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Dear Sir

Re: Proposals for controlled foreign companies (CFC) reform: discussion document

We are grateful for the opportunity to comment on the above consultation document dated January 2010.

By way of background, 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 has been prepared by the CLLS Revenue Law Committee.

Our comments on the consultation document are as follows.

General

Overall, we consider that the latest proposals represent an improvement on previous proposals. We welcome the Government's approach of facilitating an open and transparent consultation with a sensible timetable for implementing any changes so as to enable full and proper discussion with businesses and other stakeholders. CLLS was represented at the Stakeholder event on 23rd February 2010.

Our main concerns over the latest proposals can be summarised as follows:

- (i) If fully adopted, the proposals may not ultimately fully adhere to the stated policy of only targeting the "artificial diversion of UK profit and not taxing profits that are genuinely earned in overseas subsidiaries".

We would draw attention in particular to paragraph 2.17 of the consultation document, which confirms the Government's policy decision to eliminate the former "default assumption" that all activities that it was commercially feasible to carry on in the UK would have been carried on there but for a fiscal motive. In our view, the acid test is to look at a situation where there is no commercial advantage or disadvantage either way as to whether the activity is carried on within or outside the UK, and the activity is carried on outside the UK (a "**commercially equivalent case**"). If the former assumption has truly been eliminated, then, in that situation, nothing further should be required to secure exemption. However, in the very next sentence after stating that the old assumption has been eliminated, paragraph 2.17 indicates that, even (apparently) in this situation, exemption would still be subject to a "redesigned motive test", according to which it would be necessary to "demonstrate the non-tax related commercial rationale" for a specified transaction or for the role of the company concerned. There is a clear contradiction in terms in first saying that the old assumption has been eliminated, and then postulating that the above test would apply even (apparently) in a commercially equivalent case. In a commercially equivalent case, there may be a "diversion of profit from the United Kingdom", but that diversion is, by definition, not "artificial". In addition, a provision which applied to a "non-artificial" diversion of profits would, in our view, clearly contravene EU law (see further below).

- (ii) The current proposals are more than likely to lead to a regime which will justify being referred to as complex and involve unwelcome compliance costs and therefore may not meet the stated objectives of achieving minimised compliance costs and certainty with the result of also not achieving the key policy of enhancing the competitiveness of UK.
- (iii) We support the principle that there should be a single worldwide regime rather than different regimes for EU and elsewhere. It is therefore absolutely crucial that any reform should demonstrably comply with EU law, as read in the light of the *Cadbury Schweppes* case. Stability and certainty of the tax system - as needed by business and stated to be a policy objective of Government - are not served by the enactment of provisions in respect of which, at the least, there is a good argument that they run contrary to EU law. A good example would be the legislative response to the *Marks & Spencer* decision, which was widely (and, as it turned out, correctly) believed from the outset to be insufficient to address the EU issues, and so only promoted further uncertainty. We are not convinced that the proposals yet fully take on board the extremely limited potential scope for a CFC regime permitted by the *Cadbury Schweppes* decision. After all the time and effort put into the process by many parties, it would be a disastrous outcome to end up with a regime that immediately faced further challenge in the courts.
- (iv) The UK has a well developed transfer pricing regime which is the main weapon against the artificial diversion of profits overseas. The World Wide Debt Cap ("WWDC") is now in force and, to an extent, addresses the issue of "fat capitalisation" of overseas subsidiaries. The CFC regime should not seek to

address any of the perceived abuses which these regimes are in place to prevent. If nothing else, this is likely to lead to complexity and confusion: the interaction between the WWDC rules and the transfer pricing regime is problematic since in many circumstances the two measures target the same arrangements (in our view, this is the case notwithstanding paragraph 5(9) of Schedule 28AA, which specifically provides against double-counting between WWDC and transfer pricing, and gives transfer pricing priority).

Similarly the WWDC rules sit uneasily with other interest restrictions (in particular the late paid interest rules). We would urge most strongly that further overlap between anti-avoidance regimes, each of which counteracts the perceived avoidance in different ways, should be resisted. If the transfer pricing and WWDC rules are not working as intended, then that should be addressed directly by changing those regimes

In our view, any Government concerns over "fat capitalisation" should be dealt with comprehensively under the WWDC and kept entirely out of the CFC forum. This is the only certain way of forestalling overlaps and impingements as between the CFC and the WWDC rules. We would also make the point that it would be absurd, and self-defeating in policy terms, if the CFC and the WWDC rules covered the same areas, but with different exemptions and definitions applying in each case.

- (v) The proposals assume that there can be an artificial diversion of UK profit where a foreign subsidiary carrying on genuine activities abroad is financed with too much equity. We do not accept this. Whereas a company can have too much debt, in the sense that it has more debt than a third party would lend, it cannot have too much equity: investors do not, in our experience refuse to invest in equity because there is insufficient debt. Equity will carry an arms' length reward in the form of dividends and capital growth. If the real concern is that the UK should not be allowing deductions for the cost of financing equity in foreign subsidiaries yielding exempt dividends, as stated above, the CFC rules are not the right vehicle for addressing this concern.

Ultimately, our level of overall concern will depend on the final form of the legislation and we would welcome seeing proposed draft legislation at an earliest stage as possible in the timetable.

Responses to Questions

Question 2A

We do not think it simple to design a test that would exclude companies in jurisdictions with similar statutory rates and tax basis to the UK. In our view, the simplest way to frame this exclusion would be to have a white list of acceptable jurisdictions/entities. We do not understand why a white list is seen to be unattractive. Provided it is regularly reviewed and updated, it would provide certainty for business and is likely to entail lower compliance costs.

Question 2B

We welcome introducing specific exemptions for types of companies. However, on the basis that the regime should only apply to the artificial diversion of profits, we are

concerned that the final proposals may ultimately include other overly complex provisions relating to intra-group transactions which should not be necessary on the basis that the transfer pricing regime is designed to avoid UK profits being artificially reduced.

Question 2C

As stated above, we can only welcome further specific exemptions, although we do find it difficult to accept the assertion that there may be an "artificial" erosion of the UK tax base where an overseas property subsidiary managing non-UK properties is not "appropriately funded". How can it be "wholly artificial" to hold an offshore property not used in a UK business in an offshore company? In particular, if the property was used by a UK group entity the overseas company would be subject to UK tax on actual, or transfer-priced, rent. There are also EU compliance issues. If the concern here is "fat capitalisation", that should be addressed by the WWDC rules.

Question 2D

Our preference is to include substantive provisions in statute rather than guidance but for there to be detailed guidance on how the provisions are to be applied in practice.

We suggest at least 3 years as an appropriate time period for a "period of grace" following an acquisition from a third party. In our experience, post-acquisition restructurings can in more complex cases take that long to implement.

We consider that there should be a similar "period of grace" where a non-UK based group relocates to the UK by superimposing a UK holding company on top of the existing parent company. Groups occasionally do this to obtain the benefits of listing on the London Stock Exchange. There is no scope for artificial diversion of profit in such transactions, and a statutory period of grace would be appropriate.

On the motive test generally, we regard it critical that this is carefully and clearly drafted so that it does only catch the "wholly artificial" diversion of UK profit. We refer to paragraph (i) of our general concerns above.

Whilst a motive test has some attractions, not least if accompanied by a clearance procedure, it must reflect the *Cadbury Schweppes* decision or it will be invalid (the motive test will need to be drafted in such a way as to ensure that it is EU-compliant, bearing in mind the principles of *Cadbury Schweppes*). So the bar for "bad" motive must be set very high. The CFC regime can only apply if there is a wholly artificial arrangement intended to circumvent national law. A test requiring the taxpayer to demonstrate a non-tax related commercial rationale (as referred to in the document) would set the bar too low (see in particular paragraphs 36 and 37 and paragraphs 49-55 of the judgement). It is clear from *Cadbury Schweppes* that a CFC regime cannot apply merely because a taxpayer has undertaken a tax-motivated transaction.

We have concerns over how any test would be applied in practice – what would be required in practice from taxpayers to demonstrate an acceptable non-tax related commercial rationale etc? This will need to be set-out in statute or, more likely we expect, in detailed guidance.

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Question 3A

As stated above, we welcome having a specific exemption for treasury operation companies which we suggest, if possible, should be kept simple, although ultimately it is recognised that it may be logical to adopt the definition of "group treasury company" in the WWDC rules on the basis that the respective tests for the two regimes should in any event be similar, in order to avoid mutual encroachments.

Questions 3B and 3C

We are most concerned that the proposals to introduce some form of "fat capitalisation" test will lead to an overly complex regime (as should be self-evident from the questions posed at Question 3C). We also refer you to paragraph (v) of our general comments above.

We also note that such rules can lead to double tax, since it is unlikely that the foreign jurisdiction in which the subsidiary is resident will allow any corresponding adjustment for any part of the equity which the UK taxes as an interest bearing loan.

Although, preferable to the tracing proposal, we do not believe this would ultimately prove to be simple to operate and this proposal will therefore add more complexity to the tax rules governing group funding arrangements (i.e. the existing the transfer pricing and WWDC regimes). If such a proposal is pursued, it will be necessary to consider how it would interact with the transfer pricing and WWDC regimes which we do not believe could be made simple to operate in practice.

In addition, the premise that "a risk of artificial diversion of profits exists where finance companies are funded through UK capital on which the UK does not earn a return" (paragraph 3.7 of the consultation document) implies an assumption that a taxpayer would have invested in something giving rise to UK taxable profits but for the tax advantages afforded by the overseas location. This is inconsistent with the Government's stated intention (in paragraph 2.17 of the consultation document) to move away from the default assumption that all activities that could have been undertaken in the UK would have been undertaken here, but for those overseas tax advantages. Consequently, the rationale for the "fat capitalisation" measures is not apparent to us.

Depending on the final form of any rules, it may be necessary to introduce a speedy clearance procedure so that businesses can be certain that their particular funding arrangements are acceptable.

Question 3D

If this proposal is to be adopted, it would seem simplest to treat combined treasury and finance companies in the same way as finance companies.

Question 3E

If this proposal is to be adopted, we support limiting as suggested. However, the proposal to tax interest income earned from the "excess cash" referred to in the consultation document appears to be based on a presumption that surplus cash in overseas subsidiaries ought to be held by the UK parent of those subsidiaries. It is not clear to us why this should be the case, especially as one can think of many genuine commercial reasons why an overseas subsidiary may want to hold cash.

Question 4A

On the IP proposals generally, we welcome that Government finally recognises that IP management can be a trading rather than an investment activity and that conducting this activity in a non-UK company can be a genuine activity.

However, we are concerned once again about introducing an overly complex regime (the proposals described at paragraph 4.9 of the consultation document in relation to the transfer of IP from the UK could well end up being some of the most complex in the UK tax rules) in circumstances where artificial arrangements should already be caught by the existing transfer pricing rules. We would also make the point that taxing the transfer of IP in the way described would mean taxing transfers from the UK in a way which is fundamentally different to UK to UK transfers. We therefore strongly encourage the Government to consider addressing its concerns through changes to the transfer pricing and exit taxes rather than introducing a further regime.

Question 4B

We would repeat our general comments about introducing a complex regime. If these proposals are to be pursued further, detailed further discussion with business will be needed to develop a workable approach and it is likely that you will find that almost every international group operates their IP management activities differently. Again, in our view, it will be necessary to introduce a clearance procedure so that businesses can be certain that their particular IP management operations are acceptable.

Questions 4C and 4D

We would repeat our general comments about introducing a complex regime and the need for one having regard to the existing transfer pricing and other rules.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Bradley Phillips', written in a cursive style.

Bradley Phillips
Chair
City of London Law Society Revenue Law Committee

**THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE**

Individuals and firms represented on this committee are as follows.

- B.S. Phillips (Herbert Smith LLP) (Chairman)
- H. Barclay (Macfarlanes LLP)
- C.N. Bates (Norton Rose LLP)
- D. Friel (Latham & Watkins LLP)
- P.D. Hale (Simmons & Simmons LLP)
- M.J. Hardwick (Linklaters LLP)
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