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By post to:

Jennifer Payne and Robert Edwards
Corporate Tax Team
HM Treasury
1 Horse Guard's Road
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22 February 2011

Dear Ms Payne and Mr Edwards

Comments on Part IIA (Controlled Foreign Company (CFC) Reform) of the 'Corporate Tax Reform: Delivering a More Competitive System' Document

We are pleased to have the opportunity to comment on the current proposals for the reform of the UK's controlled foreign company rules as set out in Part IIA of the 'Corporate Tax Reform: Delivering a More Competitive System' document, dated November 2010.

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

References below to paragraph numbers are to paragraph numbers in Part IIA of the Corporate Tax Reform document.

Introduction

1. In our view, it is important that the Government should announce as soon as possible as much detail as possible of the final form of the controlled foreign company rules. While we recognise that the issues involved in this reform are difficult, and that a balance needs to be drawn between protecting the Exchequer from avoidance and enhancing the UK's tax competitiveness, uncertainty has now pervaded this area for a number of years. It is important that this uncertainty should now be laid to rest so that multi-nationals can plan their affairs with reasonable certainty.

2. We consider that it is important that the proposals are as simple as possible and do not entail undue compliance cost. It is particularly important that exemptions should not be hedged around with complex anti-avoidance provisions.

3. We agree with the statement in paragraph 1.4 that to be more competitive the UK's corporate tax system should focus more on taxing the profits from UK activity rather than attributing the worldwide income of a group to the UK. We consider, however, that it is important to recognise that in some respects the proposals for the new finance company exemption and IP holding companies represent a pragmatic solution which is not entirely consistent with this principle. The UK is taxing a proportion of the underlying profits from non-UK activity: it is doing this in order to limit the cost of the decisions to retain an unrestricted deduction for interest even where it is paid on a loan financing an equity investment in a foreign subsidiary and to exempt from tax dividends from foreign subsidiaries. We understand the reasons for maintaining an unrestricted deduction for interest: but we regard it as important to stress that financing a foreign subsidiary with equity is not artificial nor is there any firm basis for determining an arm's length amount of equity in a foreign subsidiary: what is being taxed is part of the underlying profits in order to keep within acceptable bounds the cost of the unrestricted deduction for interest when coupled with a dividend exemption. We come back to this point in our comments on the partial finance company exemption and IP holding company rules.

4. We agree with the points made in paragraph 1.5, subject to the points in the previous paragraph.

5. We agree with the objectives set out in the first three bullet points in box 1A.

New CFC Rules for Monetary Assets

6. The partial finance company exemption seems to us to represent a sensible pragmatic compromise, although we cannot comment on whether an effective tax rate of 8% by 2014 will be sufficiently low to remove the incentive for UK multi-nationals to emigrate from the UK. We believe that it may be possible to achieve lower effective tax rates where a non-UK resident parent company of a multi-national group has a financing subsidiary in an appropriate jurisdiction, such as Luxembourg. It must also be borne in mind that a rate which is low enough that it is not worthwhile for a UK multi-national to emigrate (bearing in mind that emigration is a costly exercise and involves significant disruption to the business) will not

necessarily be low enough to encourage a foreign multi-national to migrate into the UK or to establish a holding company in the UK.

7. We accept that both the methods outlined in paragraph 2.3 can be used to strip profits out of the UK. Logically, however, we consider that the source of the mischief (assuming there to be mischief) where a UK group takes out debt in the UK and that money is used to equity fund a low tax offshore investment is the deduction which the UK gives for interest on a loan which is used to finance an investment generating income exempt from UK tax. The equity funding of an offshore investment is not necessarily artificial: however, by giving a tax deduction for interest on a loan financing a low tax offshore investment that does not yield any income taxable in the UK, the UK is effectively subsidising the activity in the offshore jurisdiction. We accept and agree that the UK's current interest rules are considered by businesses to be a significant competitive advantage and that modifying these rules would both disrupt existing arrangements and undermine one of the UK's main competitive advantages. For this reason, we recognise that the partial finance company exemption is an appropriate pragmatic solution to the problem. It must, however, be recognised for what it is. It is a compromise, and should not be undermined by excessive anti-avoidance rules.

8. We do not believe that the proposal on its own would be sufficient to address *Cadbury Schweppes* where the finance company is actually established in an EU territory and carries on genuine economic activities there, e.g. whether all the staff running the finance company's activities do so from premises in an EU territory. In our view, equity funding a finance company genuinely established offshore does not satisfy the "wholly artificial" test in *Cadbury Schweppes*. We consider that there needs to be a further exemption in the CFC legislation for companies actually established and carrying on genuine economic activities in an EEA territory, which would be capable of applying to a finance company in appropriate circumstances.

9. We agree that there will need to be targeted anti-avoidance rules to prevent groups artificially recycling money back to the UK. The simplest way of achieving this would be to deny the benefit of the exemption to the extent that a company receives interest income directly or indirectly from a connected UK resident company or UK permanent establishment of a connected company. We do not believe that any targeted anti-avoidance rule should apply to interest received from persons who are UK resident or UK permanent establishments but who are not connected with the finance company. Indeed, it would seem to us that any anti-avoidance rule that targeted loans to unconnected UK taxpayers might infringe an EU based finance company's freedom to provide services or free movement of capital.

10. We note the suggestion in paragraph 2.14 that if artificially diverted UK profits arise in a CFC these profits will not be able to benefit from the finance company exemption. We do not find the use of the term "artificially diverted UK profits" helpful in this context and question whether there is any need for further anti-avoidance rules in this context. What is envisaged?

11. We agree with the suggestions in paragraph 2.16. The simplest way of apportioning debt and equity between the activities of a company that engages in both trading and financing transactions would be to assume that the company's overall debt/equity ratio applied to the financing transactions.

New CFC Rules for Intellectual Property

12. We welcome the decision outlined in paragraph 3.9 not to introduce an earnout charge. We also agree that crafting the CFC rules on intellectual property in a way which forces economic activity out of the UK or businesses to restructure in a non-commercial manner is undesirable.

13. We welcome the suggested exemptions for trading entities which have an incidental or ancillary amount of IP income with a UK connection and entities which only make small amounts of profits on IP with a UK connection but consider that they may not go far enough. In this connection, the rules should recognise that most trading concerns derive their profits in part from intellectual property. For example, a retailer will rely on its goodwill, food manufacturers will exploit brands, publishers will exploit copyrights and manufacturers may use industrial knowhow and patents in the production of their goods and exploit trademarks in the sale of the goods. Where a trading entity's activities are not confined to the exploitation of IP but the exploitation is part of a wider non-IP trade (such as in the examples in the previous sentence) we believe that the profits deriving from the IP should be outside the scope of the CFC rules so long as the trading activities are genuinely carried on outside the UK.

14. In determining whether IP has a UK connection, we do not believe that the location of a CFC's customers or of licensees of the IP is relevant. This is particularly the case where the customers/licensees have no connection with the CFC. We do not believe that it would be appropriate for the CFC rules to seek to target profits made by a CFC from the exploitation of IP simply because some of the profits were earned from sales or licences to UK persons: to target such profits may well infringe the CFC's freedom to provide services where the CFC is located within the EU.

15. We consider that the proposals outlined in paragraphs 3.14 to 3.16 have the potential, albeit at the cost of some complexity, to produce a workable regime in the first two cases outlined in paragraph 3.14, but we have significant misgivings about the proposals so far as they relate to IP effectively held as an offshore investment.

16. It is proposed that, in order to remove low risk entities, a safe harbour test could be applied that relates to the return earned in the overseas entities. In our view, it would not be appropriate to relate the return to employment costs in the manner adopted by the CFC interim improvements. Where IP has been transferred from the UK, it might be appropriate for the safe harbour test to focus on the return earned on the value of the IP at the point at which it is transferred from the UK: an acceptable return might, for example, be based on a market rate of interest applied to the value at the point of transfer. Similarly, where significant amounts of activity to maintain and/or generate the IP value are undertaken in the UK, the safe harbour could operate by reference to the part of the profits attributable to UK activities. The return might be computed by applying a market rate of interest to either the reward earned by UK taxpayers for the UK activity or, possibly, the costs of the UK activity. When applying a just and reasonable basis of apportionment to excessive profits, an allocation based on costs incurred in the various territories in which activities have contributed to the development of the IP might be appropriate: basing apportionment on sales made would, we consider, produce

haphazard results and might be inconsistent with EU rules on freedom to provide services.

17. As mentioned earlier, we have misgivings about the proposals for IP effectively held as an offshore investment. As we understand it, the proposals relate to cases where a UK parent company has established a subsidiary in an offshore investment and that subsidiary has purchased or created IP which has not been transferred from the UK within the previous 10 years, nor has significant activity to maintain and/or generate the IP value been undertaken in the UK. In other words, the IP itself has nothing to do with the UK. The real concern here seems to be either that a deduction has been given in the UK for interest on borrowings financing an equity investment in an offshore company which does not generate any UK taxable profit or that dividends received on equity in a foreign subsidiary are exempt from tax. In either case, targeting a proportion of the profits of the IP holding company does not seem to be an appropriate solution. For reasons which we understand, decisions have been taken to exempt dividends from foreign companies and to allow unrestricted deductions for interest on loans financing equity in foreign companies. Those decisions having been taken, we think that the consequences which flow from them have to be accepted where the underlying investment, whether it is intellectual property, real estate, a foreign trading activity or an investment in a foreign company or group, has nothing to do with the UK beyond being equity financed from the UK.

We trust that the above comments will be of assistance. As a Committee of experienced tax lawyers, we are very well placed to comment on the process relating to tax law making and we would be happy to meet with Treasury/HMRC to discuss this topic further.

Yours sincerely

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.

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