



## TAXREP 8/10

# PROPOSALS FOR CONTROLLED FOREIGN COMPANIES (CFC) REFORM – DISCUSSION DOCUMENT

*Memorandum submitted on 19 February 2010 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales as an initial, high level, response to the discussion document published on 25 January 2010. A detailed response will be published at a later date.*

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ICAEW Tax Faculty, Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ, UK <a href="http://www.icaew.com/taxfac">www.icaew.com/taxfac</a>	T +44 (0)20 7920 8646 F +44 (0)20 7920 8780 E <a href="mailto:taxfac@icaew.com">taxfac@icaew.com</a>
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## INTRODUCTION

1. We are writing to provide our initial, high level, response to the discussion document published on 25 January 2010.
2. We are submitting this initial response in advance of our attendance at the presentation of the proposals by HM Treasury and HM Revenue & Customs at a Stakeholder event which is to take place on 23 February 2010.
3. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

## COMMENTS

4. The discussion document is a high level overview of a potential new CFC regime which now contains more detailed comments on features of the new regime that are likely to be necessary in relation to 'monetary assets' (chapter 3) and 'intellectual property' (chapter 4).
5. The comments in the current representation contain an initial, high level, response to the proposals in the discussion document.
6. We will be attending the HM Treasury and HM Revenue & Customs Stakeholder event on 23 February 2010 and after that meeting we will submit our more detailed comments before the deadline for comments on 10 April 2010.
7. We have some concern that after almost four years of discussion of these issues a general election has to be called within the next four months. We hope that if there is a change of government all the hard work that has been put in to date will not be lost.

### *Our initial reaction*

8. We believe that the proposals in the discussion document represent a credible approach to a new CFC regime in the UK which it is proposed will be limited to the taxation of profits that have been diverted from the UK.
9. We do, however, feel that the government ought to consider whether there is a need for a CFC regime in the light of all the other measures that help to achieve the basic aim of the proposed CFC regime.
10. A major concern in relation to the current proposals is whether they will in practice achieve the stated objective of being compliant with the EC Treaty. We have set down some concerns with the current proposals in relation to this compliance issue.
11. Inevitably when more detailed proposals are available for comment other difficulties are likely to emerge. Overall the government must not lose sight of the

need to maintain a competitive tax environment for business operating in the UK and the detailed proposals will need to be judged against that overall objective.

*Is a CFC regime still necessary?*

12. The first bullet point in Box 1.A states:

‘There is a continuing need for CFC rules to protect the UK tax base from erosion through the artificial diversion of profits from the UK which is not countered through other measures.’

13. We recommend that this should be debated during the current phase of consultation, including at the Stakeholders’ meeting on 23 February, as it is not immediately clear to many of our members why the existing transfer pricing regime, plus other international anti-avoidance measures, do not already provide sufficient protection to the UK tax base.

*A welcome to the content of the discussion document*

14. If there is to be an amended CFC regime, which as indicated above we feel needs to be properly debated, then we welcome the opening statements in the discussion document which indicate, in general terms, what the new regime is intended to achieve.

15. We welcome in particular the following statements in Box 1.A

The new rules will be targeted on artificial diversion of UK profit and not on taxing profits that are genuinely earned in overseas subsidiaries.

An essential part of adapting a more territorial approach to the new rules will be moving from the current default presumption that all activities that could have been undertaken in the UK would have been carried out here, had it not been for the tax advantage of the overseas location.

The new regime is not intended to increase the scope of the current CFC rules and any new regime must be compliant with EU law.’

*Concerns about compliance with the EU law*

16. We welcome the explicit intention to ensure that the new regime ‘must be compliant with EU law.’

17. But we have serious doubts as to whether that is going to be the case on the basis of the current proposals.

18. It seems clear from the ECJ judgment in the case of Cadbury Schweppes C-196/04 that if a company is genuinely established in an EU member state, and that will extend to the EEA area, and carries on commercial activities there then that company must fall outside any CFC regime if that regime is to be compliant with EU law.

19. The judgment paragraph in Cadbury reads:-

‘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 CFC 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 3<sup>rd</sup> parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activity there.’

[capitals added by ICAEW Tax Faculty in the above quote]

20. Our reading of this is that a permissible CFC inclusion is subject to a 2-part test viz it must ONLY relate to wholly artificial arrangements (which we accept would arguably be met in relation to the ending of swamping) but the second part of the test is that the CFC is NOT genuinely economically established (which in our view would not be met by the current proposals).
21. So in our view the current proposals in the discussion document will either have to be amended for companies established in the EU or EEA, or there will have to be amendments to the basic proposals themselves.
22. For instance in paragraph 2.9 there is an indication that the Government is considering a replacement to the current ‘lower level of tax’ test by a new test to exclude companies that operate in jurisdictions with (a) similar statutory rates and (b) similar tax bases to the UK. But in our view this test would have to include an effective presumption that all EEA states will be assumed to have complied with the requirement and that therefore so long as a company is genuinely established in an EEA member state and carries on commercial activities through its establishment in that member state, such that the arrangements could not be considered wholly artificial, construed in accordance with the ECJ judgments, it should be assumed that the similar rate and tax base conditions have been met. We accept that the exclusion from the CFC regime need not necessarily apply to the income generated by activities carried on by the EEA company outside the EEA .
23. There are similar concerns about paragraph 2.12 which we discuss in more detail below and where we welcome the proposal to extend the definition of trading activities. But we do not believe that the proposal to prevent the swamping of ‘good’ income can be compliant with the EU Treaty for the reasons we have set out below.
24. Equally in relation to paragraph 2.17 where under the proposed new motive test income would not be treated as artificially diverted from the UK if the overseas subsidiary can ‘demonstrate the non-tax related commercial rationale for any specified transaction.’ In order to be EU Treaty compliant it is the underlying rationale for the company’s existence which determines whether it can be caught under an EU Treaty compliant CFC regime, at least as far as companies established in the EU and EEA member states are concerned.

*Proposals that we welcome*

25. We welcome the proposal in paragraph 2.8 to continue to exclude capital gains from the scope of the CFC regime, subject to the existing anti-avoidance provisions.
26. We also welcome the intent behind the proposal in paragraph 2.9 to seek to exclude from the new CFC regime subsidiaries operating in tax jurisdictions comparable with the UK.
27. Similarly we welcome the statement in paragraph 2.11 that 'to the extent that ... intra-group transactions do not pose a risk to the UK tax base, it is proposed that the profits arising would be exempt from a CFC charge under the new regime.' This paragraph then goes on to suggest that as such transactions do pose a theoretical opportunity for tax avoidance that the rules in this area will have to be designed with care and that the design will benefit from a full discussion with business and organisations like our own. We wonder whether significant provisions are needed in relation to intra-group transactions as any Intellectual Property and Finance measures should take care of any potential problems in this area.
28. We welcome the proposal in paragraph 2.12 to extend the definition of trading activities to include genuine offshore group treasury operations and the active management of intellectual property. But at the end of that paragraph there is an indication that measures will be introduced to prevent swamping which is described in the discussion document as:

Artificially locating unrelated non-trading profits (typically intra-group interest income) alongside trading profits in order to shelter income from a CFC charge.
29. It is not clear how these anti-swamping proposals can be made to be compliant with the TFEU Treaty. If the company is established for bona fide commercial purposes the fact that it has some non-trading profits cannot change that basic purpose.
30. We welcome the proposal in paragraph 2.19 to suspend the application of the new rules for a period of time following the acquisition of a new sub-group overseas. But we believe that this would have to be put on a statutory basis of some sort if it is not to fall foul of the Wilkinson decision as not being able to fall within the non statutory 'care and maintenance' powers of HMRC.

*Initial comments on the detailed proposals on monetary assets and intellectual property*

31. We will comment on these proposals in our detailed response to the discussion document.
32. We have some initial comments which we hope will be clarified at the meeting on 23 February.

*Monetary assets*

33. We wonder whether the experience obtained putting together the 'world wide debt cap' regime can be used to help to resolve the issues covered in paragraph 3.5.
34. The proposals in paragraph 3.10 re the funding mix clearly need further clarification and it is hoped a better indication of current thinking will be given at the 23 February meeting.
35. In relation to the comments in paragraph 3.13, we consider that it would be unlawful to take action against loans to the UK from a company which is genuinely established in the EU or EEA.

*Intellectual property (IP)*

36. We are concerned by the proposals in paragraph 4.9. We do not believe that a solution akin to either that adopted in Germany, with a 10 year commutation of income foregone capital charge, or that adopted in the United States, with a pure income look back with the benefit of hindsight, are appropriate for the UK.
37. We welcome the approach in paragraph 4.11 but note that it may be easier to demonstrate that there is little active management in the UK rather than that there is active management abroad.
38. We also welcome the approach in paragraphs 4.15 and 4.16 which, as acknowledged, now requires further work on the factors that will demonstrate that IP is being actively managed. The approach of the OECD in relation to risk factors may be a helpful means of clarifying the relevant issues.
39. And finally we also welcome the approach outlined in paragraphs 4.18 and 4.19 in relation to IP that is not actively managed.

iky February 2010

### ICAEW AND THE TAX FACULTY: WHO WE ARE

1. 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.
2. 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.
3. 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 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at [taxfac@icaew.com](mailto:taxfac@icaew.com) or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

## 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.co.uk/index.cfm?route=128518>.