system of exemption certificates, registration cards and annual returns, will be replaced by a system which will be heavily reliant on online facilities and a monthly return. For contractors, the entire key to the new scheme is to classify workers quickly and accurately and then take appropriate steps to deal with the consequences. This classification of workers falls into two stages, with the second leading on from the first under certain circumstances.

A contractor has first and foremost an obligation to determine whether the person he wishes to engage is in fact an employee. In such cases, all payments are subject to PAYE and the CIS is not relevant. If the subcontractor is correctly classified as self employed, then under the new scheme, on engagement the contractor will check with HMRC to enable him to decide whether the subcontractor is to be paid gross or is subject to tax deduction at one of two rates

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(please see appendix two). Such self employed subcontractors will settle their eventual exact tax liability under the self assessment system in the usual way, having deducted any CIS deduction already suffered.

The ICAEW does not see the evidence for justifying such an increase in accelerated tax collection. This standard deduction rate of tax is meant to be an estimate of the tax that a subcontractor will eventually be paying for a tax year. This seems to suggest that the current 18% rate has resulted in serious underpayment of CIS tax in recent years, but no evidence has been produced to support this.

We also note that this increase, and presumably the current under collection of tax which has given rise to it, has not been discussed at any of the current consultation meetings with representative bodies and other interested parties.

We suggest that Treasury Committee might ask for further evidence as to why increasing the deduction is necessary in order to deal with the justification given in the PBR.

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About the ICAEW

The Institute of Chartered Accountants in England and Wales (ICAEW) works in the public interest to promote enterprise, innovation and sustainable growth in a socially-responsible business environment.

Our strength and knowledge are drawn from that of our members who hold the world's most highly-respected finance qualification. They work in every sector of the economy, size of business and public body, from FTSE 100 boardrooms and Government departments, to high street practitioners, small businesses and charities.

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Appendix One

Controlled Foreign Companies: text of TAXREP 35/06



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
in 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.

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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

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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.

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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

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for the long-term. We, therefore, welcome the proposals contained in the Varney Review Report published on 17 November 2006.

28.

RECOMMENDATIONS

29.

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

30.

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

31.

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

32.

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

33.

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.

Recommended Changes to the Exempt Activities Test

We believe that the provisions introduced in FA 2003 (Section 200 and Schedule 42) and in particular 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 Two

The Construction Industry Scheme

CONTRACTOR REGISTERED STATUS	PAYMENT ARRANGEMENTS
Registered for gross payment	Pay without deduction of CIS Tax.
Registered for net payment	Deduct CIS tax at the first rate from payments for labour. This rate is currently 18%, but following the PBR announcement will be 20% for the new scheme. Do not deduct tax from payments for the cost of materials, but record the amount allowed for materials.
Not registered	Deduct CIS tax at the second (higher) rate from payments for labour. This rate has been announced to be 30% in the PBR 2006. Do not deduct tax from payments for the cost of materials, but record the amount allowed for materials.