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By post to:

Jennifer Payne and Robert Edwards
CT Reform
Corporate Tax Team
HM Treasury
1 Horse Guards Road
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9 February 2011

Dear Ms Payne and Mr Edwards

Comments of the Revenue Law Committee on the Draft Legislation for Finance Bill 2011 in relation to Controlled Foreign Companies

The City of London Law Society (“CLLS”) represents approximately 14,000 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 draft legislation dealing with interim improvements to the controlled foreign companies legislation has been prepared by the CLLS Revenue Law Committee.

We are pleased to have the opportunity to comment on the draft which will be included in Finance Bill 2011.

1. Section 751AB(5)(b), 751AC(4)(b) and 751A(4)(b)

Each of Section 751A, 751AB and 751AC provide for an application to be made for the chargeable profits of a controlled foreign company for an accounting period to be reduced to a specified amount. The sections are mutually exclusive, in that an

application may only be made under one of them, even though it is possible that the circumstances of a controlled foreign company could fall within more than one of the sections. In our view, the restriction on making an application where an application has been granted under another of these sections should be removed, although we would accept that there will need to be provision to ensure that the resulting reduction in the chargeable profits of the controlled foreign company concerned is just and reasonable in all the circumstances.

2. Section 751AB(8)(b), paragraph 12E(5) (definitions of “UK-related gross income” and “UK-related business expenditure”) and paragraph 12K(2)(b)

All of these provisions seek to restrict transactions with persons within the charge to UK tax. Where the controlled foreign company carries on transactions with persons with whom it is not connected, this will cause compliance problems. For example, if a controlled foreign company carries on a business from premises in Jersey, is the controlled foreign company required to ask each of the customers who visits its premises whether the customer is within the charge to UK tax? More fundamentally, we consider that the attempt to restrict transactions with third parties within the charge to UK tax will potentially infringe European law because it will operate as a restriction on the controlled foreign company's freedom to provide services and will not be regarded as proportionate. We consider that each of these provisions should be limited so as only to apply to transactions with persons who are connected or associated with the controlled foreign company and within the charge to UK tax.

3. Paragraph 12D

In order for a controlled foreign company to benefit from the new exemption for trading companies with limited UK connection, the company's business must not, at any time during the accounting period, include to a substantial extent non-exempt activities. We understand, but should be grateful for confirmation, that this will be interpreted the same way as for the substantial shareholdings exemption. Non-exempt activities includes the holding of intellectual property. Most normal trading companies will hold intellectual property which they use for the purposes of their businesses. For example, a retailer will have goodwill and may use trademarks in connection with the sale of goods. A solicitor's firm or accountancy firm will have significant goodwill and may make use of both knowhow and copyrighted materials in connection with its business. A manufacturer may manufacture patented goods or use a patented process to manufacture goods. We see no reason why the use of valuable intellectual property in connection with a wider trade should disqualify the controlled foreign company from the new exemption. In our view, paragraph 12D(2)(b) should be limited to the holding of intellectual property which is not used for the purposes of a trade unless the sole activities of the trade comprise exploiting intellectual property.

4. Paragraph 12E

The new exemption for trading companies with limited UK connection only applies where the controlled foreign company does not have a significant connection with the UK during the accounting period. For these purposes, it has a significant connection with the UK if either more than 10% of its total gross income derives directly or indirectly from persons

within the charge to UK tax or more than 10% of its business expenditure is paid to persons within the charge to UK tax. In our view, this restriction is unnecessary. We have already set out in paragraph 2 our view that the limitation, if it is retained at all, should be confined to transactions with connected persons. In our view, even a limitation confined to transactions with connected persons would be unnecessary since the transfer pricing rules will prevent exploitation of the pricing of the transactions to shift profits out of the UK.

Paragraph 12E(3) provides a safe harbour. In order to qualify for this safe harbour, the controlled foreign company's relevant profits must not exceed 10% of its relevant staffing costs. We have a number of comments on this safe harbour. First, the safe harbour tends to favour businesses which have relatively high staffing costs relative to their remaining costs. In our view, the relevant profits should be tested against the whole of the revenue expenditure of the controlled foreign company so as to include, for example, rent paid for premises and the cost of raw materials. In so far as the safe harbour operates by reference to relevant staffing costs, these should include the whole of the staffing costs of the controlled foreign company. The current definition of "relevant staffing costs" does not include pensions, bonus or social security payments.

5. Paragraph 12E(5), 12F(7) and 12M(2)

In paragraph 12E(5) the definition of income does not include amounts that would be taken into account in computing chargeable gains. There are a number of provisions under which what would normally be regarded as a capital profit would either not be taxed at all (for example, in the case of a sale of tangible moveable property) or would be taxed as income (for example, intangible fixed assets). In our view, the definition of income should not include any amount that would be regarded as a capital receipt. The same point arises in relation to paragraph 12F(7) and 12M(2). In paragraph 12F(7), the words "does not include" have also been duplicated.

6. Paragraph 12F

In order to qualify for the new exemption for trading companies with limited UK connection, not more than 5% of the controlled foreign company's gross income can consist of either financing income or relevant IP income. Relevant IP income means income arising directly or indirectly from the exploitation by the controlled foreign company of intellectual property. We have already explained earlier that most normal trades hold intellectual property of various types which they use in the course of the trade. It can therefore be said that their income arises, at any rate to some extent, directly or indirectly from the exploitation of their intellectual property. For example, if an accountancy firm such as Pricewaterhouse Coopers has a branch in Jersey, it could be said that the profits of its Jersey branch arise from the exploitation of its goodwill in Jersey. In our view, computing the percentage of a trading company's income that derives directly or indirectly from a broad range of intellectual property is fraught with difficulty. We consider that income arising directly or indirectly from the exploitation of intellectual property used in a trade carried on by the controlled foreign company which does not comprise solely the exploitation of intellectual property should be excluded.

7. Paragraph 12I

The new exemption for companies exploiting intellectual property with limited UK connection only applies if the company's main business throughout the accounting period consists of the exploitation of intellectual property which does not have a relevant UK connection. We are unclear how far this extends. Is it confined to companies which hold and licence out intellectual property? Does it include companies who use intellectual property in a wider trade of, for example, retailing, providing professional services or manufacturing?

For the purposes of this paragraph, intellectual property has a relevant UK connection if at any time during the previous ten years it has been held by a person resident in the UK. Where a previous holder has no connection with the controlled foreign company it may be difficult for the current owner to know whether that person was (or indeed any other previous owners were) resident in the UK or not. We suggest that paragraph 12I(2)(a) be confined to persons connected with the controlled foreign company and resident in the United Kingdom.

8. Paragraph 12J

In order to qualify for the new exemption for companies exploiting intellectual property with limited UK connection, if the controlled foreign company carries on any activities other than exploiting intellectual property without a relevant UK connection, the activities must either not constitute a substantial part of its activities or must qualify for the new exemption for trading companies with limited UK connection. It seems to us that the secondary activities should also be permitted to satisfy the existing exempt activities test in paragraph 6(2) of Schedule 25 ICTA 1988: if such activities were carried on in a separate controlled foreign company they would be exempt: if they are combined with exploiting intellectual property without a relevant UK connection in one company we do not believe that there is any mischief which needs to be countered.

9. Section 748ZA

In the third line of Section 748ZA(2)(a), the word "be" needs to be inserted between "falling to" and "made".

10. Paragraph 15B

Paragraph 15B(7)(a) refers to "non-exempt activities" carried on by X. We could not find a definition of "non-exempt activities". Is it intended to have the same meaning as in paragraph 12D?

11. Paragraph 15C

The word "consists" should be "consist".

If you would like to discuss any of these comments in more detail, please contact Mr M.J. Hardwick at Linklaters on 020 7456 5658, email: michael.hardwick@linklaters.com.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Bradley Phillips'.

Bradley Phillips
Chair
City of London Law Society Revenue Law Committee

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REVENUE LAW COMMITTEE**

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