The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

Response re HMRC Consultation: "Taxation of the Foreign Profits of Companies: Draft Provisions"

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the HMRC consultation regarding "Taxation of the Foreign Profits of Companies: Draft Provisions" has been prepared by the CLLS Revenue Law Committee. The Committee is made up of a number of solicitors from City of London firms who specialise in revenue law. The Committee's purpose is to represent the interests of those members of the CLLS involved in this area of law.

We are grateful for the opportunity to comment on HMRC's consultation document on the "Taxation of the Foreign Profits of Companies" published in December 2008.

1 Comments on Schedule 1 (Corporation tax treatment of company distributions)

1.1 We welcome the decision to introduce a dividend exemption regime.

1.2 In the context of a competitive international environment, the structure of the exemption is key. For that reason, we are concerned about the way in which the dividend exemption rules will apply. As the provisions are currently drafted, a company will only be entitled to the exemption if it can prove that it falls within an exception to the rule that dividends are generally taxable and satisfies itself and HMRC that it does not fail any of a number of complex anti-avoidance conditions. It is very difficult to see how this can give the UK the competitive edge it needs to encourage inward investment and burnish the credentials of UK plc. Our strong preference would be for a general rule under which dividends are exempt, with exceptions for circumstances in which the exemption would not apply. Where specific types of arrangements are found to be outside the spirit of the exemption, additional exclusions could be added in due course.

1.3 The dividend exemption may have an adverse impact on UK resident companies receiving dividends from overseas companies in certain circumstances. This would be the case where withholding tax is payable by the payee in respect of the dividend and the relevant double taxation agreement requires the UK resident to be "subject to tax" in order to benefit from reduced rates of withholding. We note that this point is under consideration by HMRC but work in this area will need to be expedited if there is to be real encouragement for permanent repatriation of overseas income by UK groups.

1.4 In our view Sections 212 and 213 TA 1988 do not comply with EC law. The present would be an opportune time to amend these provisions so that they apply on a cross-border basis. Alternatively, Sub-section 209(2)(e) and Section 212 could be repealed and replaced with amendments to the loan relationships rules. This would be more appropriate in the context of interest payments in any event.

1.5 Given the number and breadth of targeted anti-avoidance rules in the draft legislation, we would strongly advocate the inclusion of a formal clearance procedure. This is necessary to give taxpayers certainty.

1.6 As drafted, Clause 930E is very broad and is likely to give rise to uncertainty. It should be narrowed in scope so that its objective is clearly identifiable.

2 Comments on Schedule 2 (Tax treatment of intra-group financing costs and income)

2.1 In our view, the draft worldwide debt cap provisions will place different groups whose UK parts have equal debt/equity ratios on an unequal competitive footing. They are, therefore, likely to lead to behavioural changes which may ultimately serve to reduce inward investment into the UK and encourage UK groups to look outside the UK for investment or structuring purposes. The proposal will also give rise to arbitrary effects, with matters such as overseas interest rates and, possibly, FOREX movements, affecting the UK tax liability of companies with no business in other jurisdictions.

2.2 We do not consider the policy concern behind the legislation to be valid. Why should a UK company not be able to claim greater interest deductions than its worldwide group if that result reflects its financing needs? Surely the correct principle should be that the UK company cannot borrow more from its fellow group members than it could from a third party bank – the internationally accepted arm's length principle enshrined in the UK's transfer pricing rules. The policy behind the proposals leads inevitably to a number of the greatest problems with the new rules, in particular that:

2.2.1 the UK will effectively be offering the opportunity to secure greater tax relief to an inward investor that is already highly geared, as against one that is more conservatively financed, so placing the over-leveraged at a competitive advantage;

2.2.2 groups already carrying on business in the UK will be incentivised to increase their gearing in order to maximise UK tax relief; and

2.2.3 groups will be incentivised to acquire new assets abroad rather than in the UK (and to move already UK based assets offshore) in order that the borrowing associated with those assets can count towards the "available amount", so increasing the potential for UK tax relief.

2.3 The issue of existing thin capitalisation agreements will need resolving: a number of groups have agreements in place with HMRC as to the level of shareholder debt they can bear, which will now presumably be overridden. Even allowing for those agreements being made subject to a change in law, this hardly seems fair. This point highlights most clearly the extent to which these measures move the UK away from the international norm of testing deductibility on an arm's length basis.

2.4 We would strongly recommend that the debt cap provisions be removed in their entirety and be replaced by more targeted anti-abuse provisions. We would take this view even if the price of doing so was a delay in the introduction of the dividend exemption, so seriously do we regard their potential to damage the UK economy by discouraging inward investment.

2.5 In support of the points made above:

2.5.1 we can see no conceptual connection between the dividend exemption and the debt cap and, therefore, no reason in principle for both to be enacted together (by contrast, if a restriction on interest incurred on loans taken out to acquire exempt shareholdings were introduced, there would be a logical link between the two measures). The dividend exemption is intended to move further towards a "territoriality" limitation and to align the tax treatment of UK and non-UK source dividends. The debt cap appears to be intended to prevent "debt dumping". However, we are not convinced that the debt cap will serve to achieve that aim in practice (and even if it does it will be an extremely blunt instrument when something more targeted would be more appropriate); and

2.5.2 multi-national groups with operations in the UK may be treated very differently under the debt cap rules, notwithstanding that their UK operations may be substantially identical, due to entirely commercial differences in the structure of the overseas part of each group. Similarly, the same group might be treated differently under the proposed rules purely because a commercial change has taken place in its structure over which it has little or no control (for example, where an equity-funded group is taken over by a group funded by overseas debt, or even just where overseas interest rates move materially).

2.6 While we do not seek to make detailed comments here, if the debt cap is brought into force we would suggest that clarification be given as to whether (and if so to what extent) the debt cap rules are intended to apply to controlled foreign companies. For instance, are CFCs members of the UK part of the group for the purposes of the "tested amount" and members of the non-UK part of the group for the purposes of the "available amount"?

3 Comments on Schedule 3 (Loan relationships and derivative contracts: anti-avoidance)

These provisions are very broad. At the least, there should be clear guidance in place to give greater certainty as to the types of situations in which the provisions are intended to apply. Such guidance should include examples of safe and at risk transactions, should be produced in draft form and should be subject to consultation before it is finalised. It should also include scenarios where there is potential for interaction between these rules and other provisions. For example, HMRC has indicated that it will not seek to prevent taxpayers from carrying out transactions designed to rescue losses which become stranded as a result of the operation of the debt cap rules, and it should be made clear that the extensions to the anti-avoidance provisions in the loan relationships and derivative contracts regimes will not prevent access to such losses.

4 Comments on Schedule 5 (International movement of capital)

4.1 We welcome the proposed abolition of the current Treasury Consent regime.

4.2 We cannot see any imperative for imposing reporting requirements for cross-border transactions going forward. In our view, the proposals in Schedule 5 should be dropped.

4.3 If continuing reporting requirements are inevitable, they should be introduced solely for arrangements where there is tax avoidance and brought into force in the form of amendments to the disclosure rules, rather than the separate broad reporting requirements currently proposed. The original requirements date from the time of exchange controls and this type of requirement has no place in a modern, globalised economy of the kind the Government is seeking to promote.

4.4 If, contrary to our primary request above, the new reporting requirements will come into force, we would make the following comments:

4.4.1 We do not consider the proposed monetary threshold for transaction reporting to be a good indicator of the risk or harm which HMRC is trying to eliminate. A threshold based on the amount of tax at stake would be a more accurate indicator.

4.4.2 In our view all security arrangements for financing transactions should be clearly excluded from any reporting requirements.

4.4.3 The new reporting requirement should be subject to exceptions which are based on the existing Treasury General Consents.

4.4.4 Paragraphs 6(2)(c) to (e) of Schedule 5 appear to be in point even where there is no cross-border transaction. The cross-border requirement should be made clear in the obligation provisions rather than requiring taxpayers to place reliance on one of the excluded categories in paragraph 7.

3 March 2009

THE CITY OF LONDON LAW SOCIETY
4 College Hill, London EC4R 2RB
Tel: 020 7329 2173, Fax: 020 7329 2190
E-mail: mail@citysolicitors.org.uk

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REVENUE LAW COMMITTEE

The City of London Law Society is the local Law Society for solicitors practising in the City of London. It has a number of specialist Committees, the Revenue Law Committee being one of them. This response has been prepared and reviewed by the Revenue Law Committee as a whole.

Individuals and firms represented on this Committee are as follows:

Chris Bates
Norton Rose LLP

Christopher Cox
Beachcroft LLP

Nigel Doran
Macfarlanes LLP

Karen Hughes
Lovells LLP

Paul Hale
Simmons & Simmons

Michael Hardwick
Linklaters LLP

Colin Hargreaves
Freshfields Bruckhaus Deringer

Christopher Harrison
Allen & Overy LLP

Bradley Phillips
Herbert Smith LLP

Stephen Shea
Clifford Chance LLP

Cathryn Vanderspar
Berwin Leighton Paisner LLP

Simon Yates
Travers Smith LLP