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Dear Sir

Revenue Law Committee response to Consultation Document on Controlled Foreign Companies (CFC) Reform

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.

References in this response to chapters, annexes or paragraph numbers are to chapters, annexes or paragraph numbers in the consultation paper published in June 2011.

Chapter 1: Introduction

We agree with the aim of introducing a modernised CFC regime that fits with a move towards a more territorial tax system and better reflects the way that businesses operate

in a globalised economy. We agree wholeheartedly with the aims of the new regime outlined in paragraph 1.12, that the new CFC regime should:

- target and impose a CFC charge on artificially diverted UK profits, so that UK activity and profits are fairly taxed;
- exempt foreign profits where there is no artificial diversion of UK profits; and
- not tax profits arising from genuine economic activities undertaken offshore.

In order to encourage more businesses to be based in the UK, it is important that the aims of the new regime should not be obscured by excessive detail and concern about anti-avoidance. We consider that it is vital that the new rules should be drafted in as straight-forward a manner as possible. Wider exemptions, protected where necessary by purpose based TAARs, may be preferable to narrow exemptions which mean that a greater number of companies need to rely upon the general purpose exemption.

Getting the drafting of the new legislation right is merely the first step towards encouraging businesses to be based in the UK. It is vital that when the rules come into force they are operated in a manner consistent with the aims of the new regime and are not subverted by excessive concern about avoidance.

The impact of other measures upon the attractiveness of the UK as a location for international business must also be borne in mind. It would be timely to reassess the impact of the worldwide debt cap provisions in order to determine whether they are fulfilling a useful role and, indeed, are the most proportionate way of addressing any perceived mischief.

Chapter 2: Overview of Regime

Question 2A: Do the proposals overall strike the right balance to deliver a more competitive corporate tax system while providing adequate protection of the UK tax base?

Overall, we are generally content with the proposed structure of the new legislation. In particular, we welcome the proposals to have an excluded countries list, a finance company partial exemption and a general purpose exemption. We are, however, concerned that the details of the new rules may not live up to the aims of the new regime.

For UK based multi-nationals, we consider that the proposed new rules should be a significant improvement over the rules which applied before the interim improvements. In particular, it appears that the new rules should not counter foreign supply chain management structures, intellectual property holding structures or financing structures where the supply chain/intellectual property/financing is not connected to the UK. They should therefore remedy one of the problems with the old rules which caused multi-nationals to redomicile.

We are less convinced that the new rules will be effective in terms of attracting foreign groups into the UK. The new rules appear likely to be relatively complex and burdensome to apply and will therefore compare unfavourably with regimes such as The

Netherlands which have simpler CFC systems. On a more detailed level, while the finance company partial exemption may well be attractive enough to keep UK based multi-nationals with foreign financing structures in the UK, a 5.75 per cent. rate on profits from overseas intra-group finance income may still not be competitive when viewed by a foreign multi-national or by merger parties seeking to choose a holding jurisdiction for a new parent company and able to choose a jurisdiction with more limited CFC rules.

Question 2B: Do you have any views on how the rules should be administered, and in particular how the clearance process could be improved?

As mentioned earlier, we consider that it is vital that when the rules come into force, they are operated in a manner consistent with the aims of the new regime. In order to encourage foreign multi-nationals to base activities in the UK, it is important that HMRC should be prepared to give clear and binding guidance on how the new rules will apply to the multi-national in advance of any transaction being implemented. Certainty is one of the key factors that influences the choice of jurisdiction and the UK can sometimes appear in a less favourable light than jurisdictions which have binding rulings systems.

Chapter 3: Defining a controlled foreign company

Question 3A: Which of the options for defining control would be preferable and why? Or would a combination be preferable?

Our overall preference would be to adopt Option C, since this is based on familiar concepts which are well understood. We consider that it should be possible to adopt a control based test, possibly with an anti-fragmentation TAAR, without the attribution rules in the current test.

As an alternative, Option B may also be a viable approach. Option A would be likely to require more work in order to produce a sufficiently certain definition of control. Economic rights can be hard to define and lead to uncertainty in practice.

It will be necessary to make sure that straightforward loans are ignored in determining whether one person controls a company.

We consider that genuine commercially motivated joint ventures should be outside the new regime.

Question 3B: Are there other options for the calculation of the lower level of tax which would ensure that the UK measure of tax would broadly reflect the figure calculated under the existing rules? Can the chargeable profits approach be simplified?

We believe that the lower level of tax test should operate by reference to the amount of tax which is paid by the CFC on its income, whether directly or by withholding at source, under the law of any territory, whether the territory of residence of the CFC, the territory in which it has a non-local permanent establishment, the UK or the territory from which it derives income. If the total tax paid by the CFC on its income profits is more than 75 per cent. of the total tax which would have been paid if it had been UK resident, it is most unlikely that the CFC is engaged in tax avoidance involving the artificial diversion of profits from the UK.

Other issues

Treaty non resident companies should not be treated as UK residents for the purposes of the new regime. Treating treaty non resident companies as UK residents for these purposes means that it is not possible to use a UK incorporated company for FTSE inclusion purposes but then have it non UK resident for tax purposes. Companies wanting FTSE inclusion but to be non-UK resident for tax purposes therefore tend to use Jersey incorporated companies. This disadvantages the UK because advisory income which would otherwise have arisen to UK advisers arises instead to Jersey professionals. The current rule is not an effective deterrent to redomiciling a group outside the UK. People do not normally redomicile a group by moving the management and control of the existing holding company outside the UK. Instead, they incorporate a new company outside the UK to acquire the existing group.

Chapter 4: Low profits, excluded countries and temporary period exemptions

Question 4A: Which option for the low profits exemption is preferred? The Government would welcome views from groups on the options outlined, and the proportion of their CFC's that could potentially qualify under each option.

We prefer Option A, because this gives a higher threshold than the existing test and therefore reduces the compliance burden on multi-national groups. Option B looks potentially complicated, not least because groups would not know during an accounting period whether a particular company was excluded or not by the low profits exemption because total group turnover would not be known. It might be possible to modify Option A to achieve some of the benefits of Option B by providing for a higher threshold of £1m if the total assets of the consolidated group exceeded a particular threshold.

Question 4D: Which of the proposed options for an excluded countries exemption would be the easiest to operate and is preferred?

We consider that Option C would be the easiest to operate. Each jurisdiction will need to be considered separately, so having a category of territories, even if it is a very limited category, where there are no conditions to be checked will simplify the compliance burden. The excluded countries regulations are heavily relied on and the new rules should be no narrower than the current rules. In particular, they should include all the countries on the current list.

Question 4E: The Government welcomes views on what the appropriate limits should be for the general conditions set out in paragraph 4.14 and on what basis they should be applied.

We consider that if there is to be a general condition relating to the proportion of the CFC's total income that is derived from transactions with the UK, the condition should be limited to income arising from transactions with connected parties in the UK. If a CFC deals with independent parties in the UK there appears to us to be no mischief. It can be difficult to monitor the extent of dealings with persons in the UK: for example, if you run a retail business in The Netherlands, do you have to check whether customers entering your shop are UK resident for tax purposes? Clearly, a requirement to check whether

customers are resident in the UK or operating from a branch in the UK could in some circumstances be onerous.

Chapter 5: Territorial business and sector specific exemptions

We question whether local management conditions are appropriate. It needs to be recognised that in modern conditions businesses are often managed on a regional or product line basis.

Question 5A: Would the proposed safe harbour be effective at removing CFCs that make a low level of profit and pose a low risk to the UK tax base?

We consider that the proposed safe harbour should be effective to remove low risk CFCs. We consider, however, that the cost base should include in operating expenses related party business expenditure so long as the related party business expenditure is arm's length in nature. If thought necessary, the inclusion of related party business expenditure could be subject to the expenditure not having a main purpose of tax avoidance.

Question 5D: Would the proposed manufacturing TBE be useful to remove manufacturing CFCs from the rules? How many CFCs would it apply to?

We consider that the proposed manufacturing TBE would be useful. We assume that the CFC would be permitted to use IP rights not extending substantially beyond what is necessary for the CFC where the IP rights are licensed to the CFC by a fellow group member. We consider that it is important for a manufacturing CFC to be permitted to use IP licensed to it by a non-UK resident group IP holding company or by a UK company (so long as the license is on arm's length terms). If this is not possible, the attractiveness of the exemption would be significantly reduced.

Question 5E: If a CFC currently qualifies for the exempt activities test is it likely to qualify for this exemption? If not, why not? Please distinguish between the changes which address "swamping" and other aspects of the rules. If the failure is marginal or a minor adjustment to the TBEs would result in exemption please provide details.

The drafting of Exemption 3 is going to be key to the attractiveness of the new rules, but we found it very difficult to work out what it would look like in legislative terms. We would appreciate early sight of a draft of this exemption so that we can formulate detailed comments. We would urge that the exemption be drafted broadly, possibly with a TAAR, which we believe would be a preferable approach to a narrowly crafted exemption.

Interaction with investment activities

Real estate is not a mobile asset. We consider that all subsidiaries leasing non-UK real estate should be excluded from the definition of investment activity. If there is a concern that financial activities could be disguised by crafting property leases which in essence give an interest based return, we believe that any potential mischief could be addressed by an appropriately targeted TAAR.

The current proposals for property investment are too limited because they only apply to long term rental of property where the risks and rewards of the property ownership

belong to the CFC. Risks and rewards will commonly be split: the tenant will often have risks in relation to maintenance and insurance and rewards may be split where there is, for example, a turnover sharing lease. Short term rental may be appropriate where a property investment subsidiary acquires a building with a view to redeveloping it but wishes to let it short term pending obtaining the necessary planning consents.

It is important that a property should not be treated as owner occupied simply because it is void pending a new letting or redevelopment/refurbishment.

It is also important that the local management requirement for property companies recognises that very little local management may be required for a single purpose subsidiary owning for example, an office block in Frankfurt. Day to day property management is likely to sub-contracted to third party agents. All that the subsidiary is likely to need to do is to resolve periodically to pay dividends, and consider whether to approve the agent's leasing strategy, sell or refurbish or develop the building or refinance borrowings. All these decisions can be made at board meetings: no employees need to be based permanently in the territory.

Question 5F: Would setting a minimum value of assets leased under an operating lease of £10 million per asset provide a reasonable approach to identifying business activity for this purpose?

It seems to us that all forms of operating leasing should be excluded from the definition of investment business. We do not understand why, for example, a foreign subsidiary carrying on a plant hire business or car leasing business should be treated as carrying on an investment activity. It should be able to rely on the general exemption for commercial activities.

Question 5G: The Government would be interested in views on how adequate protection of the UK tax base could be provided against such tax driven arrangements without introducing rules which would have a disproportionate effect on supply chains, procurement companies and intra-group service provisions.

We consider that the transfer pricing rules should provide adequate protection to the UK tax base where a CFC provides goods or services directly or indirectly to the UK, or where a high proportion of the costs of the activity are incurred in the UK. To the extent that any further protection is required, we consider that it would be preferable for the protection to be provided by introducing a TAAR along the lines suggested, rather than setting limits for receipts from the UK or costs undertaken in the UK. Monitoring such limits merely imposes unnecessary compliance costs on genuine business activity.

Question 5H: The Government invites views on the options for defining incidental finance income set out above.

We prefer a definition of incidental finance income which reflects the particular facts of the CFC's business and therefore prefer Option C. A profits based percentage would have the result that a CFC which is loss making – perhaps because of capital allowances – would not qualify for exemption on any interest income, however small, even if the interest is received on temporary cash balances arising as an integral part of the CFC's trade. This does not seem an appropriate result.

Question 5I: The Government welcomes views on the preferred option to define incidental investment income more generally, and how that should interact with the incidental finance income definition.

We consider that Option C should be capable of adaptation to deal with incidental investment income such as, for example, incidental royalty income or rents received for letting surplus office or warehouse space.

Question 5J: Does the proposed treatment of holding companies raise any issues? Would an alternative approach to this be preferred and, if so, what would the advantages be?

The proposed treatment of holding companies appears to be satisfactory. The fact that most dividends are exempt from tax in the UK should result in most dividend income of holding companies not giving rise to an apportionment of income for CFC purposes.

Question 5K: Could a principles-based approach to drafting the TBE offer an alternative to the more mechanical TBE proposals? The Government welcomes early views on this.

We consider that developing a principles-based approach to the TBE is likely to require more time than is available if the CFC legislation is to be reformed on the current timetable. We believe that the best approach to the reform of the CFC legislation would be to have relatively broadly drafted mechanical TBEs, supported where necessary by TAARs, and with a principles-based GPE. We believe that this will provide the best balance between achieving certainty for multinational business and protecting against avoidance.

Chapter 6: Finance Company Rules

Question 6A: Do business prefer the simplest option, one of the more flexible options (as outlined in Annex D) or an alternative approach? Would the benefits of the simplest option outweigh the cost of any intra-group debt restructuring where required?

We consider that the simplest solution outlined in paragraph 6.17 would be too restrictive and would not accommodate the sort of structures in use in multinational groups. We believe that a solution built on Option C could be the most logical solution, but Option C will need to be adapted so that where a finance company borrows money from a UK group company, the finance company obtains a full deduction for the interest which it pays. It would not be appropriate for the interest on such a loan to be taxed at 23% in the UK group company but relieved at 5.75% in the foreign finance company.

Question 6D: Bearing in mind the need to deliver an affordable regime, what circumstances and qualifying conditions should the Government consider when determining when a full exemption might apply?

We consider that full exemption should be available for local or territorial finance companies which derive substantially all of their funding from outside the UK and make substantially all of their loans to non-UK group companies and, possibly, third parties. In principle, the general purpose exemption ought to be capable of exempting such companies from the new regime so that a separate exemption should not be required.

Question 6G: Based on the design options available, do you think that the finance company rules should apply to mixed activity companies, despite the added complexity? If so, what would be the most appropriate way to identify the profit arising from each activity?

We consider that the finance company rules should apply to mixed activity companies. In our view, the approach outlined in paragraph 6.34 should be workable.

Chapter 7: General Purpose Exemption

We welcome the policy objective of moving towards a more territorial regime which would apportion only profits artificially diverted from the UK. We particularly welcome that there will be no default assumption that profits received by a CFC would have arisen in the UK if the CFC did not exist. It is absolutely critical that the general purpose exemption should be drafted to fulfil these objectives and should be applied according to its spirit. There should only a CFC charge to the extent that profits have been artificially diverted from the UK.

Question 7A: The Government welcomes views on applying principles based on those set out in Article 7 to apply the GPE, and any alternative methods for the calculation of "commensurate with activities" profits.

Question 7B: The Government welcomes views on the likely compliance impacts of adopting this approach, and any situation in which this attribution may significantly increase compliance burdens.

The proposed method of giving effect to the GPE appears relatively complex and the description seems to conflate the separate issues (i) whether profits have been artificially diverted from the UK and (ii) whether profits are commensurate with the CFC's activity. Artificial diversion seems to us essentially to involve issues of whether the CFC carries on activities that, ignoring tax considerations, would have been carried on in the UK and whether profits are alleged to arise in a territory without there being a genuine establishment there. Whether a company's profitability is commensurate with its activity appears to us to be essentially a transfer pricing enquiry: looking at the actual activity in the CFC, is its profitability commensurate with that activity?

We do not think that the GPE in its current form is consistent with the decision in *Cadbury Schweppes* which seems to us to ask, in essence, whether the CFC is genuinely established in a particular jurisdiction. If so, the fact that it is established there for tax reasons is immaterial (see our comments on Annex I). It seems to us that it would be possible for a CFC to be genuinely established in *Cadbury Schweppes* terms in a particular jurisdiction even though in an uncontrolled situation it would not have owned the assets or borne the risks which it owns or bears.

We consider that further thought needs to be given to the interaction between transfer pricing rules and the GPE. The consultation document indicates that transactional diversion would be an indicator of profits having been artificially diverted from the UK for tax purposes. However, it appears to us that the transfer pricing rules would in any event apply to counter transactional diversion.

Question 7C: Does the GPE provide a suitable and effective replacement for the motive test that can be applied to any CFC to determine whether and to what extent profits have been artificially diverted from the UK?

In its current form, we are concerned that the GPE will be difficult and complex to apply and could lead to difficult arguments between multinationals and HMRC.

A possible alternative approach might be simply to ask whether the profits of the CFC have been artificially diverted from the UK and to set out in the legislation some non-exclusive indicia of when profits would have been artificially diverted from the UK. These could include:

(i) the transfer of assets and risks that would not have been transferred in an uncontrolled situation;

(ii) a lack of substance in the CFC; and

(iii) arrangements having been made that do not reflect the economic substance of the transaction.

The first of these indicia on its own would not be sufficient to amount to artificial diversion.

Chapter 8: Treatment of Intellectual Property

Generally, we are concerned that the consultation document treats any activity involving the use of intellectual property connected to the UK as "bad" in too many instances. Low risk, genuine commercial activity that has been priced in accordance with OECD principles may be treated as bad and CFC apportionments suffered where this is currently not the case. The rules relating to intellectual property need to be better targeted to capture situations that are non commercial and not those which are commercial.

Question 8B: The Government welcomes views on the indicators described in Annex E that may indicate whether a transfer of IP has given rise to an artificial diversion of UK profits or not, and whether inclusion of such indicators in guidance would be helpful in assisting with interpretation of the CFC rules as they relate to IP.

We believe that the indicators described in Annex E are appropriate and inclusion of such indicators in guidance would be helpful in assisting with interpretation of any generic general purpose exemption insofar as it relates to the transfer of IP.

Question 8C: The Government welcomes views on whether the above proposals are appropriate to deal with CFCs where IP is held as a passive investment.

Question 8D: Is the pure income profits approach to determining whether IP is held as an investment workable?

We do not believe that a "pure income profits" approach is likely to be effective to distinguish IP held as a passive investment. Even where IP is held as an investment, it is likely that the IP holding company will have to monitor the quality standards achieved by licensees of the IP and monitor potential infringements of the IP in order to maintain its

value, so that it is unlikely that royalty income will in fact be pure income profit as generally understood.

We do not believe that where a CFC holds IP as an investment and more than an incidental amount of the CFC's profits consists of investment income there should automatically be a CFC charge on the excess. It is still necessary to determine whether there has been an artificial diversion of profits from the UK. If a group establishes, for example, a Dutch, Luxembourg or Swiss subsidiary to hold non-UK IP and that subsidiary is funded with surplus cash arising outside the UK or third party borrowings, we do not believe there has been any artificial diversion of profits from the UK and there should accordingly be no CFC charge. If some of the IP is UK IP or some of the funding is equity funding derived from the UK it might be appropriate for there to be a partial charge on the company, but a full charge would be disproportionate.

Question 8E: Is there a case for the tapering charge? Are there sufficient instances to which a tapering charge could be fairly applied to justify the additional rules that would be needed?

We doubt whether a mechanical tapering rule merits the additional complexity that it would bring. We think that a properly crafted general purpose exemption should be capable of dealing with situations where activity migrates to a CFC and the proportion of profits attributable to the IP transferred from the UK reduces over time.

Question 8F: The Government invites views on these proposals and whether in practice tax is paid on IP transfers sufficiently frequently to merit the additional complexity that relieving rules would introduce.

We cannot comment on how frequently tax is paid on IP transfers. If, however, relief is to be made available we would favour Option 1. If it transpires that there are relatively few occasions where tax is paid on IP transfers, it may be possible to have a relatively straightforward rule that a just and reasonable proportion of the tax paid as a result of the transfer of the IP to the CFC can be credited against tax on a subsequent CFC apportionment. Guidance could then give examples of how a just and reasonable proportion could be calculated in various circumstances. We doubt whether Option 2 would be attractive to business.

Chapter 9: Foreign Branches

Question 9A: Is the local management requirement proposed for the CFC regime appropriate for foreign branches?

It is difficult to comment definitively on the local management requirement without seeing detailed drafting. However, we would anticipate that a local management requirement should be capable of applying to foreign branches (although it will need to have regard to the fact that in modern business conditions businesses are often managed on a regional or product line basis).

Annex A

Question A2: Will the proposed property exemption, when considered in conjunction with the proposals for the low profits and excluded country exemptions reduce the compliance burden currently faced by property investment businesses?

We have already commented in our comments on chapter 5 on the proposals in paragraph A.4. We do not repeat those comments here.

One further issue which needs addressing is the interaction between the CFC legislation and the domestic exemptions for real estate investment trusts. For historic reasons, a number of REITs hold UK real estate through Jersey subsidiaries. Where those subsidiaries are exempt from income tax under the REIT exemptions, they should be exempt from the CFC rules because there can have been no artificial diversion of profits from the UK. The legislation needs to make clear that there can be no CFC charge on a UK parent of the Jersey subsidiary in these circumstances. In the past, clearances were available under the motive test, but we are unclear whether the proposed general purpose exemption would be capable of application to the Jersey subsidiaries.

Question A4: The Government's initial view is that this change in treatment in comparison with the existing CFC regime is more likely to be of relevance to the operating leasing of small numbers of large high value assets than of large numbers of small lower value assets, but is interested in hearing views on this.

As mentioned in our comments on chapter 5, we do not understand why the change in treatment of operating leasing should be more likely to be of relevance to the operating leasing of small numbers of large value assets. In our view, the change should apply to all forms of operating leasing, including operating leasing of cars and plant hire companies.

Annex G: Charging Mechanics

Question G3: Are there any other issues that arise in respect of the charging mechanics proposed?

In paragraph G15, it is stated that "to aid risk assessment and inform policy evaluation it would be helpful if the requirement covered all of the new exemptions". If the intention is to require a UK parent to state, for all its CFCs, all of the exemptions which may potentially apply to the CFC, that would be a very significant extra burden and lead to a huge increase in compliance cost for the UK parent, because it would be necessary to check all the detailed conditions of all the potentially available exemptions. It would also be at odds with the statement on page 12 of the consultation document that "a CFC may well qualify for more than one of the exemptions. In practice it is expected that the majority of CFCs will apply one of the more straightforward exemptions."

Annex I

We note HMRC's interpretation of the relevant case law. As will be apparent from our comments on the general purpose exemption, we doubt whether the proposed regime is wholly consistent with the decision in *Cadbury Schweppes*. We think that it may catch some CFCs that are genuinely established in their territory of residence but carry on

activities that in the absence of tax would have been carried on in the UK. We note especially paragraphs 34 to 39 of the European Court's judgment and, in particular, its conclusion that the fact that Cadbury Schweppes decided to establish CSTS and CSTI in the Irish Financial Services Centre for the avowed purpose of benefitting from the favourable tax regime which that establishment enjoyed did not in itself constitute abuse and did not preclude reliance by Cadbury Schweppes on the freedom of establishment conferred by EU law. The question is whether, despite the existence of tax motives for the establishment of the CFC, that company is actually established in the relevant territory and carries on genuine economic activities there. We do not believe that this is the same test as asking whether, in an uncontrolled situation, activities would have been transferred to the CFC.

Of course, it is possible that since Cadbury Schweppes EU law has moved on, but we consider that there will remain uncertainty as to whether the new regime, if drafted in the form currently intended, complies with EU law.

We would be happy to discuss any of these comments if that would be of assistance.

Yours faithfully

Bradley Phillips

Chair

City of London Law Society

Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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