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By post and by email (carol.johnson@hmtreasury.gsi.gov.uk)

Dear Sir

Comments of the Revenue Law Committee on draft clauses of Finance Bill 2012 published on 6 December 2011 relating to controlled foreign company reform and "Controlled Foreign Company (CFC) – an update" published in January 2012

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 multi-national 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 consultation on controlled foreign companies reform has been prepared by the CLLS Revenue Law Committee.

We are pleased to have the opportunity to comment on the draft legislation for the proposed new controlled foreign company rules.

General Comments

1 We are disappointed at having such a short period in which to comment on the January update document and accompanying revised draft legislation. Obviously we recognise that the reform process for controlled foreign companies has not been easy, but ultimately it is the legislation which will determine the liabilities - and compliance burdens - of taxpayers in this area so appropriate consultation on the wording as well as the principles is important.

Similarly, we are concerned that there will be very little time for consultation on the revised draft legislation that is yet to be published (for example the updated version of the gateway test).

2 ***General comments on the draft finance income provisions***

2.1 We would note that nothing within Chapter 8 excludes finance profits from the computation of the "Chapter 8 profits". Therefore, finance profits (even those of a finance company) may be picked up both within Chapter 8 and either Chapters 9 or 10. In our view, the rules would be easier to apply in relation to finance companies if, for example, taxpayers were only required to consider Chapter 9 in the context of non-trading finance profits rather than both Chapters 8 and 9. We assume that the Government does not intend there to be any element of double-counting, but this could be made clear in Clause 371GA(2).

2.2 Chapter 10 includes profits earned on loan relationships and derivative contracts to which a CFC is a party for the purposes of a trade. It is our understanding that Chapter 10 is only intended to apply to financial trades. However, we believe that Chapter 10 may have a wider application than is intended. We would highlight the following:

2.2.1 Chapter 10 could include loan relationship and derivative contract credits arising from financial assets held for the purposes of a non-financial trade. For example, this would include profits arising from price hedges such as commodity or oil futures and profits arising from deposits in an interest-bearing account to meet current or short-term trading liabilities. Even if a non-financial trader were to pass through the gateway or satisfy a safe-harbour in Chapter 8, it could still have Chapter 10 profits arising from such financial instruments. We note that the exemptions set out in Chapter 13 do not extend to incidental trading finance profits.

2.2.2 Chapter 10 could include loan relationship and derivative contract credits arising from debt finance, and hedges of debt finance, provided to a CFC and used to fund a non-financial trade. Therefore, even if a CFC does not pass through the gateway or satisfies a safe-harbour in Chapter 8, Chapter 10 could nevertheless capture loan relationship and derivative contract credits relating to the CFC's funding arrangements. It is not uncommon for funding arrangements to give rise to loan relationship credits; for example, as a result of foreign exchange movements on non-functional currency debt or on debt waivers. While it is helpful that Step 4 in Clause 371JA provides that the "Chapter 10 profits" must arise from the investment or other use of excess free capital (which presumably is intended to exclude credits arising from debt funding arrangements), we consider that any confusion or uncertainty should be avoided by making this clear.

2.3 We note that much of Chapters 9, 10 and 17 include mechanics which in effect require a taxpayer to "trace" the source and destination of financing through the corporate group. For example:

2.3.1 Clause 371IC requires one to identify whether profits arise from funds or assets which represent or derive from capital contributions, accumulated profits or receipts from UK connected companies;

2.3.2 Clause 371ID requires one to identify whether a loan is made directly or indirectly to a connected UK resident company or to a UK permanent establishment of a non-UK resident company;

2.3.3 Clause 371QC requires one to identify the profits, sums or other assets which are used to fund a loan; and

2.3.4 Clause 371QH requires one to identify whether a loan is made and used solely for the purpose of funding (directly or indirectly) a loan to another person.

We believe that this may in practice prove to be a difficult exercise, and would accordingly entail a significant compliance burden for taxpayers. Money is of course fungible, and to identify whether the funds used to make an advance today derive from capital, profits or receipts earned or received in the past may well not be possible without a significant amount of guidance as to how this exercise should be undertaken.

Comments on specific clauses

Part 1: Part 9A TIOPA 2010

1 ***Chapter 1: Introduction***

1.1 *Clause 371AB(8) and (9) ("parent undertaking")*

We are concerned at the addition of the accounting "parent undertaking" test to the definition of "control". The remainder of the control definition, whilst complex, applies a variety of tests where in each case it is possible to look at a given set of facts and determine with confidence whether or not control exists. Our experience of the application of the parent undertaking test in other contexts is that it is often difficult to obtain concrete advice as to the position, and in particular that concerns can arise that the accounting definition is met where a company has a surprisingly low equity interest in the other company of which it is potentially the parent undertaking. Our concern at the adoption of this definition is therefore threefold:

1.1.1 it will lead to material practical uncertainty as to whether a control relationship exists in many circumstances;

1.1.2 it may lead to companies being found to be CFCs at levels of ownership/influence where this is inappropriate; and

1.1.3 changes in FRS2 over which neither taxpayers nor HMRC have any control may lead to changes in the CFC status of companies.

Especially given the reduced circumstances under which a CFC charge can arise in the first place under the proposed new regime as opposed to the former regime, we do not consider that there is sufficient of a lacuna in the remainder of the definition of control to justify adding a limb which will be difficult to apply with any certainty in practice.

2 ***Chapter 3: Low Profits Exemption***

We welcome the retention of a low profits exemption, and the ability for the exemption to apply based either on the CFC's accounting profits or its assumed taxable total profits.

We would like to highlight the following:

2.1 We query the rationale for Clause 371CD(3)(b), which deems a CFC which is a partner in a partnership to have accounting profits equal to a "just and reasonable" apportionment of the partnership's income. We believe the accounting profits should reflect the actual income sharing arrangements among the partners. The same issue arises in respect of Clause 371CD(4), why not apportion the income in accordance with the terms of the settlement?

2.2 Given that the CFC's accounting profits will already be adjusted by the transfer pricing rules (Clause 371CD(6)), we query the need for the very detailed targeted anti-avoidance rules ("TAARs") in Clause 371CE and Clause 371CG, at least in their current form. These only add to the overall complexity. If a CFC has entered into non-arm's length arrangements with another group company in order to secure the benefit of the exemption by manipulating the accounting profits of either company, the transfer pricing adjustment in Clause 371CD(6) should be sufficient to defeat such an arrangement.

2.3 We do not see the rationale for excluding from the exemption all CFCs whose business is wholly or mainly the provision of UK intermediary services, regardless of whether the arrangements with which the CFC is involved are tax-motivated or are entered into with an intention of benefiting from the exemption (Clause 371CE(7) and (8), and Clause 371CG(6) and (7)).

3 ***Chapter 4: Low Profit Margin Exemption***

We welcome the inclusion of a low profit margin exemption, and agree that it is simpler to use a 10% threshold rather than introducing sector-specific rates. We also welcome the Government's agreement to include in the "relevant operating expenditure" the cost of goods imported into the CFC's territory.

We note the Government's decision to continue to exclude related party business expenditure from the "relevant operating expenditure". We believe there is a good argument that such expenditure should be included, at least to the extent that (a) the expenditure is an arm's length amount, or (b) the related party receiving that expenditure is itself in the UK or an excluded territory.

4 ***Chapter 5: Excluded Territories Exemption***

We welcome the Government's decision to include a longer rather than shorter list of excluded territories, and to drop the proposed "general conditions" regarding transactions with the UK and investment income that were proposed in the June 2011 consultation document. We also welcome the more proportionate approach of the Excluded Territories Exemption ("ETE"), in that (for the most part) only income that has been taxed at a reduced rate would be counted towards the £50,000 or 10% of profits threshold.

However, we believe the ETE still has a number of shortcomings. In particular, we believe it is overly complex and too narrowly drawn. The ETE's complexity will entail a significant compliance burden for taxpayers, which runs counter to the policy behind the ETE to enable taxpayers to "remove CFCs that pose a low risk to the UK tax base as straightforwardly as possible" (June 2011 consultation document, para 4.11). We welcome the Government's willingness (as expressed at the recent HMT open day) to look again at the ETE conditions, and hope they will be revised in a simpler form.

We would like to highlight the following specific points:

4.1 The TAAR in Clause 371EB(1)(d), which prevents the exemption being available if the CFC is "involved in an arrangement the main purpose, or one of the main purposes of which, is to obtain a tax advantage for any person", is drafted in very broad terms. We appreciate this is close to the TAAR in the current ETE (Reg 4(A2) of SI 1998/3081), which is drafted in the same terms. However, we believe a more appropriate TAAR would be one limited to arrangements whose purpose is to secure that the conditions of the ETE should apply, and not simply to any arrangements having a tax motive. This would be consistent with the TAARs in the low profits exemption (Sub-clauses 371CG(2) and (3)) and the commercial profits safe harbour (Clause 371HK(3)) and would also be more proportionate.

4.2 We note that Category A, C and D income includes local as well as non-local income. The inclusion of local income makes the ETE conditions potentially harder to satisfy than the current rules, which use a similar "£50,000 or 10% of profits" threshold, but limited to non-local income only. We do not see the rationale for local source income to be counted towards the threshold amount, which has the effect of narrowing the scope of the exemption considerably, as well as increasing the compliance burden on taxpayers, who will no longer be able only to consider whether the CFC has significant amounts of non-local income.

4.3 Regarding Clause 371EE(4), we believe it will be difficult for taxpayers to be able to determine whether a local law provision that causes income to be taxed at a reduced rate has a purpose of encouraging investment in the CFC's territory. In many cases the "purpose" of a local law may not be at all clear. We appreciate the Government may consider this formulation provides more flexibility than including a list of specific outlawed provisions (as in the current regime) which would require updating. However, the benefit of a list is that it provides certainty for taxpayers as to which provisions are "bad" in the eyes of HMRC, and comfort that provisions that are not on the list will not prevent the ETE from applying. As well as the compliance burden on taxpayers in having to form a judgment about the "purpose" of local provisions, there is also the danger that the scope of Clause 371EE(4) could be interpreted as capturing many more provisions than those on the current list. We note that a "list" approach is to be used in specifying what are "designer rate provisions" (Clause 371FD), so we do not see why the current "list" approach cannot be retained for the purposes of the ETE as well.

4.4 We believe Clause 371EE(2)(b)(ii) should be amended to exclude any UK permanent establishment of the CFC. The CFC's income attributed to its UK permanent establishment would already be within the scope of the UK tax regime, and so should not have to be taken into account in computing the CFC's Category A income for the purposes of the ETE. If it were the case that

a UK provision had caused the income of that permanent establishment to be taxed at a reduced rate, this should not cause the availability of the ETE to be prejudiced for the CFC.

4.5 We note that Category C income is counted towards the £50,000 threshold amount even if it has been fully taxed locally. We do not see the rationale for this. We believe Clause 371EJ should include a proviso that Category C income is only included towards the threshold where it has been taxed at a reduced rate (in line with Category A, B and D income).

4.6 It seems unfair that Category C income should include partnership income. If there is a legitimate concern at all with partnership income, it should only be included in Category C income to the extent that it is part of a tax avoidance arrangement. Given the basic requirement in Clause 371EB(1)(d) that the CFC is not involved in an arrangement the main purpose or one of the main purposes of which is to obtain a tax advantage for any person, a separate restriction on partnership income seems unnecessary.

4.7 The provision on intellectual property ("IP") in Clause 371EL (Excluded Territories Exemption) and Clause 371HI (Trading Income Exclusion) appears to apply where IP has been transferred to the CFC from a UK resident company or a UK permanent establishment ("PE") or the CFC has derived IP rights from a UK resident company or UK PE and in consequence of that the value of the IP held by the UK resident company or UK PE has been reduced. We consider that HMRC guidance would be useful in relation to this provision, including examples of situations where the value of the IP would not be treated as having been reduced in the hands of the UK party. An example we would consider falling within such parameters is where IP is licensed to a CFC by a UK resident company on a non-exclusive basis and the CFC pays no premium but pays a market royalty for the IP.

4.8 It is not clear to us that any tax charge on the licensor or transferor by reference to the same transaction is to be taken into account where there is a reduction in value, for example where the CFC pays a premium to the UK party for an exclusive licence or there is a transfer of IP. The aim of the legislation should be to counter artificial diversions of profits; where there is a real tax charge in the UK it should not operate in so far as there would be a double charge to tax in the UK.

5 ***Chapter 6: Tax Exemption***

5.1 In general, we welcome this exemption.

5.2 In Clause 371FB, step 2 should take account of all tax paid by the CFC, not just tax paid in the territory of residence.

6 ***Chapter 7: Chargeable Profits – Main Provision***

Please see the comments made in relation to Chapter 8 below.

7 ***Chapter 8: Chargeable Profits – Profits Attributable to UK SPFs***

7.1 The "gateway" test is a key part of the legislation, but most people coming to the draft legislation for the first time find the drafting inaccessible and the concepts unfamiliar. We believe that the principles underlying Chapter 8 are appropriate and do target the chapter on profits artificially diverted from the UK. The

difficulties seem to us to stem partly from the way in which the principles are articulated, and partly from the fact that they build on OECD principles relevant to the attribution of assets and risks as between a permanent establishment and its establishment in its home territory. These OECD principles will not be familiar to the great majority of taxpayers, since most multi-nationals do not in fact operate through branch structures. Even those who are familiar with these concepts may have considerable practical difficulties in applying the legislation in a number of cases (for example in identifying assets and risks, assessing the extent of the involvement of UK significant people functions and determining whether the substantial non-tax value test is satisfied).

7.2 It seems to us that it is important to the competitiveness of the UK's tax system that it should be possible to explain Chapter 8 in a relatively simple manner to foreign investors contemplating investment in the UK. We set out below some suggestions for how the legislation could be redrafted so as to be more accessible, while preserving the underlying substance of the legislation.

7.3 We believe that Clause 371HA could be made more accessible by redrafting it to provide that the provisional Chapter 8 profits are those arising from assets or risks held by the CFC, to the extent that the significant people functions relevant to the acquisition or management of those assets or assumption or management of those risks are carried on in the UK, otherwise than through a UK permanent establishment of the CFC through which the CFC trades.

7.4 We consider that Clause 371HA should provide specifically that "significant people functions" do not include activities confined to governance, oversight of the CFC or the provision of advice to the CFC. We recognise that this is implicit in the OECD Report on the attribution of profits to permanent establishments, but we consider that it makes it unnecessarily difficult for taxpayers for them to have to refer to a lengthy OECD Report with which they are likely to be unfamiliar in order to draw out this key principle.

7.5 We consider that Clause 371HA needs to be much clearer in how it applies to tangible assets. As we understand it, the OECD approach to attributing economic ownership of tangible assets depends on use rather than significant people functions (see paragraph 75 of the OECD Report). We note that in paragraph B32 of the guide to the draft legislation it is stated that "under the principles of the OECD Report the attribution of tangible assets may often be based on use rather than a determination of SPFs, so Chapter 8 in its application to assets will generally be restricted to intangible or monetary assets". We suggest that this should be made explicit in the legislation. There should be an exclusion for profits, to the extent that they arise from tangible assets used outside the UK. If there are any exceptions to this principle, they should be spelt out in the legislation.

7.6 We consider that it will be difficult in practice to assess the precise extent to which many scenarios potentially falling within Clause 371HA will be difficult to assess.

7.7 Clause 371HB is also difficult to understand. It could be drafted more accessibly by providing that no profits are to be included in the provisional Chapter 8 profits where more than half the profits are attributable to significant people functions carried on outside the UK.

7.8 In its current form, Clause 371HC is going to give rise to significant compliance burdens. It requires economic values to be placed on matters which are

inherently difficult to value. This is a difficult and time consuming exercise. We suggest that it should be replaced by a test which excludes profits from assets/risks from the provisional Chapter 8 profits where the non-tax commercial reasons for holding the asset or bearing the risk outside the UK are substantial relative to the UK tax reasons for holding the assets or risks offshore.

7.9 We consider that the requirement in Clause 371HD that the CFC would enter into arrangements "identical" to the actual arrangements between the CFC and its connected companies is too tight. Intra-group arrangements are unlikely to be documented in the degree of detail that would be appropriate to a fully negotiated arrangement with a third party. We suggest that the requirement be relaxed so that it is sufficient that the CFC would enter into arrangements substantially similar to the arrangements actually entered into.

7.10 It appears to us that the current version of Clause 371HH will be difficult to apply in practice. For example, it may well be difficult to identify what the relevant expenditure is (this raises similar issues to those which arise in trying to identify SPFs). This weakens substantially what should be one of the prime exemptions from the regime.

7.11 A specific issue with Clause 371HH is that it is not clear how Clauses 371HH(7) and (8) interact with Clause 371HH(2). If it is possible to apply Clauses 371HH(7) and (8) to more than one asset or risk (or group of inseparable assets or risks) it seems to have the effect of substituting a 50 per cent test for the 20 per cent test in Clause 371HH(2). Is this what is intended?

7.12 We would make the same comments on Clause 371HI (the IP condition) as we have made at paragraphs 4.7 and 4.8 above in relation to Clause 371EL.

7.13 We note that an updated gateway test is awaited, but from the current drafting it seems to us that the gateway test will not always be clearly satisfied or failed. In such circumstances, it appears that the strictness of the other exclusions and exemptions from the regime may mean that it catches non-UK IP. This surely must not be an intended result of the legislation. In this regard, the previous proposals and the temporary exemption for foreign IP were clearer than the current drafting.

7.14 We consider that Clause 371HK is incorrectly targeted. It seems to us that there is nothing wrong in a CFC group organising its business so that particular companies satisfy the trading company safe harbour, providing that the companies do genuinely meet this safe harbour. Surely the whole purpose of a safe harbour is that it should be available to those groups wishing to utilise it. The TAAR should be aimed at artificial arrangements that are not genuinely within the safe harbour.

8 ***Chapter 9: Chargeable Profits – Non-trading Finance Profits***

We would like to highlight the following:

8.1 Some confusion may be caused by the fact that the definition of "non-trading finance profits" specifically includes amounts arising from "relevant non-lending relationships" but not amounts arising from other relationships treated as loan relationships by Part 6 CTA 2009 (for example, disguised interest, transferred income streams, bond funds and alternative finance arrangements). Arguably the reference to section 481 CTA 2009 is not required, because it is clear that

non-trading profits arising from "relevant non-lending relationships" are charged under section 299 CTA 2009. However, if it is considered that a reference to "relevant non-lending relationships" is required then the reference should be expanded to cover all relationships treated as loan relationships.

8.2 It is not clear what an "acquisition of shares" referred to in Clause 371IC(2)(a) is intended to cover. Clearly it covers an issue of shares to a UK connected company. Presumably it would cover an issue of shares to a non-UK company which are immediately transferred to a UK connected company. What if a UK connected company were to acquire the share capital of a CFC some time, say years, after the issue of the share capital?

8.3 Clause 371IC(2)(d) appears wide enough to cover a loan from a UK company. Loans from UK companies should not be covered since the UK company will be taxed on any interest paid or deemed by transfer pricing rules to be paid on the loans.

8.4 We understand that as a matter of principle it is intended that foreign branches of UK resident companies which have made an election under section 18A CTA 2009 should be treated consistently with non-UK resident companies. Should such branches therefore be excluded from Clauses 371IC(4) and 371ID(2)(a)(i)?

8.5 It is not clear to us that Chapter 9 is fully compliant with the decision of the European Court of Justice in *Cadbury Schweppes Plc v Inland Revenue Commissioners* (C-196/04). In particular, Clause 371IC does not seem to be sufficiently limited to wholly artificial arrangements with no commercial purpose. In contrast, the tax related test in Clause 371ID(2)(d) is more likely to be compliant.

8.6 Notwithstanding the comment made above in relation to Clause 371D, we consider that it is unhelpful that a new formulation has been proposed for the TAAR contained in Clause 371ID(2)(b). In particular, we do not see the rationale for using the word "reason" as opposed to "purpose", which is commonly found in other TAARs. We also do not see the rationale for referring to tax imposed under the law of any territory as opposed to just the UK. There may be perfectly valid local tax reasons for making up-stream loans as opposed to distributions (for example, to maintain an acceptable debt to equity ratio), and if there is no UK tax advantage (for example, because interest accruing on the loan is not deductible in the UK) then we do not see why Clause 371ID should apply.

9 ***Chapter 10: Chargeable Profits – Trading Finance Profits***

We welcome the on-going discussions between the Government and the banking and insurance sectors in relation to the development of industry specific safe-harbours. However, we would note that Chapter 10 potentially has a wider scope of application than solely to the banking and insurance sectors; it would cover other companies which make and manage investments as part of a trade and, as currently drafted, non-financial traders which enter into loan relationships and derivative contracts as part of their non-financial trades. Chapter 10 will need to provide a safe-harbour test for other companies.

We would like to highlight the following:

9.1 Step 1 set out at Clause 371JA(1) provides that a taxpayer should identify any "trading income" arising in respect of its loan relationships and derivative contracts. The "Chapter 10 profits" are determined by reference to this "trading income". However, we are concerned that the reference to "income" could be interpreted to mean that only loan relationship and derivative contract credits (which are treated as receipts of the relevant trade under section 297(2) CTA 2009) would be taken into account, and that debits arising in relation to the same or other financial instruments would be ignored. Chapter 10 should apply by reference to the overall net trading profits of the relevant CFC taking into account all credits and debits arising in respect of all financial instruments held for trading purposes for the relevant period.

9.2 The definition of "free capital" set out at Clause 371JA(2) focuses on funding which does not give rise to loan relationship debits for the CFC. It is our understanding that the purpose behind Chapter 10 is to identify capital which is not subject to UK corporation tax in the hands of the holder of the capital (e.g. share capital). By focussing on whether or not the capital gives rise to loan relationship debits in computing the CFC's assumed total profits, the following would be treated as "free capital" notwithstanding that the holder may be subject to corporation tax in respect of its holdings:

9.2.1 funding which is in the form of derivative contracts; for example, cash settled warrants;

9.2.2 share capital which is treated as a loan relationship for its holder; for example, under Chapter 6A of Part 6 CTA 2009 ("shares accounted for as liabilities"); and

9.2.3 regulatory capital which is not deductible for the issuer but is nevertheless taxable in the hands of the holder.

9.3 In relation to Clause 371JA(6), we make the same comment as that made at paragraph 8.2 under the heading "Chapter 9" above.

10 ***Chapter 11: Chargeable Profits - Captive Insurance Business***

We would like to highlight the following:

10.1 We note that a distinction is made between CFCs resident in an EEA state and CFCs resident in other states, in that the profits of a CFC resident in an EEA state would only be caught by Chapter 11 if the insured has no significant UK non-tax reason for entering into the contract. We query the rationale for not applying the same requirement to profits of all captive insurance CFCs. In line with the overall policy intention of the new rules to counter artificial diversion of profits from the UK, we believe it would be more appropriate for this requirement to apply to all CFCs, not just those in EEA states.

10.2 We note the policy behind this chapter is to prevent erosion of the UK tax base through the use of captive insurance companies that originate within the same group (December policy document, para 1.14). We note, however, that Clause 371KA(3)(c) refers to contracts of insurance entered into with a UK resident person in relation to the provision of goods or services to or by that person, who need not be connected with the CFC. In line with the policy objective, we believe contracts with unconnected persons should not be caught. Such contracts should not lead to an erosion of the group's UK tax base, and there should be a presumption that the terms of such a contract would be at arm's

length. Given that Clause 371KA(3)(a) would already capture all contracts of insurance with UK connected persons, we believe Clause 371KA(3)(c) ought to be deleted.

11 ***Chapter 13: Chargeable Profits – Amounts to be left out***

11.1 We welcome the exclusion for profits of a property business and the incidental non-trading finance profits exclusions. In particular, we welcome the exclusion for non-trading finance profits arising from the investment of funds held by the CFC for the purposes of its trade, and the fact that this is not subject to a 5% limit.

We would like to highlight the following:

11.2 We see the incidental finance profits exclusions as being of practical benefit if they enable trading groups to carry on their activities without the compliance burden of having to consider whether activities that are genuinely incidental to those trading activities may cause the CFC rules to apply to them. We note the Government has chosen to set the limit for the non-trading profits exclusions in Clause 371MC and Clause 371 ME at 5%, rather than 10% as was indicated in the June 2011 consultation paper (at para 5.26). Clearly the limit will need to take into account affordability to the Exchequer. However, our concern is that if the limit is set too low, this will negate the practical benefit of the exclusion. We would therefore ask the Government to consider raising the limit in these clauses to 10%; this should still be low enough to ensure that genuinely non-incidental finance profits are not covered by the exclusion, but not so low as to render the exclusion of limited practical benefit.

11.3 Regarding the exclusion for non-trading finance profits arising from the investment of funds held by the CFC for the purposes of its trade in Clause 371MD, in our view Clause 371MD(3) may be better replaced by a targeted anti-avoidance rule. In addition, we query the rationale behind some of the carve-outs from the exclusion in Clause 371MD(3). The assumption behind these carve-outs seems to be that the CFC ought to dividend any excess cash as soon as possible to its parent. However, it does not seem fair to penalise a CFC where it is prevented by law from paying dividends (Clause 371MD(3)(a)), as in this case it is not through the CFC's choice that it has failed to pay a dividend of its excess cash. Moreover, it would not necessarily be inconsistent with normal commercial activity for a CFC to decide to wait more than 12 months after the end of the accounting period before paying a dividend (Clause 371MD(3)(b)). Also, the 12 month period in Clause 371MD(3)(d) is too short a period for major development projects, which could well last significantly longer than 12 months. Similarly, it seems unfair to penalise a CFC for choosing to retain cash for contingencies (Clause 371MD(3)(e), or to fund its own tax liabilities (Clause 371MD(3)(f), both of which may be regarded as commercial actions that ought not to be regarded as an artificial diversion of profits from the UK. Thus we would request that the Government looks again at the carve-outs in Clause 371MD(3), and seeks to remove some of them.

11.4 We note that the exclusions in Clause 371MC, MD and ME cover non-trading finance profits only, which are defined (in Clause 371UA) as profits that would be chargeable to tax under section 299 CTA 2009 (including as applied by ss.481 and 574 CTA 2009) or Part 9A of CTA 2009. We note that this would not include all the items referred to in the June 2011 consultation document, which refers to "finance, royalty and other investment income" (para 5.29). We

therefore suggest that consideration be given to widening the scope of these exemption to cover other types of incidental investment income, in particular royalty income.

12 ***Chapter 17: Exemptions for Profits from Qualifying Loan Relationships***

We welcome the full exemption for finance profits contemplated by the revised Chapter 17 which was published on 31 January 2012.

We would like to highlight the following:

12.1 It is not clear from the drafting of Clause 371QB that the claim referred to in Clause 371QB(1)(c) is to be made on an accounting period by accounting period basis. We assume that this is the intention.

12.2 The inclusion of the words "(but no other company)" in Clause 371QB(2) suggests that only one "chargeable company" is entitled to make a claim under Clause 371QB in respect of a CFC. It should be made clear that other "chargeable companies" can also make their own claims under Clause 371QB.

12.3 Clauses 371QC(2) and 371QC(7) require that a company's claim under Clause 371QB must "establish" various matters (i.e. that a certain percentage of the qualifying loan relationship is funded by qualifying resources, the residence of the ultimate debtor or the derivation of certain sums or assets). The use of the word "establishes" suggests that the claiming company must do more than merely confirm in the claim that the requirements in Clause 371QC are satisfied, as would normally be the case for a claim made under the self-assessment regime, but that it must also provide evidence to HMRC as part of the process for making the claim (as opposed to subsequently as part of the enquiry process).

12.4 Clause 371QC(2)(b) does not contemplate that the identity of an ultimate debtor in relation to a qualifying loan relationship may change during an accounting period.

12.5 Clause 371QC(6) defines "qualifying resources". The effect of the definition is that the full exemption would only apply to profits earned by the CFC from debt and equity investments in a member of the CFC group if those profits are reinvested back into the same jurisdiction. We would question the rationale of favouring reinvestment of overseas earnings back into the same jurisdiction rather than permitting the CFC to expand the group's overseas operations by investing in new jurisdictions. Our assumption would be that a rule which favours reinvestment of profits back into the same jurisdiction would have a distorting impact on business decisions. We would also note that the effect of Clauses 371QC(6)(a) and (c) is that the CFC must have advanced loans directly to or held shares directly in a company which is resident in the same jurisdiction as the "ultimate debtor". In reality, it is common for group finance companies to invest both debt and equity in trading subsidiaries indirectly through a holding company or a chain of holding companies which may or may not be resident in the same jurisdiction as the trading subsidiary. Accordingly, if a CFC has invested in a trading subsidiary through a holding company which is resident in a different jurisdiction, then the CFC will not be able to benefit from the full exemption by reinvesting its profits back into the jurisdiction of the trading subsidiary. However, if that CFC had invested directly in the same trading subsidiary then it would be able to benefit from the full exemption by reinvesting its profits back into that jurisdiction.

12.6 Clause 371QC(6)(b) deals with capital raised by a group from existing shareholders through a rights issue. We would make the following points:

12.6.1 subsection (i) requires that the issuing company is not "controlled by any person or persons". A company will always be controlled by its shareholders. If the intention is to identify the holding company of the group then the drafting could refer to a member of the CFC group which is not controlled by any other member or members of the CFC group, or which is not a 75% subsidiary of any other company;

12.6.2 subsection (ii) requires that the shares are issued under an offer of shares to existing shareholders; in practice issuers may not be able to make an offer to all existing shareholders (particularly those resident in a jurisdiction which have particularly onerous regulatory rules). It would be helpful if subsection (ii) could be treated as being satisfied where the offer is not made to all existing shareholders in such circumstances;

12.6.3 subsection (ii) also requires that the offer must be in proportion to the existing shareholders' existing holdings; this should be amended to deal with fractional entitlements by inserting the words ", or as near as may be, " after the word "proportion"; and

12.6.4 it would be helpful if section 1122(4) CTA 2010 could be disapplied for the purposes of interpreting the meaning of "connected" in subsection (iii).

As a more general point, we would query why Clause 371QC(6)(b) should be limited to rights issues as opposed to covering all scenarios whereby the CFC group raises capital from external sources, provided that the arrangements do not give rise to interest deductions within the United Kingdom.

12.7 It is not clear what is meant by the phrase "taking on debt in the United Kingdom" used in Clause 371QC(8). We assume this refers to a United Kingdom resident company becoming a party to a loan relationship as debtor (otherwise than through a permanent establishment which has made an election for exemption) or to a non-United Kingdom resident company becoming a party to a loan relationship as debtor through a United Kingdom permanent establishment.

12.8 Clause 371QE(3) refers to "companies the main business of which is banking business". The effect of Clause 371QE(3) is to disapply the 75% exemption from loan relationships which are funded directly or indirectly by a company which carries on a banking business in the UK. The term "banking business" is defined widely at Clause 371UA to include, for example, any business which is or is similar to money-lending. Arguably, this would include capital provided to a finance company by a holding company whose business comprises lending money to subsidiaries. The definition of "banking business" should be more targeted towards banking institutions, for example by reference to the definition in section 991 of the Income Tax Act 2007, or by replacing the word "business" with "trade".

12.9 We welcome the inclusion of the matched interest mechanic in Clause 371QF. However, it is not clear what Clause 371QF(5)(b) is contemplating. If the

intention is merely to identify the "leftover profits" which would result in a CFC having finance income under section 314A, then is subsection (b) needed at all? If the intention is to identify loan relationship credits arising in a UK resident member of the worldwide group in respect of debt finance provided to the CFC (the word "corresponding" being used widely to refer to loan relationships which "correspond" with the "qualifying loan relationship" because they fund, directly or indirectly, the "qualifying loan relationships"), then should any finance expense amount arising in the CFC also be included in the definition of "relevant amounts"? If corresponding finance expense amounts arising in the CFC are not excluded but corresponding finance income amounts arising in the UK resident member of the worldwide group are excluded, then the tested income amount referred to in Clause 371GF(2) would be artificially inflated relative to the tested expense amount.

12.10 Clause 371QG provides for how one should compute the "profits of a qualifying loan relationship". The first step is to determine the credits which are brought into account in determining the CFC's non-trading finance profits. It is not clear whether this should be limited to non-trading finance profits which form part of the "Chapter 9 profit", or whether it should also extend to non-trading finance profits which form part of the "Chapter 8 profit" (i.e. because the loan relationships are attributable to UK SPFs). We assume that Step 1 should include non-trading finance profits whether they arise under Chapter 8 or Chapter 9.

12.11 Amendments have been made to what is now step 3 of Clause 371QG to limit the debits (other than those arising under hedging contracts) which can be taken into account to those which can be allocated on a just and reasonable basis to the qualifying loan relationship in question. It would be helpful if it could be made clear that debits which are directly attributable to a given loan relationship (for example, in respect of foreign exchange movements, fair value adjustments and write-downs) are always taken into account for the purposes of step 3, and that a just and reasonable allocation need only be made where debits arise in respect of both one or more qualifying loan relationships and one or more other matters.

12.12 Clause 371QH defines the term "qualifying loan relationship". It is not clear whether the concept of a "qualifying loan relationship" would include relationships which are treated as loan relationships by Part 6 CTA 2009 (such as alternative finance arrangements and repos). If the concept is intended to cover relationships which are treated as loan relationships then the reference to a "loan" in Clause 371QH(3) is not correct; relationships which are treated as loan relationships would not be in the form of a loan. For example, repos are in the form of a sale and repurchase of securities.

12.13 The reference to a loan being "made and used solely" for a given purpose in Clause 371QH(3)(a) and (b) means that if, for example, the recipient of the loan from the CFC deposits the cash with a bank (or otherwise makes a loan to a third party), and then subsequently withdraws the deposit to use the funds for business purposes, the loan made by the CFC cannot be a "qualifying loan relationship" as the "ultimate debtor" would be the bank. It would be helpful if the identity of the ultimate debtor, and therefore the status of a loan relationship as a "qualifying loan relationship", could change from time to time (or at least from accounting period to accounting period) to recognise the commercial reality that a recipient of a loan from a CFC may use the funds advanced to it for different purposes from time to time, or that a loan could be split so that there is

more than one ultimate debtor. If the drafting is left as it is, then it may be necessary for a loan from the CFC to be repaid and readvanced as and when the recipient changes the purpose to which it puts the amounts advanced, which may trigger detrimental accounting and other consequences and would put an administrative burden on tax payers.

12.14 We welcome the deletion (in the update published in January 2012) of Clause 371QH(6) (formerly Clause 371QD(6) in the 6 December version of the draft legislation).

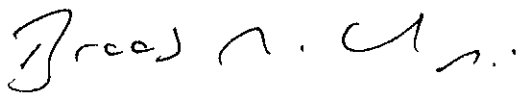
13 ***Chapter 18: Assumed Taxable Total Profits, Assumed Total Profits and the Corporation Tax Assumptions***

13.1 We consider that Clause 371RJ should be broadened so that it applies to any capital expenditure on the provision of plant or machinery for the purposes of any qualifying activity within Section 15 of the Capital Allowances Act 2001.

14 ***Chapter 20: Management***

14.1 In our view, Clause 371TD(7)(b) should also include as a relevant allowance a loss relating to an intangible fixed asset falling within Section 753 CTA 2009.

Yours faithfully



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