THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW TAX FACULTY REPRESENTATION

TAXREP 13/11

DRAFT FINANCE BILL 2011:
CORPORATION TAX – CFCs AND FOREIGN BRANCHES

Comments submitted on 9 February 2011 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales on the proposed legislation on 'CFC interim improvements' and 'Taxation of foreign branches' published as part of the draft Finance Bill 2011 on 9 December 2010.

Contents	**Paragraph**

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DRAFT FINANCE BILL 2011:
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INTRODUCTION

1. This document sets out the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) on the proposed legislation on **CFC interim improvements** and **Taxation of foreign branches** published as part of the draft Finance Bill 2011 on 9 December 2010.

2. These comments were sent to the HMRC officer responsible for this topic on 9 February 2011.

3. They are also included in our comprehensive response to the draft Finance Bill 2011, which is published as TAXREP 5/11 and was submitted to the Exchequer Secretary to the Treasury and to the Permanent Secretary for Tax at HMRC on 9 February 2011.

4. Information about the Tax Faculty and the ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

WHO WE ARE

5. 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.

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.

KEY POINTS

CFC Interim improvements

8. We note that the current provisions are a stopgap and will be replaced by a new permanent regime which is to be enacted in Finance Act 2012. We have made a number of detailed recommendations as to how we believe the interim improvements can be further improved.

Taxation of foreign branches

9. We are concerned that some of the provisions are in breach of the EC Treaty or contravene EU State Aid rules. We recommend the Government reconsiders the legislation so as to address these concerns.

10. We do not believe it is realistic to make the opt-in election irrevocably and we have suggested a practical solution which we believe will retain a sufficient degree of permanence to the election.

11. We recommend that consideration is given to backdating the effective date for the new election to 1 January 2011.

COMMENTS ON THE DRAFT PROVISIONS – CFC INTERIM IMPROVEMENTS

General comments

12. The Controlled Foreign Company (CFC) interim improvements are a stopgap and will be replaced by the new permanent regime which is currently under discussion and will result in new provisions for enactment in Finance Act 2012. Our comments on the Interim Improvements should be seen in that light.

13. Overall we welcome the Government's efforts to introduce temporary easing measures to the CFC regime prior to the new regime to be put in place in 2012.

14. We welcome the introduction of the statutory exemption 'grace period' of three years for foreign subsidiaries that, as a consequence of a reorganisation or change of UK ownership, come within the scope of the CFC regime for the first time.

15. We do not believe that cash and finance income that is derived from previous 'good' overseas income should potentially come within the CFC regime. It would be possible to pay this income up to the UK parent by way of dividend and then reinvest as equity to the potential CFC subject to any possible Fat Cap provisions. But we do not see why there should be a need to do that and it could also be expensive if the local jurisdiction operates a withholding regime.

16. We welcome the 'other improvements' set out in paragraphs 2.29 to 2.35 in Part 111A of the Corporate Tax Reform document but suggest in the comments below some alternative to the proposed monetary increase in the de minimis limit.

Revisions to section 748 ICTA 1988

17. There is a proposal for new section 748(3)(da) to increase the de minimis limit from £50,000 to £200,000. The limit for small and medium sized enterprises would remain at £50,000. We suggest that, as an alternative, there should also be a de minimis based on group turnover.

New section 751AB ICTA 1988

18. We found it extremely difficult to read and understand the provisions in this new section. We understand that new section 751AB is intended to allow partial CFC relief claims similar to section 751A/AA/B, where the provisions of new section 748(3)(ba) or (bb) are failed. Section 751AB(2)(a)(i) then addresses the situation where the new section 748(3)(ab)/Part 2A trading company relief is not applicable by virtue of UK-related gross income or expense being > 10% but </= 50%, and section 751AB(2)(b) addressing the situation where > 5% of the CFC's gross income for the new section 748(3)(bb)/Part 2B is intellectual property. Section 751AB(2)(a)(ii) then appears to allow partial trading company relief where > 5% of a CFC's gross income is either finance income or relevant intellectual property income, but the relevant intellectual property income itself is </=5% of the CFC's gross income. Is this right? If so, we recommend that this is redrafted to make this clearer.

19. We recommend that the limit on intellectual property income below which no apportionment will apply should be 10% rather than 5% (section 751AB(2)(a)(ii)) for consistency/accessibility of the new exemption.

20. Our general concern is that if these exemptions are made too complicated then business will revert to, and rely on, the existing motive test.

Amendments to Schedule 25 ICTA 1988

21. We are concerned by the provision in paragraph 12D which requires the CFC not to have 'to a substantial extent' non-exempt activities. Without a more precise definition of substantial we are concerned by the uncertainty that this particular provision may create. We understand that this is to be based on the substantial shareholding exemption practice of interpreting substantial as 20% or more, but would be grateful for confirmation of this. However, we believe that it should be statutorily defined.

22. We welcome the provisions in new paragraph 12E which are no longer an all or nothing test. However we do have a concern with the definition in sub-paragraph (5) where 'UK-related gross income' is defined to include income derived from persons within the charge to UK tax and also UK-related business expenditure with third parties. This would include income from unrelated i.e. non-group persons in charge to UK tax. If such income is greater than 10% of total gross income then the exemption is reduced *pro rata* and if such income is greater than 50% exemption is totally denied. We suggest that the 10% limit should only operate with regard to UK-related gross income from connected or related UK persons as per paragraph 12D(3). This would also mirror the provisions in paragraph 12F(4)(b) and paragraph 12K(2). It should also be noted that existing paragraph 10 of Schedule 25 already exempts goods delivered into the CFC's territory. A final concern with sub-paragraph (5) and the proposed definition of 'UK-related gross income' is that it could include the income from transactions with the foreign permanent establishment of a UK related company.

23. The measures in new paragraph 12 G et seq are more demanding than the proposed 1:2 Fat Cap ratio considered for the new, post 2012, CFC regime and outlined in paragraphs 3.17 and 3.18 of Chapter 3 of part IIA of the Corporate Tax Reform document. There is some lack of clarity here as the Fat Cap concept is applied to situations where the intellectual property is held as an offshore investment. Is there to be a distinction between passive and active intellectual property? If this is the intention, why should passive intellectual property be easier to deal with by way of a simple ratio concept?

24. In paragraph 12I (2)(a) there is a requirement that the intellectual property has not been held by a person resident in the UK within the previous 10 years. If there is to be such a provision we believe that the period specified should be reduced to say 6 years, which is in line with the provisions in section 179 TCGA 1992. However, even with this reduced period, we are concerned that the basic provision may be in breach of the EU/EEA law where the CFC is an EU or EEA non-UK company. It may also be the case that the original intellectual property may have moved from the UK and an exit charge paid in which case any future income would have been captured in that exit charge and shouldn't be subject to a further CFC charge. It may also be difficult to determine what constitutes intellectual property previously held in the UK, which is a similar problem to that faced by the FA 2002 intellectual property provisions: see CIRD paragraph 11678 of HMRC's Corporate Intangibles Research and Development Manual for a discussion of the problem in that earlier context.

25. Also in paragraph 12I(2) intellectual property has a UK connection if it has been held within the previous ten years by any person resident in the UK whereas if the intellectual property has been created, maintained etc this is only caught if it has been carried out by a person related to the overseas subsidiary and where the creator etc is within the charge to UK tax. The first condition would have the effect of catching an innocent case where a foreign subsidiary has acquired IP from a completely unconnected UK person and we believe this provision needs to be amended to take account of this.

26. In paragraph 12K(2)(a) the indirect equity funding of the CFC's business could present a significant problem because, in theory, all CFCs, however remotely held from the UK, could arguably have been indirectly funded from the UK parent.

27. We believe that in paragraph 12K(2)(b) IP income from unrelated persons should be specifically excluded.

Interaction with exempt dividends

28. There will be cases where a CFC that might otherwise qualify as an exempt trading or intellectual property company will be disqualified from such status because it receives dividend income that would constitute an exempt distribution under Part 9A CTA 2009 if it was apportioned.

29. For example, the relevant shareholding could fall within paragraphs 12D(2)(a) and 12J(1) even though the consequent dividends would constitute exempt distributions. It is noted that an exclusion from exempt distributions has already been applied in paragraph 12F(3).

COMMENTS ON THE DRAFT PROVISIONS – TAXATION OF FOREIGN BRANCHES

30. There would appear to be no potential relief for investment companies. In our view this will cause the provision to be in breach of EU State Aid rules.

31. Para A2 of the Technical Note indicates that there will be an irrevocable election for every UK resident company under which all of its foreign branches will be exempt from UK corporation tax.

32. We do not believe it is realistic to expect a company to be able to commit itself irrevocably. It would seem more appropriate for the initial election to be for a minimum period of say four years and for there to be a facility to bring the election to an end by giving a minimum period of advance notice of say one or two years' such notice not to be effective before the end of the initial four year period.

33. There would appear to be no potential relief for terminal losses for which relief would need to be given to keep the UK legislation EC Treaty compliant on the principles established by the *Marks & Spencer* ECJ judgment. Equally, if on the closure of the foreign branch there was a foreign exchange loss on the branch 'investment' then not to give loss relief to the UK 'parent' would be contrary to the ECJ judgment in the case *Deutsche Shell GmbH v. Finanzamt für Grobunternehmen in Hamburg* (C-293/06).

34. We are also concerned by new section 18B (1) (b) CTA 2009 under which the election to exclude certain profits and losses will apply 'to all accounting periods of the company following that in which it is made.' This would mean that for companies with a calendar year end, the election could not be validly made until after Royal Assent in July 2011 and so branch exemption would only apply for the accounting period beginning on 1 January 2012. Companies with a June year end would be even worse off and would only be able to elect into the new system for accounting periods beginning on 1 July 2012. We believe that the election should commence at the very least with effect from 1 April 2011, as was the original intention, with split accounting periods. We recommend that consideration is given to backdating the effective date of the new election to 1 January 2011 as was done in Finance Act 2004 on the introduction of the Interest and Royalty Directive (see now sections 757–767, ITTOIA 2005).

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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.