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Dear Edward

RE : CONTROLLED FOREIGN COMPANY REFORM

Following the business representative meeting with HMT and HMRC to discuss CFC reform, we have set out below our thoughts on a framework for developing policy and principles underpinning a CFC regime. In our view the key challenge is for HMG to determine and explain in clear terms the policy objective in seeking to tax income arising outside the UK. It is hoped that what follows will assist in achieving that objective. It is recognised, however, that the effectiveness of any regime in achieving policy aims depends on the detailed definitions and provisions so what follows will need further refinement.

Any CFC reform needs to be considered in the context of other reform to the taxation of foreign profits and the UK's holding company regime generally to ensure a new regime is competitive. Specifically, these comments are made in the context of a package of reform including an exemption to tax of all foreign income arising from foreign participations. Whilst there are different views as to the behaviours that would arise from a full participation exemption, we would expect a rigorous impact assessment and that any new CFC regime be proportional to the need to prevent significant abuse and no more.

We have previously submitted examples of the inappropriate application of the current regime and do not intend to provide further commentary on these unless you request it.

Introductory comments

1. A new CFC regime should be based on clear Government policy, law and guidance in order to allow taxpayers to apply mechanical rules with certainty and absent subjective judgment as far as is possible. Such a policy requires transparent and coherent underlying logic as to the specific abusive circumstances in which any sources of income arising outside the UK should be taxed in the UK.

2. The regime should be internationally competitive and should not discourage commercial investment from the UK in overseas territories.
3. A new regime should apply on a worldwide basis without distinction between EU member states and non-members.
4. As previously recommended any new regime needs to focus on sources of income in circumstances of abuse rather than entities. In the examples previously submitted, the current entity based system is less effective both in terms of failing to tax certain sources of income within entities and taxing entities which should fall outside any reasonable regime. The current regime also restricts repatriation of overseas income through inappropriate application to intermediate holding companies.
5. A regime focussed on specific income in cases of abuse not only provides a better framework within which to apply a clear policy but also allows a clean break from the previous regime.

Framework for developing CFC policy

6. The policy is currently unclear and confusing, which is not surprising, as it has evolved over some 22 years. In its place there should instead be a set of principles, which defines targeted offshore income, and explains clearly the policy under which the HMG considers the income should be taxed in the UK.
7. In determining policy, the following needs to be considered:
 - a. What is the purpose of a CFC regime? Is it to support capital export neutrality or to encourage holding company location in the UK?
 - b. Should the UK have the de facto right to tax worldwide income not subject to a certain level of tax simply due to the UK domicile of the ultimate parent?
 - c. Should certain types of income / business activity be targeted?
 - d. Is the underlying source of income relevant – UK or overseas?
 - e. Should income be traced to a business activity?
 - f. Should income arising offshore be targeted (i) at all; (ii) automatically; or (iii) only where there is a UK related expense?
 - g. Whether policy is better implemented by denying tax relief for UK expenses related to generating targeted CFC income as an alternative to taxing offshore income?
 - h. What is the rationale for taxing offshore services provided by substantial operations?
 - i. In the context of clear policy on targeted income, is a motive test relevant; and if so how should it apply to determine whether income should have been taxed in the UK?
 - j. It needs to be demonstrated that other measures available to HMRC including PE, residence and transfer pricing are not sufficient to provide necessary protection to the Treasury e.g. in relation to offshore service providers?
 - k. What is competitive in developed country CFC regimes?
 - l. A new CFC regime should be consistent with AG's opinion and the ECJ's decision in Cadbury Schweppes?

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- m. Objective tests should be applied to income sources such that provided there is local substance the motive and the structure remain irrelevant?
 - n. Should there be de minimis rules?
8. The principles derived from answering the questions above should be developed in the context of a detailed understanding of modern business practices to avoid ambiguity in the interpretation of concepts including “exempt activities”, “diverted from the UK” and “not in the ordinary course of business”.
9. It may be unnecessary to retain any form of motive test but we would reserve judgement in this depending on how the principles on targeting artificial situations with no substance develop.
10. As mentioned above, an anti-abuse income based regime provides the opportunity to apply greater precision as to the targeted income. Emerging principles may target income arising offshore in artificial situations with no substance; however, identifying only that income which is connected to a UK expense would be progressive and competitive. Certainly our preliminary view is that income derived from any genuine commercial (trading, including the provision of inter-company services, intangibles or investment activity) should be excluded from the new regime.
11. In our view an objective test applied to income based on substance and real economic activity should be sufficient to determine its CFC status. The guidance offered by the AG’s opinion in Cadbury Schweppes and the ECJ’s subsequent decision, i.e. any source of income should be exempted provided there is proof of establishment and that the arrangements are not wholly artificial i.e. lacking substance. However, definitions in this area are key to providing clarity. Those definitions in turn should be clearly linked to policy.

The above paragraphs record business’ views on the approach to developing a framework for a new anti-abuse income based CFC regime. It is clear that little progress can be made absent a coherent and transparent underlying policy in this area. In the context of wider reform of the taxation of foreign profits, we would welcome the continuing opportunity to discuss policy aspects and subsequent detailed provisions that are best able to reflect this policy in the modern business world.

Yours sincerely



Chairman – 100 Group Fiscal Committee

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