

DELOITTE

14 September 2007

Our ref: WJID/SJC/T 4-NS

Dear

### **Taxation of the Foreign Profits of Companies**

We very much welcomed the publication by the Treasury of this discussion document as we believe that the areas covered in the document are in need of reform. We welcome many of the proposals set out in outline in the document, although we have major reservations about one of the proposals. Our detailed comments are set out in the Appendix.

### **Dividends**

It's probably fair to say that the proposal for a dividend exemption was a little unexpected – but it's very welcome. Double tax relief has become an administrative nightmare, which (at least for 10% and greater shareholdings) yields very little money to the Exchequer.

The discussion document made no mention of any transition and we think this is entirely the right approach. Many of the benefits of introducing a dividend exemption would be lost were there to be some attempt to charge tax on earnings that had arisen before the introduction of the new regime. Our research with clients makes it quite clear that many companies will repatriate funds to the UK once a dividend exemption is introduced. We recognise that such repatriations are unlikely to yield sufficient additional tax on their own to cover the cost of abolishing double tax relief – but imposing a transitional charge would simply mean that much of the expected repatriation would not take place. The only minor exception to this will be the need for something to cover ADP dividends.

We believe that the dividend exemption should also be extended to 10% or greater shareholdings in non-controlled companies, as suggested in the document. However, we remain concerned by the administrative burden involved in attempting to track passive income in non-controlled companies, as well as double tax relief. Many shareholders will find it difficult – if not impossible – to obtain this sort of information. We would prefer to see a general exemption introduced, perhaps with anti-avoidance to prevent fragmentation of ‘bad’ activities in non-controlled companies.

### **Protecting the UK tax base**

We recognise it is important to protect the UK tax base and we acknowledge that a dividend exemption may lead to a slight drift of activities outside the UK to lower taxed territories. However, we do not think that the proposed controlled company regime set out in the document is a proportionate response or will achieve the desired results. Instead, we believe it is important to identify the exposures and target the protection to them. For example, one concern might be the danger that what is effectively deposit interest earned from third parties could be turned into exempt dividends. However, provisions like the repo rules and 'Section 91B' offer stronger protection than exists in some existing exemption countries.

We consider that measures should be introduced aimed specifically at protecting the UK tax base, rather than seeking to tax worldwide passive income as a proxy for the UK tax base. Such measures could include:

- An effective exit charge when assets are transferred outside the UK.
- Incentives to encourage the retention of intangibles in the UK and to bring intangibles into the UK.
- Limits on UK interest deductions where there are overseas cash-box operations under UK control or upstream loans without a commercial rationale (which rationale could include - but is not limited to - restrictions on dividends and treasury management).
- A minimum tax (at a rate below the mainstream rate) on UK profits (before deduction of interest and other general items, such as losses or management expenses). There is a range of international models in this area.

We believe there is support for measures focussed on the UK tax base, although individual measures would need to be put forward for consultation to identify issues which acted unreasonably. Introducing properly targeted measures would mean that the CC regime was either not needed at all, or could be significantly scaled back.

The discussion document acknowledged that UK multinationals need to be allowed to plan their international tax affairs, which is welcome (and, in our view, rightly recognises the value of headquarters operations in the UK). However, the controlled company proposals have been widely interpreted as likely to raise substantial amounts of additional tax from UK multinationals. We think this is because of their unduly wide remit; the proposals seem to charge UK tax on virtually

all low-taxed profits overseas. There is some allowance made for intra-group finance companies – but that is restricted by the phrase “appropriately capitalised”, which gives the impression that tax is being sought from existing activities which currently are not liable to UK tax. Further, the limitation to interest and the wide definition of passive and other mobile income adds to the impression of revenue-raising.

The suggestion that capital gains should come within the regime is troubling. We recognise that there are planning techniques that may turn income into capital and understand that these cannot be ignored. However, if this proposal would charge UK tax on the disposal of shares or of real property, it would go far further than necessary or appropriate. It would act as a real barrier to normal, commercial transactions and (amongst other things) makes group reorganisations potentially subject to UK tax.

In addition, it is very clear that the administrative burden of the controlled company proposals would be significantly in excess of the current burden. This is because there is no simple way to identify income potentially subject to a controlled company regime without going to every individual entity within a worldwide group. More details of issues here are given in the Appendix.

Finally, we cannot see that the controlled company proposals protect the position of ‘genuine economic activities’, as set out by the European Court of Justice. It is vital that measures are compatible with the EC Treaties; in reality, it is in no one’s interests for there to be doubts about the legality of national tax legislation.

Our detailed comments on the controlled company aspects are set out in the Appendix.

### **Control**

It is acknowledged that there have been some cases of non-controlled companies being used to achieve tax advantages. However, there are of course many commercial, jointly-owned activities, as well. It is important that commercial activities are recognised and treated as such.

This is an area where detailed consultation involving draft clauses will be needed.

### **Treasury Consent**

The whole business community welcomes the abolition of this anomalous section. We find it difficult to understand what information would be needed in its place. At present, most activities (making loans, issuing or transferring shares) are not reported due to the General Consents.

We think that full justification would be needed, should the Government propose further information requirements. There is no such justification in the discussion document.

## **Interest relief**

Whilst at first sight the proposal to limit UK interest deductions to worldwide external interest deductions sounds reasonable, we have come across a number of commercial circumstances where such a rule could operate entirely unreasonably. Details are in the Appendix.

## **Branches**

We do not think it is feasible to delay consideration of the treatment of branches. If branches remain as taxable when a dividend exemption is introduced, there will surely be a one-way bet against the Exchequer. Companies with loss-making branches will retain them to gain UK relief for the losses and those with high-tax branches will be able to retain them without additional UK tax cost. By contrast, those with low-taxed branches will look to incorporate them and there will no doubt be claims taken to the European Court of Justice as well.

An additional concern is that the current rules on branches, which mean that the effective total corporate income tax rate suffered by a foreign branch of a UK company is the higher of the UK and local rates, makes it particularly uncompetitive for banks operating significantly through branches for regulatory reasons to operate a global bank from the UK. This may not have mattered in the past, but on the eve of a likely global consolidation of the banking industry, would seem to be taking a risk with an important part of the corporation tax base.

Insurers too are increasingly moving to branch structures for regulatory and capital reasons, particularly within the EU, and it would be a concern if the result of the reform would be to create a tax disincentive or penalty to operating a branch structure from a UK headquartered company as compared to operating through foreign subsidiaries.

## **Discussion process**

We regret that the discussion process does not appear to have gone particularly well. There appears to have been a variety of different views expressed by Treasury and HMRC representatives. There do seem to be signs of policy proposals that were not included in the discussion document, but which have been discussed at some of the meetings. Business and tax advisers have no knowledge of the KAI calculations, which has added to the difficulty of responding to Treasury concerns about behavioural change. We would urge the Treasury to discuss the assumptions with business and tax advisers, so as to achieve a better understanding of potential behavioural issues. The representative bodies and major firms have not been involved in discussions, which is regrettable as many companies do not respond to consultation and others represent simply their own company's viewpoint.

We believe that two further consultations are needed to achieve the desired goal of a reformed, more competitive UK tax system. The first consultation would cover a range of responses to business concerns (including a wider range of industry streams and the involvement of representative bodies and advisers) and the second would set out substantive proposals for reform so as to consider detailed comments. In our view, this should be achievable within the timetable of

a new system applying from 1 April 2009 (and business is very clear that the proposals should not slip into 2010).

We should be happy to meet should you wish to discuss our overall or detailed comments.

Yours sincerely

## Appendix

### 1. Foreign dividends received by UK companies

- 1.1 We strongly believe that a move to an exemption system should go ahead irrespective of the proposed changes to the CFC and interest relief rules and that such a move should be viewed by HM Treasury as a compelling opportunity to increase the competitiveness of the UK without significant cost.
- 1.2 We agree that groups that do repatriate profits to the UK suffer significant compliance costs in meeting their tax return filing obligations. Many groups find the existing credit system rules to be overly complex and to apply them is a hugely administrative and time consuming undertaking, especially when many tiers of companies are involved. Accordingly, we agree that an exemption system should be much simpler to administer and would bring about a material saving of compliance costs both for business and for HMRC.
- 1.3 Our experience is that very few large international groups currently pay UK tax on overseas dividends, either because they have been highly taxed abroad or simply because groups choose not to pay dividends to the UK. Overseas headquartered groups with investments in low tax territories avoid holding them through the UK because of the potential UK tax cost on dividend repatriation.
- 1.4 We note that HM Treasury has not published the KAI estimate of what an exemption system would cost in terms of lost UK tax on dividends. However, based on our experience of working with our extensive client base, we do not believe that the cost would be significant. Nonetheless, we do accept that there could be a small increase in the location of certain activities in low-tax jurisdictions which then benefit from a dividend exemption.
- 1.5 The exemption of tax on dividends will, we believe, significantly encourage investment in the UK either by international groups locating their head offices and ultimate parent companies here or through inbound investment from other nations who view the UK as the preferred location from which to invest in Europe. As noted in the discussion document, many of the UK's competitors already operate an exemption type system and we agree that the UK's rules are widely regarded as less competitive.
- 1.6 Whilst we applaud HM Treasury for supporting a move to an exemption system, we would like to ensure that the exemption isn't seen as second-rate when compared to other EU countries. We suggest that further thought is given to the following:
  - 1.6.1 We would strongly suggest that consideration is given to exempting from tax all foreign dividends received by UK companies (other than dividends which are taxed as trading income or which are not paid out of profits) and is not limited to the profits of companies to which the controlled companies rules apply. We do not see any merit in linking the qualifying criteria for a participation exemption to the CC rules, which brings with it significant complications, and would like to see the two decoupled. In particular, we foresee serious problems arising from applying the exemption in investment situations where there is a lack of UK control, along the lines set out in the footnote on page 14 of the discussion document. Take for example the relatively common situation where a UK

company has a greater than 10% but non-controlling investment in a non-UK group. The discussion document suggests the dividends from such an investment will be exempt if they are paid out of profits which would be exempt under the CC regime. The difficulty, or even impossibility, that arises is how the UK company goes about identifying the underlying source of the dividends when typically it does not have full access to the books and records of its non-controlling investment.

- 1.6.2 We also believe that the participation exemption should be applied to dividends received by small businesses, even if this means small businesses would be theoretically subject to the new CC regime. To have a different method of taxation, such as a simplified credit system, for small business would only add to the complexity in this area, and especially if small groups could move between regimes due to fluctuations in their results. Complexity of the UK tax system is one of the major factors that many groups cite as being a deterrent to doing business in the UK and this should be avoided wherever possible. Furthermore, we do not see how the existing credit system could be greatly simplified as, contrary to what is stated in the discussion document, any credit system would still need to be capable of dealing with small businesses that do have multiple tier structures, even if these are few and far between. The far simpler solution would be to exempt from tax all dividends irrespective of the size of the group. We believe that many small businesses may prefer to pay attention to the requirements of a CC regime in place of complex tax credit calculations for dividends. In practice, we doubt if small companies would contemplate the sort of activities that would fall within such a regime. Moreover, if a simplified system gave small companies only rough justice, then it might not give equality of treatment with exemption, and would be more vulnerable to challenge in the ECJ, under the somewhat opaque proviso to their FII GLO decision last December.
- 1.6.3 We note that the discussion document does not mention any transitional rules. In our view – with the exception of providing for ADP dividends from accounting periods prior to the introduction of the new rules – few transitional rules would be needed. Limiting the introduction of the dividend exemption would simply mean many groups would not repatriate funds. If double tax relief survives in some form, of course, there will be a need to permit the carry-forward of excess unrelieved foreign tax credits.
- 1.6.4 For broadly similar reasons, we would strongly encourage the Government to take forward an exemption for portfolio foreign dividends for the majority of businesses, as is the case currently for UK portfolio dividends. Any other method of taxing portfolio dividends would, in our view, add unnecessary complexity resulting from a two-tier system. However, we believe that the cost of this measure should be borne within the savings industry (who will benefit from it) rather than generally.
- 1.7 Clearly, it is difficult to predict future behaviour, but we see no reason why businesses won't be encouraged to return surplus funds in overseas subsidiaries to the UK for future investment if they can do so tax-free.

## **2. Reforming the UK's CFC rules**

- 2.1 As mentioned in our covering letter, we have grave concerns regarding the proposed CC regime, which are split broadly between conceptual and practical (administrative) issues. As set out in the body of the letter, we favour the introduction of measures to protect the tax base in preference to the proposed CC regime.

### *Conceptual issues*

- 2.2 Whilst we accept that the CFC regime is in need of revision, it is our belief that the proposals regarding CC would result in a significant number of taxpayers facing an increased UK tax burden in comparison with the current rules. It would be instructive to see the calculations upon which the expected 'revenue neutrality' is based, including the assumptions relating to taxpayer behavioural change.
- 2.3 The proposed CC regime would mark a shift towards a system that taxes worldwide profits by default, whilst exempting income from certain activities. This is a significant conceptual change from the current approach of taxing only income sourced in the UK as well as income from controlled overseas entities that would be UK resident were it not for favourable overseas tax rates. In our view, this could significantly detract from the UK's tax competitiveness, both from a financial and an administrative viewpoint, and could dissuade companies from locating holding companies here.
- 2.4 By way of extension, it is our view that the proposals are a close approximation of the US 'subpart F' rules, which themselves are widely seen as punitive. However, the subpart F rules offer a degree of flexibility due to the ability of the taxpayer to make 'check the box' elections and were significantly relaxed by the Tax Increase Prevention and Reconciliation Act of 2005. Given that no equivalent election is catered for under the proposals, the UK would potentially be at a competitive disadvantage in relation to the US.
- 2.5 A key aspect of the proposals would be the way in which they interact with existing tax rules, particularly with regard to loss relief. For example, to what extent would brought forward losses be available for use against apportioned profits (of both UK and non-UK CCs), and how would group relief rules be affected? A detailed understanding of this interaction is crucial to fully appraising the proposed rules.
- 2.6 We are concerned that the CC rules will bring certain types of income within the UK tax net when there appears to be little or no justification for doing so. In particular, we believe that the taxation of royalty income and other income derived from intellectual property that has never been located in the UK will significantly extend the UK tax base.
- 2.7 Furthermore, the allocation of profits to income-generating intangible assets could be a massively complex exercise and bring with it extreme uncertainty in an era in which giving certainty to business over the tax treatment of transactions is a primary requirement. If the purpose of such rules is to prevent intangible assets being transferred offshore, a more appropriate measure would seem to be to strengthen any perceived weaknesses in the rules in relation to exit charges.

- 2.8 We are similarly concerned that the rules provide little by way of exemption. More specifically:
- 2.8.1 The proposals make no reference to an equivalent of the 'lower level of taxation' requirement as currently contained within s747(1)(c) ICTA 1988. We would hope that companies would not have to recalculate taxable profits in respect of controlled companies located in jurisdictions with higher or equivalent tax rates to the UK as this would constitute an unacceptable administrative burden.
- 2.8.2 There would appear to be no equivalent to the 'motive test' currently contained within s748(3) ICTA. This, again, signifies a broadening of the tax base and a regression in competitiveness, illustrating that the regime is being stretched far beyond the anti-avoidance purpose for which it was originally created. At an absolute minimum, we would suggest that the 'period of grace' motive test clearance for the first twelve months following an overseas group acquisition should continue to be available.
- 2.8.3 There is no equivalent of the current 'excluded countries list'. As well as broadening the tax base, this is likely to increase the compliance burden. This coupled with 2.8.1 and 2.8.2 above should remove the need to apply the proposed CC rules to the income of controlled UK companies; this could otherwise represent a large administrative burden for some groups.
- 2.8.4 Paragraph 4.26 of the document refers to an exemption in respect of 'incidental income'. No definition of this term is provided, but it is important to understand exactly what this means and how it fits in with the issue regarding income from intellectual property rights referred to above.
- 2.8.5 Whilst we accept the desire to include some capital gains in order to prevent passive income being reconstituted as exempt, we would suggest that this rule applies only to commercially artificial scenarios. We would not wish to see changes in this area which could impact the long term investment decisions of groups. It is clear, for example that charging tax on overseas real estate disposals would drive part of the UK real estate industry overseas, to the detriment of London's position as a financial centre.
- 2.8.6 There will also be a number of specific industry sector points arising from the abolition of the exempt activities test, given that it has a number of industry variants such as for the banking industry where it is directed at the position of offshore deposit-takers and bona fide foreign bank subsidiaries. Likewise, in the insurance sector, the current rules provide certainty for certain insurance subsidiaries, including on the underwriting of large risks. Whilst there are inflexibilities in the current rules, it seems likely that the replacement of these provisions by the exemption of active non-mobile income and active finance income will increase compliance and tax costs as the impression from the discussion document is that some non-exempt income may arise in subsidiaries that are currently wholly exempt.

*Practical issues - administrative burden*

- 2.9 The most immediate concern of affected companies will be the vastly increased administrative burden, some of which could be impossible to comply with. The reasons for this are twofold:
- 2.9.1 Firstly, the changes commented on above will bring a much broader range of activities within the reporting requirements in comparison to the existing rules. This could be of particular importance to groups looking to establish holding companies which are not employee intensive and could struggle to resource these onerous requirements.
- 2.9.2 Secondly, the shift towards an income based system will require widespread changes to most groups' internal reporting systems, as well as introducing uncertainty (for example, in the need to determine the proportion of income arising from intellectual property rights). The cost and time required for enterprises to change the way in which they operate to such a profound degree would be extremely prohibitive.
- 2.10 The first point, the broadening of the potential tax base and hence the broadening of the associated reporting requirement, is subject to the same concerns as already listed. Chief amongst these would be a clear and expansive list of exemptions, meaning that groups would not need to expend resources in tracking the income of companies based in jurisdictions where the tax level is consistently the same as or higher than that in the UK.
- 2.11 In respect of the second point, we disagree with the Treasury's assertion that the income tracking requirements would fall broadly within the reporting mechanisms already adopted by most groups. Aside from the fact that commercial interests have no need to distinguish between active and passive income (and hence probably have no systems to do so) it is common for many groups to net off various types of income against each other. In addition, tax would undoubtedly require that the income of each entity be considered – which is not the case for group accounting. Furthermore, management reporting is often rounded to the nearest thousand or even million.
- 2.12 A further concern regarding the reporting requirements relates to the potential inability to obtain the relevant information in the first place where the UK does not hold a majority shareholding. In addition, paragraph 4.16 of the discussion document refers to a reduction to the trigger for application of the rules to 10% - we note that the threshold was increased from 10% to 25% in 1999 to mitigate the burden of the existing CFC rules and it seems a backward step to return to this lower apportionment hurdle.
- 2.13 It is clearly necessary to understand what form the 'modernisation' of the definition of control will take before assessing the potential impact. However, it should be borne in mind that in some cases legal restrictions will render it impossible to compel a company over which a small amount of control is exercised to provide the information required. Further, there are many commercial joint ventures (and companies under multiple ownership) which need appropriate protection.

- 2.14 In order to comply with the corporation tax self-assessment regime it is of paramount importance that any CC rules are workable and do not leave groups vulnerable to interest and penalties for unpaid tax through no fault of their own.
- 2.15 Our final concern with regard to the CC proposals relates to the anticipated method for measuring income. We do not believe that UK GAAP is an appropriate standard for sole use, since the overseas subsidiaries of UK multinationals will be reporting their results under IFRS and their local GAAP. Requiring the use of UK GAAP would impose another accounting regime solely for the purpose of complying with the CC rules. A more reasonable (and less burdensome) approach would be to offer a range of permissible international GAAPs.

#### *UK controlled companies and EC Treaty compliance*

- 2.16 It is vital that any regime complies with the EC Treaties. We would urge the Government to do its utmost to ensure there is widespread agreement that any new regime is indeed EU compliant. It is very damaging to have a national tax regime that is under constant legal challenge and where there is the perception that the Government is seeking to avoid compliance with the UK's treaty obligations. Such perceptions damage the UK's reputation overseas.
- 2.17 Applying the CC regime to UK companies as well as to overseas companies is highly questionable. Although in some cases it would lead to extra UK tax, there would be the widespread perception that this was simply a matter of form, rather than of substance. Whilst some might consider that the current European Court of Justice could accept the proposals, changes to the composition of the court are likely to lead to challenges to the UK proposals.
- 2.18 It seems extraordinary that the discussion document does not mention the 'genuine economic activities' test in *Cadbury Schweppes* or the commercial borrowing test in the *Thin Capitalisation GLO*. Both exceptions would need to be reflected in UK law.
- 2.19 Applying the CC rules to UK companies would lead to unjustified extra tax liabilities in some cases. How, for example, would such a system deal with a UK subsidiary with losses (including loan relationship deficits), either currently, or brought forward from prior years?

#### *Transitional rules*

- 2.20 Depending on the direction that the proposals take, transitional rules may be needed to allow groups to adapt to the new rules without tax charges on the transition itself.
- 2.21 As noted above, there will need to be some protection to cover ADPs in respect of the existing regime, which may need to be paid after dividend exemption commences.

#### *Double Tax Treaties*

- 2.22 The changes proposed may lead in some cases to changes in taxing rights under UK double tax treaties. Some countries – for example, South Africa, are successful in negotiating

changes to treaties to ensure that domestic changes are effective. We hope that there will be a review of issues under treaties and priority given to negotiating protocols. Examples of treaties that may need a protocol are the UK-Russia and UK-Israel treaties.

### 3. Interest relief

- 3.1 We do not see any need to link any restriction on interest costs to the other proposals regarding dividend exemptions and controlled companies and would suggest, if necessary, that this is considered as a separate measure.
- 3.2 We are concerned that the proposals could act as a strong disincentive for certain groups, for example cash rich groups which may not need to externally borrow at the parent company level, or groups subject to borrowing restrictions (for example, a US parent in Chapter 11).
- 3.3 The proposals treat UK companies of groups with cash rich foreign parent companies differently from the UK companies of groups that are heavily debt funded at the parent level, albeit the UK companies could be equivalent in all other respects. This is not equitable and could be construed as giving preference to certain sectors over others.
- 3.4 Also, take for example the situation where a foreign parent multinational group is initially geared globally, makes a UK acquisition, and pushes down some of the debt to the UK (as is commonplace in structuring acquisitions). The group later disposes of a part of its business not connected with the UK and uses the funds raised to repay the external borrowing. Under the proposals, this would result in an immediate reduction/termination of UK tax relief for the UK intercompany debt as a consequence of transactions which are not within the control of the UK subgroup.
- 3.5 In these situations, it seems to us that to conclude that the UK subgroup's finance costs are not commercial is not a true reflection of the reality of the situation.
- 3.6 Furthermore, we are concerned that the proposals do not take into account the fact that some multinational groups may hold separate and autonomous UK subgroups with no consolidating entity in the UK. In such cases, interaction between the respective entities can be non-existent, resulting in UK companies having little or no control or knowledge over total UK financing. The proposals do not appear to address this situation, or stipulate the way in which the ability to obtain a tax deduction for the overall UK interest cost would be allocated.
- 3.7 It is clear that (as set out) the proposals do not satisfy the judgement of the European Court of Justice in the *Thin Capitalisation GLO*, which require that the UK allows deductions for commercially driven finance costs.
- 3.8 Finally, the issue of which GAAP to use also arises in respect of the calculation of group financing costs. Aside from the significant differences that can arise depending on what constitutes debt and equity under the GAAP in question, we are concerned that UK taxpayers may struggle to obtain the information in the correct form in the first place. In

addition, it will need to be clear what exactly should be included as a 'financing cost' - for example, would leasing activity, which does not show interest income or expense be a financing activity?

- 3.9 If such a key change is to be implemented, it is vital that businesses are given sufficient guidance (including a number of example scenarios) in order to ensure that certainty is achieved; this being one of the objectives coming out of the Varney proposals.

#### **4. Treasury Consent**

- 4.1 It has been clear for many years that the Treasury Consent rules are anachronistic and required abolition. The rules simply acted as traps for the unwary and never presented a significant barrier for the well-advised.
- 4.2 We note the proposal for a more targeted reporting requirement to be introduced that will be "in line with the real-time auditing approach". No detail is provided as to what is meant by "real-time" and how this is to be linked to the timing of a transaction. However, there is no justification in the document for any information power. It seems fundamental that the Treasury should explain why it needs any additional information and also that any information sought does not increase the reporting burden on business. At present, many transactions fit into the General Consents, such that no information need be provided. Business would regard it as most unhelpful if extra reporting were required. Equally, it seems unnecessary to provide extra information outside the normal CTSA return.
- 4.3 We would further comment that following the linking of the enquiry window to the date on which tax returns are filed for accounting periods ending after 31 March 2008, businesses are likely to file tax returns earlier than at present and thus provide HMRC with the information contained therein at an earlier stage.
- 4.4 Furthermore, under the current Treasury Consent rules certain transactions are removed from the pre-transaction application requirement through Section 765A ICTA 1988 in respect of capital movements in the European Economic Area. There is no mention in the discussion document of a similar relaxation in the proposed new reporting requirements and without something similar, the new requirements, depending on their exact form, could be seen as more, rather than less, administratively burdensome. Clearly, any changes in this area will need to be compliant with European Council Directive 88/361, including Article 7 which relates to movements of capital to or from 'third countries'.
- 4.5 We consider that pre-transaction or immediate reporting requirements would in many ways be worse than the existing regime.

## 5. Portfolio dividends

In our view, the vast majority of portfolio dividends are received as part of the savings sector and we think that solutions to the issue need to be resolved within that sector. The effects of each option on the various sectors within the savings industry and entities concerned needs to be carefully considered to avoid creating potentially significant distortions. We would make one point of detail: we would be concerned to find a ‘theoretical’ solution being proposed, which failed to work in practice. For example, retaining exemption for UK portfolio dividends whilst introducing underlying tax relief for overseas portfolio dividends would not be a realistic proposal. Since in practice few holders would ever be able to obtain the information to make a claim, such a solution would simply bring the UK tax system into disrepute. However, allowing double tax relief to be based on the current tax charge in the payor’s accounts might be a practical solution.

Having noted where the majority of issues currently arise, it is also worth recording that there are a few examples of strategic minority shareholdings in very major overseas companies, where holdings above 10% are not permitted. Examples of such holdings are likely to grow, as UK multinationals invest in the emerging economies. This may be another reason to extend dividend exemptions to all but financial traders.

10 September 2007

## Response to the 'Taxation of the foreign profits of companies: a discussion document'

On 21 June 2007, HM Treasury ('HMT') and HM Revenue & Customs ('HMRC') issued a discussion document, Taxation of the foreign profits of companies, setting out a package of proposals for modernising and creating a more straightforward regime. Diageo welcomes the opportunity to discuss the impact of the proposals with the Government.

The package seeks to achieve a 'broadly revenue neutral outcome' that meets the needs of both business and the Government.

We understand that the proposals are intended to:

- Improve the competitiveness and attractiveness of the UK as a location for multinational business, while ensuring the proposals do not undermine the UK tax base;
- For large companies, simplify the dividend taxation rules and provide increased levels of certainty from the new Controlled Companies ("CC") regime; and
- Reduce the administrative burden on corporates

Unfortunately, if implemented in their current form, we believe that the proposals would significantly extend the UK tax base. Furthermore, they introduce additional layers of complexity and significantly increase the administrative burden.

Overall, we do not consider the package to be revenue neutral and do not believe it is practical to apply the proposed CC regime without increasing uncertainty. The proposals seem to directly contradict the Government's commitment to the 'better regulation agenda' and 'Hampton' principles and commitment to reduce administrative burden.

In contrast, we consider that the underlying philosophy should be for the Government to tax UK economic activity, coupled with measures to prevent the artificial diversion of profits from the UK where there is inadequate commercial substance. Generally, we would expect the transfer pricing legislation to be adequate to deal with circumstances where the real activity is performed in the UK.

We welcome the introduction of the participation exemption and the removal of the Treasury Consent provisions. We consider the overwhelming dominance of the new CC

regime to result in a package that is less competitive than other major European and US economies. As a result, the proposals would place UK multinationals at a distinct disadvantage to their non-UK peers. Consequently, in our view, the proposals do not fulfil the Government's objectives and do not meet the needs of business.

### The way forward

Notwithstanding our views of the current draft of the proposals, Diageo welcomes the Government's desire to modernise the UK tax system and to seek to make the UK a more competitive territory.

Diageo is committed to working with the Government to identify alternative proposals to meet the objectives outlined above. We have therefore enclosed a more detailed analysis of the proposals, together with some suggestions as to how the proposals could be more balanced and achieve the aims set out in the document.

We would encourage HMT and HMRC to enter into an open dialogue with us to resolve some of our concerns.

Yours sincerely,

**Head of Global Tax**

Enc.<sup>1</sup>

---

<sup>1</sup> The information in this letter and accompanying documents is confidential information provided on a confidential basis. It is also commercially sensitive and its disclosure would be prejudicial to the company's commercial interests. It should therefore be considered to be exempt information within the meaning and for the purposes of Section 2 of the Freedom of Information Act 2000

As such, Diageo has identified critical issues associated with the proposed CC regime, which would result in a failure to fulfil the stated objectives and render the UK uncompetitive when compared to other territories.

- **Mobile income - active v passive**

The CC regime assumes that all profit derived from intellectual property is passive in nature. A distinction is required between profits arising from intellectual property held for investment purposes and profits generated from a brand-based business, where intellectual property forms an intrinsic part of that business.

The current CFC regime specifically provides that profits generated from the holding of intellectual property for investment purposes should be subject to UK taxation. This is on the basis that income generated from an investment activity equates to "pure income profit", as minimal activity and substance is required to generate that profit. This is not the business of Diageo.

Diageo ultimately derives its profits from the strength of its brands, built upon consumer loyalty. In order to maintain and grow that loyalty (and consequently profits) substantial and continuous economic activity is required. A brand strategy is developed for every brand, which directs its global positioning and results in consistent communication of the brand's qualities to the consumer by way of advertising and promotional initiatives. Without this activity, a brand will stagnate and ultimately decline, resulting in a reduction in profits. There is strong evidence that demonstrates profits from brand-based businesses are inextricably linked to the level of marketing activity undertaken. This is one of the key drivers for Diageo spending £1.2bn each year on marketing activity.

We have outlined above the extensive activities undertaken by Diageo in respect of developing and implementing its brand strategies; these activities go to the very heart of its business. It is inconceivable that goodwill associated with a business could ever be severed from the business operations. For Diageo, our brands are equivalent to goodwill and are not capable of separation. Therefore, we do not consider that profits derived from a brand-based business are passive in nature and can in any way be separated from the business operations.

If, however, mobile income is to be interpreted in its widest form, Diageo is uncertain as to how the mobile income element of brand-based business profits would be identified. What would this look like - a return on investment for holding the intellectual property? Diageo does not consider that this is possible on the basis of any objective criteria. It is inevitable that any attempt to do so would be subjective and create a high degree of uncertainty. This is likely to result in protracted discussions between the taxpayer and HMRC, and consequently an increased compliance burden.

Diageo's view is that a CC or CFC regime should be targeted at the artificial diversion of profits from the UK and that a substance-based regime can adequately achieve this. Hence we consider that the Exempt Activities exemption, modified for the ECJ Cadbury judgment, should be retained. Furthermore, the existing transfer pricing regime addresses any issues

associated with artificially embedding profits in a low value business activity undertaken by a non-UK subsidiary.

- ***UK viewed as default location***

Diageo believes that a CC or CFC regime should not automatically presume that profits from mobile income generated overseas have been diverted from the UK, but should consider each case on the facts. For example, if profits are earned from a brand-based business carried on outside the UK, the UK has little basis for asserting UK rights to tax and to do so would be in contravention of the primary taxing rights negotiated in our treaties. Furthermore, it would override any incentive a territory has to promote investment through its own tax system.

Similarly, the UK Government should not prohibit the transfer of business activity out of the UK provided the transfer complies with current legislation and there is sufficient substance in the overseas' territory to operate the commercial activity associated with the business.

- ***Impact on Diageo***

The majority of Diageo's overseas profits are not subject to UK tax under the current CFC provisions due to satisfying one of the exemptions available for income arising as a result of genuine economic activity. The new CC regime could result in Diageo's worldwide profits arising from its brand-based businesses being subject to UK taxation. Given the situs of some of its core brands, this would result in significant incremental cost. In the context of international taxation of global business, is this what Government intended?

For example, the Baileys brand and business was developed in and has always been operated from Ireland. As a result, its profits are subject to Irish taxation. The same is true for Guinness. Given the huge commercial activity of Baileys and Guinness undertaken in Ireland, Diageo cannot comprehend how these profits could be considered passive in nature and subject to incremental UK taxation.

- ***Impact on other UK multinationals***

The adverse impact of the proposals will not be limited to brand-based businesses. Every organisation's business is based to a certain extent on intellectual property. As such, all UK multinationals would be adversely affected by these proposals. In particular, business sectors with significant intellectual property, i.e. consumer goods, pharmaceuticals, publishing, IT and telecoms would be substantial losers.

Diageo's comments in respect of the detail proposed in the CC regime are included at Appendix I.

## Taxation of foreign profits of companies - Response to the discussion document

This response sets out the following:

- A brief overview of Diageo and the nature of its business
- Fundamental points of principle associated with the proposals
- The impact of the proposals
- Alternative proposals to maintain the competitiveness of the UK whilst protecting the UK tax base
- Appendix 1 – Further comments on the proposed CC regime

### A brief overview of Diageo

Diageo is the world's leading premium drinks business with an outstanding collection of beverage alcohol brands across spirits, wine and beer categories. Diageo is a global organisation, trading in over 180 markets around the world. The company's ordinary shares are listed on the London Stock Exchange and its American Depositary Receipts are listed on the New York Stock Exchange. Its shareholder base is diverse, with only 36% of shares held in the UK and Eire. As such, it fits with the view of a multinational set out in sections 2.7 and 2.8 of the discussion document.

Its operations include producing, distilling, brewing, bottling, packaging, distributing, brand strategy development and marketing. However, in common with most (if not all) global multinationals, Diageo operates in a brand-based industry. Diageo's profits are driven by its ability to create, maintain and grow brands and the effectiveness of its brand strategies and marketing campaigns. Dedicated global brand teams located in various jurisdictions have ultimate responsibility for initiating and directing the global position and consumer strategy of specific brands. This will include establishing and maintaining the strategic direction of the brand, initiating and overseeing changes to packaging designs, ownership and control of the brand recipe, maintaining legal protection and the consistent communication of the brands' qualities to the consumer by working with lead markets on various initiatives including advertising and promotional activities.

Diageo aims to maintain and improve its market position by enhancing the consumer appeal of its brands through consistently high levels of marketing activity. The effective positioning of a brand and its successful communication to consumers is the most important differentiator of a product and is the key driver of value for the business expressed in premium pricing or increased sales. £1.2bn was spent worldwide on marketing brands in the year ended 30 June 2007.

Diageo has a number of global brands. By way of example, we have focused on two of them, Baileys Original Irish Cream Liqueur and Guinness. Both are iconic brands, whose cultural heritage is deeply rooted in Ireland, in the case of Guinness dating back 250 years.



## Fundamental points of principle associated with the proposals

We outline below our key observations with respect to the proposals, focusing primarily on the introduction of the CC regime.

### 1. Participation exemption for foreign dividends

The participation exemption proposal is welcomed in terms of simplicity, and should make the UK more competitive. However, the benefits are vastly outweighed by the proposed CC regime, given that the majority of foreign profits remitted to the UK would already have been subject to a form of UK taxation under the CC regime before they are actually remitted to the UK. Furthermore, any reduction in administrative burden would be eliminated by the onerous income tracking prescribed by the CC regime.

Two additional concerns have been identified. First, the document is silent on whether transitional rules will be introduced to deal with historical profits. We strongly recommend that transitional rules are avoided on the basis that they would be incredibly complex to manage and would increase the administrative burden. Second, an exemption regime may result in additional cost in the form of withholding tax by virtue of the 'subject to tax' provision in a number of tax treaties.

### 2. Introduction of the Controlled Company regime

The existing Controlled Foreign Company ('CFC') regime is to be replaced with an income based system that focuses on the "artificial" location of 'mobile income' that is under the control of the UK parent. For these purposes, mobile income is defined as income that is passive in nature or active income that is 'in substance passive'. In particular, this would include 'income that derives from the ownership of - or rights over - intangible assets'. The CC regime also takes the view that, with limited exceptions, the natural location for all forms of mobile income is the UK.

The discussion document does not provide any guidance as to whether mobile income will extend to profits generated from a brand-based business, where intellectual property forms an intrinsic part of that business. Discussions that have taken place during the summer between business and HMRC have created further uncertainty as to the precise scope. HMRC officials have stated that the proposed regime would include profits derived from genuine brand-based business activity. As such, our representations have been drafted on the basis of a wide interpretation of mobile income, to include profits generated from brand-based businesses.

Diageo agrees that the regime should focus on the artificial diversion of profits from the UK where there is no commercial substance to support those profits. It also supports the principle that profits of a passive nature that have been diverted from the UK should be brought within the scope of UK taxation. However, Diageo fundamentally distinguishes these situations from profits generated from a brand-based business, and believes that the UK should not be regarded as the default location for these profits.

### 3. Interest relief restriction

We note that the proposed interest relief restriction will be limited by reference to the group's total external finance costs. Although the absolute test is welcomed in terms of simplicity, it is questionable why such a limitation is necessary if a passive income element will already have been taxed under the CC regime.

The introduction of a group-based test will provide a clear competitive advantage to non-UK multinationals. Non-UK groups will be able to highly leverage their UK holdings and still obtain an interest deduction on the basis that their total group debt is likely to be significantly greater than their UK debt. Furthermore, any income that would have been subject to the CC regime is likely to be held outside the UK subgroup. This would create a playing field that is far from level, it makes UK parented groups uniquely uncompetitive in the UK.

The proposed strengthening of para 13, Schedule 9, FA 1996 is cautiously welcomed if this creates certainty. However, Diageo is concerned that the proposed wording in the discussion document will not achieve this aim. It also does not address the lack of clarity in the computation of a main benefit, when tax relief is an inevitable consequence of incurring interest expense.

### 4. Treasury Consent modernisation

The removal of criminal sanctions is welcome. We await the proposals for real time reporting but recommend an approach similar to the s765A ICTA 1988 notification rules.

## The impact of the proposals

Based on our experience, we have set out below our view of the impact of these proposals in terms of revenue neutrality, competitiveness, administrative burden and certainty.

### 1. Revenue neutrality

We understand that the aim of the proposal is to achieve a balanced broadly revenue neutral package. As such, the taxation of passive income in the new CC regime is intended to fund the proposed participation exemption.

The paper makes reference to providing '... an alternative means of protecting UK revenues'. In undertaking such a comparison, we would encourage the Government to take into account the indirect benefits of repatriation to the UK, i.e. creation of jobs.

We do not consider the package to be revenue neutral since the CC regime is written so broadly that it could amount to worldwide taxation. Most UK multinationals would be adversely affected by these proposals and any savings generated by the participation exemption would be insignificant in comparison. Does Government

have statistical information to support its assertion that the package is revenue neutral?

## 2. Competitiveness

On the basis that the proposals are not revenue neutral, UK multinationals will be placed at a distinct disadvantage to their non-UK peers. Whilst the interest provisions and participation exemption may make the UK attractive in terms of an intermediary holding company location for non-UK groups, who can avoid the worst elements of the CC regime, we assume that it is not Government's intention for UK multinationals to fund a tax system that seeks only to attract inward investment.

No other European / US jurisdiction demands worldwide taxation of profits. Consequently, the proposed regime is not competitive when compared to these economies. We believe the package does not strike the right balance between measures to attract inward investment and protection of the UK tax base.

Furthermore, it is also questionable whether the proposals comply with the basic freedoms afforded by the EU Treaty, namely Freedom of Establishment and the Free Movement of Capital.

## 3. Administrative burden

Diageo considers that the administrative burden associated with the proposals would be enormous. Any benefits obtained from the participation exemption will be replaced by a more onerous income-tracking regime. The identification process for mobile income will also add to the compliance burden.

DTR calculations are only performed on an occasional basis, i.e. when a dividend is paid to the UK. In contrast, the CC regime will introduce an annual calculation. The position is compounded by the proposal to convert the information to UK GAAP, identify the relevant costs and prepare a tax analysis based on UK tax rules.

The CC regime may seem theoretically viable but there are real concerns over its practical application. It will be a time consuming and costly exercise to reconfigure our systems in order to track income in this way and we are not aware of any FTSE 100 groups already tracking on this basis.

The CC regime does not appear to fit with the Government's commitment to the 'better regulation agenda' and 'Hampton' principles and commitment to reduce administrative burden, at both a domestic and European level. Furthermore, the proposals do not seem to support the Varney principles of HMRC links with large business.

We recognise that some compliance burden is inevitable in today's global economy. But this burden needs to be appropriate to the needs of business. Moreover, it needs to be something that HMRC can also comply with and we see no evidence that HMRC is going to be able to deal with it.



## 4. Certainty

Under the existing CFC regime, there is certainty from the 'all or nothing' entity approach. The proposal to replace this with a regime that is far more complex and subjective will render the system more uncertain than the existing one. This will inevitably increase the compliance burden and result in additional resources being required for both the taxpayer and HMRC.

## Alternative proposals

We understand the Government's intention in reforming the taxation of foreign profits and therefore set out below some suggestions as to how the current proposals could be amended to maintain and enhance the competitiveness of the UK as a holding company location whilst protecting the UK tax base.

### Participation exemption

- Transitional rules should not be introduced

### The CC regime

- No automatic default to the UK – the UK tax system should seek to tax UK economic activity and not overseas activity where there is an established business and sufficient substance
- Target profits located outside the UK without commercial substance, retaining a substance-based test built on the Exempt Activities exemption in the existing CFC regime and the Cadbury judgment. The system should take into account that UK multinationals operate in a global economy, and consequently profits earned outside the UK are often generated from activity that has never been located in the UK and therefore has not been diverted
- Exemption for overseas' profits generated from a brand-based business – where intellectual property forms an intrinsic part of a business, profits should be excluded from the regime (where the substance-based test has been satisfied)
- Retention of a motive test – an exemption to protect the taxpayer from the arbitrary effects of the CC regime. Such an exemption should apply generally to all companies where there are genuine commercial activities as well as newly acquired companies or joint venture arrangements
- Retention of a clearance mechanism – to increase certainty and reduce the compliance burden
- Introduce a 'tracing' exemption – the CC rules should allow profits which originate from genuine overseas' trading activities to be retained and used outside the UK without any UK tax charge

- Overseas' intercompany transactions – the CC regime should not apply where only the foreign tax base is eroded, e.g. where there are inter-company transactions which cause profits genuinely originated by a high tax overseas' CC to be transferred to a low tax overseas' CC through legitimate means. In the current global environment, there should be a starting presumption that it is legitimate for intra-group activities to be undertaken outside the headquartered country
- Transactions directly with the UK – we do not understand why profits arising in an overseas' CC from transactions in goods and services with its UK parent should be included within the CC regime when the existing transfer pricing regime should provide sufficient protection

#### **Interest relief restriction**

- No additional restrictions should be placed on interest – the UK already has para 13, Schedule 9, FA 1998 and thin capitalisation rules



## Appendix I – Further comments on the proposed CC regime

### **Control threshold**

Diageo awaits further clarification on the definition of control. However, it considers the proposed 10% threshold to be too low. We have joint ventures where it would be impossible to obtain this information. In a situation where we have no legal rights to demand the information and the third party is not legally obliged to provide it, how does Government suggest we comply with the regime?

Diageo does not agree that the threshold for the participation exemption and the CC regime need to be the same. It is recommended that a 50% threshold be introduced for the CC regime, consistent with “control”.

If there is a general concern that the position will be abused then targeted anti-avoidance measures should be introduced.

### **Chargeable gains**

Diageo does not agree with the inclusion of chargeable gains in the CC regime. Instead, the introduction of anti-abuse provisions targeted at conversion of income into capital is recommended.

### **Group treasury exemption**

Diageo awaits further information on this proposal, in particular, clarification as to what a ‘typical intra-group lender’ looks like with reference to its capitalisation position.

### **Same country exemption**

An exemption for certain income derived from intra-group transactions within the same country is likely to be considered discriminatory in an EU context and fails to take into account that multinationals structure themselves on a regional basis rather than a territory by territory approach. If such an exemption is to be retained then it should be extended to include the whole of the EU.

### **Incidental income**

Clarification is required as to what will be included in incidental income.

### **Other mobile income**

In a scenario where a manufacturing activity occurs in the CC’s territory but is separated from the sales activity within the same territory, it appears that the sales income would be excluded from the proposed exemptions because the products are not delivered into the CC’s territory of residence.

We consider that there is no valid reason for this exclusion and such a scenario would fall outside the exemption purely on a technicality, despite there being genuine commercial activity and substance.

We acknowledge that this is a flaw with the current CFC regime but wanted to draw it to your attention.

**UK GAAP**

Most major UK multinationals will be reporting under IFRS by 2009 and it is likely that many of their subsidiaries will also be reporting under IFRS.

Our preference would be to use local country GAAP but if this is not acceptable, we recommend that the regime be extended to include IFRS.



## Dyson

**Comment, information and issues, with discussion document chapter references.**

### **Controlled companies (“CC”)**

#### *Compliance burden*

The rules will apply to UK and non-UK subsidiaries targeting “passive” and “mobile” income streams of each entity (4.19). For the purposes of annual CC reviews, financial results of overseas group companies will have to be analysed under UK GAAP (4.31). These proposals appear to run contrary to the stated intention of reducing complexity and will significantly increase compliance costs, especially where the local tax and finance resources are limited (e.g. due to a centralised business model).

#### *Mobile and passive income*

In its opening paragraphs on the proposed CC rules (4.19), the paper seems to suggest that the scope would be broadly consistent with the existing exempt activities test. However, the later statements seem to be importing a much wider scope into the CC regime: “This would include any income to the extent that it derives from the ownership of – or rights over – intangible assets...” (4.21) and “some kinds of active income that lend themselves to the artificial location of profits” (4.28).

These and other similar statements could be read to imply that any overseas income arising from, or attributable to, intellectual property (“IP”) would be taxable in the UK under the CC rules. Such rules would penalise IP-intensive businesses like Dyson with an IP portfolio ranging from hundreds of patented innovations to numerous examples of unpatented technological “know-how” and increasingly sophisticated marketing intangibles. In addition, attribution of overseas income to IP based on accepted valuation methodologies is likely to prove to be very difficult (if not impossible) in practice, especially before the end of the relevant accounting period where such attribution will have to be done for the purposes of quarterly instalment payments.

The main concern regarding taxation of IP-related income under the CC rules is that such income and its geographic distribution within multinational groups appear to be increasingly seen by the government as effective tools of aggressive tax avoidance. It has to be remembered, however, that for multinational IP-intensive businesses like Dyson (see further), IP retains its primary economic meaning of a complex portfolio of strategic assets that are much more than a bundle of legal documents which can be stored in any low-tax jurisdiction. If the government is concerned with IP being used as means of abusive tax avoidance, it could target such practices by tighter exit rules for the existing IP based in the UK (perhaps similar to the “transfer of package” provisions introduced by Germany).

It is equally important that a motive exemption is introduced for businesses established overseas for genuine commercial reasons where this original purpose is supported by the “economic reality” of the existing arrangements. This “economic reality” test could be based on the criteria formulated in the ECJ judgement on Cadbury Schweppes (C-196/04). For instance, the Dyson group has located its manufacturing-related operations overseas (as it happens, in countries with relatively high rates of company taxation) to make its business competitive in the face of the growing global competition, and this commercial logic should not be penalised by a heavy international tax compliance regime. The majority of the UK multinational businesses have substantial presence in countries like China, Malaysia and India (for low cost manufacturing, efficient supply chain, market penetration or other reasons). The motive exemption will be an acknowledgement of these commercial decisions and their underlying economic rationale.

14 September 2007

Direct Line:  
e-mail:

### **Discussion document on the taxation of the foreign profits of companies**

Please find attached Ernst & Young's response to the discussion document on the taxation of foreign profits. As tax advisors to a significant number of large businesses, we welcome this opportunity to comment on what has the potential to generate significant changes to the tax treatment of multinational companies.

The appendix to this letter sets out our comments on the specific proposals contained within the discussion document but we would like to take the opportunity to raise some more general comments on the issues raised. It would appear that the drive to ensure that the new regime as a whole is 'broadly revenue neutral' has created a potential regime for controlled companies that is arguably unrealistic, unworkable and potentially damaging. Taken as a package the proposals do not achieve the Government's objective of maintaining a competitive tax system for business and we would, therefore, urge the Government to reconsider the workability of the controlled company proposals.

We would also like to highlight the fact that the discussion document is framed in the context of a traditional 'manufacturer' type organisation. It therefore has limited recognition of some of the complexities and particular issues associated with the financial services business and organisational model and, most notably, the regulatory constraints. In the light of the highly successful consultation on life assurance, we would encourage the Government to refer the details on specific industries (financial services in particular) to the relevant industry teams for specific industry consultation.

The consultation document presents a coherent approach to the regime as a whole but the failure to deal with the taxation of branches brings a level of uncertainty that is unhelpful. Added to this, the proposals in respect of interest deductibility are the least well defined and we would appreciate further clarification in order to understand how they will operate in practice.

Although the consultation process is productive and helpful, we are concerned that protracted consultation will bring with it continued uncertainty in relation to the taxation of foreign profits which will create a deterrent for people considering investment in the UK.

Finally, we would encourage the Government to consider further the compatibility of the proposals with EU law and the possibility that the overall package of measures could be considered to be discriminatory. The implementation of a new regime will already be unsettling for businesses and a subsequent change as a result of an ECJ case would bring significant uncertainty. We would, therefore, urge the Government to ensure that the proposals are watertight in this respect.

We hope that you find our comments useful. Please do not hesitate to contact us if you require further information.

Yours sincerely  
For and on behalf of Ernst & Young LLP

Head of Tax Policy

## **DETAILED COMMENTS**

This paper provides detailed commentary on the elements of the discussion document on the taxation of the foreign profits of companies. However, before providing such comments, we would like to note that we are concerned at the portrayal of the set of measures as a balanced and 'broadly revenue neutral' package. As will be set out, we believe that the effect as a whole of the current proposals would be to deplete the UK's competitiveness considerably and potentially deter investment. We have, therefore, made the following suggestions for improvements.

## **DIVIDENDS**

### **Participation exemption**

The proposed participation exemption regime in isolation should enhance the attractiveness of the UK as a hub for business investment. However, we are concerned that the compliance burden that would be engendered by the CC regime, coupled with the interest deductibility proposals, would be enough to deter those for whom the participation exemption might have been attractive.

In addition, the interaction of this proposed participation exemption with the new CC rules would require the retention of the existing 'taxation with credit' regime in a number of circumstances which removes a key benefit of the reform. For some groups, the disadvantages of the proposed CC rules may outweigh the benefits of the dividend exemption. For the same reasons, we do not believe a transitional regime is required.

Although we support this measure, we believe that further detailed work is necessary to identify consequential changes that will need to be made. This will extend beyond the UK tax system. For example, the exemption could trigger overseas CFC rules exposing the income to overseas taxation. Companies might therefore choose another location. Investors in other locations will also be impacted in this way and we would ask the Government to take this into account in developing more detailed proposals.

### **The behavioural response**

Behavioural consequences are extremely difficult to predict, particularly given the broadness of the current proposals. Nevertheless, we appreciate that it is important to gauge the level of behavioural change in terms of estimating the likely revenue impact of the proposals, particularly given the Government's requirements as to broad revenue neutrality.

As indicated, in isolation a dividend exemption system would be a positive move that should allow for funds currently held overseas to be brought back to the UK. To the extent that these funds would have been stranded offshore and once repatriated, remain in the UK (which may not necessarily be the case), the repatriation of such funds could generate future UK revenue. Similarly, a dividend exemption system could result in upstream lending being replaced by dividend payments, removing the interest deduction on the upstream loans.

On the opposite side, we believe that the loss to the UK Exchequer should be small, since little UK tax is currently paid on overseas dividends. We would also suggest that the experience of the USA on the introduction of the Jobs Creation Act 2004 would be a useful benchmark in terms of behavioural change. We comment separately on the behavioural impact of the CC changes.

### **Portfolio dividends**

We believe that the arguments for not taxing overseas subsidiaries also apply to investment in overseas shares at the 'portfolio' level. The participation exemption is an appropriate mechanism for those organisations that are not trading in shares and provides few opportunities for avoidance as shareholdings of less than 10% offer little control.

In contrast, a system which allows credit for underlying tax, would represent a significant compliance burden and may not even be possible in practice due to the management information requirements. If the credit regime were to be retained, making this an elective regime would significantly improve the workability of this approach.

In our view, the next alternative, ie full exemption, is arguably the cleanest option although further work will be needed to evaluate the impact on other areas of the tax code, particularly in the securities lending and synthetic equity markets.

The final alternative of fully taxing both UK and foreign dividends could impose an additional layer of tax on portfolio dividends. This could have a disproportionate impact on certain sectors, for example in the life assurance and investment fund area where savings vehicles are prevalent and could also undermine the use of tax incentives (such as R&D tax credits) which would be taxed in the share owning company.

To be a viable alternative, it may be that the UK would need to either incorporate a lower rate of tax or indeed a carve out for certain industries (although the latter may be low given the need to ensure EU compliance).

### **Sectoral issues**

The favoured answer is likely to vary on an industry by industry basis. The proposals for portfolio dividends have particular significance for the insurance industry. The dividend exemption could have the effect under some treaties of actually increasing withholding taxes because some treaties remove withholding taxes only where 'subject to tax'. This will be a particular issue for companies where income is exempt as is already the case where it is allocated to pension business. Such businesses are likely to prefer the underlying tax route providing it is elective. That would allow companies to forgo the credit if the administrative burden of claiming it gets too complex.

## **CONTROLLED COMPANIES REGIME**

We have strong concerns as to the potential negative impact that the controlled company provisions would have on the UK's competitiveness. Rather than comment on the specific questions raised by the Government in relation to the proposed controlled company regime,

we would like to raise some high level concerns with the regime as a whole and propose ways to resolve the issues.

Looking at the proposals on the basis of our clients' interests, it is our view that the CC regime would be a negative step for the following reasons:

- The CC proposals will significantly increase the compliance burden. For example, the need to account for passive income specifically in UK GAAP, rather than IFRS, will present difficulties for many organisations. Conversion to UK GAAP from IFRS or local GAAP may be problematic and burdensome.
- The proposals could vastly increase the reach of the current CFC legislation and expose to UK taxation so much additional income currently not taxable.

### **Compliance burden**

Chief among the concerns arising from the CC proposals is the additional compliance burden it would bring. At best it would be onerous for companies to comply with the proposals and, at worst, impossible. The Discussion Document questions whether management accounts would show the necessary information in order to determine the nature of the underlying income. Our experience is that this is far from reality for many companies, especially in the context of associate investments and joint ventures, where the accessibility of management information from companies may be limited. Many multinationals already struggle to obtain the required information for the accounts where they have a 49% holding. To obtain the level of detail required in the proposals would arguably be virtually impossible in a commercial scenario, particularly where the third parties involved are unwilling to cooperate.

In light of this, we believe that the proposals neither "improve clarity and transparency" nor "make the rules more certain and straightforward in application" – they are in fact a significant move in the opposite direction.

This is a particular concern in relation to the definitions of 'active', 'passive' and 'mobile' which will bring uncertainty and complexity to the new regime. For example, the Discussion Document indicates that rent would be considered to be passive income which, in our view, overlooks the existence of rents as part of a trade. Similarly, in 4.21 intangible assets are specifically identified as assets from which the income is deemed to arise from an investment business. We would take issue from such sweeping assumptions.

Furthermore, it is our understanding that it has been argued that ordinary income can be disaggregated into embedded intangibles. From a transfer pricing perspective, this means that studies will be required to extract the values of the intangibles that are currently sitting in cross-border trades, which would be extremely complex and impractical.

### **The role of the CC regime in protecting revenue**

We agree that the role of the CC regime should be to 'provide appropriate protection for the UK tax base on any move to exemption'. However, we believe that the proposed regime extends beyond this, both in bringing into UK tax foreign profits that have no links to the UK and in situations where there was no motive to deplete the UK tax base. We therefore recommend the following changes in addition to our concerns noted above:

- The proposals assume that the CC regime should start at the same level as the participation exemption. We do not believe that this is necessary or practical. A 10% shareholding provides very limited access and no control. From an Exchequer risk perspective, there is little, if any, incentive to put money into a business in which only say 20% is owned as the net result would be the giving away of 80% of the return.

It is our view that, if the Government proceeds with a CC regime, the limit should be raised to a more realistic level such as 50%.

- Clearly the proposed CC rules bear a close resemblance to the US Sub-Part F provisions but the Government appears not to have taken the opportunity to learn from the difficulties inherent in that regime. In particular, the requirement that the source of every item of income should be determined in addition to the basis for its valuation and recognition, particularly in multi-tiered structures will be very problematic. We would also encourage the Government to include similar general financing exemptions for securitisation vehicles, for example.
- The current motive test is an important mechanism to protect genuine overseas operations although the current legislation and the way it is applied means that it does not achieve the intended result. We strongly recommend a motive test should be retained with such potentially wide ranging CC rules and we believe that it should be possible to draft a more closely targeted test which exempts bona fide overseas operations from the compliance and tax burden of the CC rules. This may require HMRC to be more specific about the kind of operations it is seeking to attack.

There is an underlying assumption that the income being targeted is very mobile. However, in the financial services sector, regulatory restrictions will act in two ways: first as an inhibitor to movement, reducing the need for specific tax rules and second by requiring additional amounts of capital to be held the return on which might fall within an arbitrary definition of passive income.

It is also worth mentioning here the specific issue of the impact on inbound IPOs where the holding company is UK incorporated but not UK tax resident. Such companies fall within the existing CFC regime by virtue of S747(1B) but the motive exemption is available to them. In our view, S747(1B) should not be replicated in the new CC rules. This is a specific issue for foreign groups seeking to list on the London Stock Exchange.

## INTEREST AND OTHER ELEMENTS

### Interest deductibility

The continued discussion in respect of interest deductibility, albeit constrained, leaves some uncertainty as to the net impact on competitiveness. In particular, the first proposed change limiting UK interest relief to the extent of the group's overall external financing costs may have significant impact for many businesses and changes the competitive position of different businesses (ie foreign owned or UK headquartered).

Groups with little or no external financing would be restricted in their ability to claim a deduction for their interest expense in the UK. Use of net interest expense per the accounts does not provide a simple comparison since the accounts may classify transactions differently.

We understand that it has been argued that any interest that is not paid outside the group is merely a mechanism of moving taxable income from one country to another and hence companies should only get relief for external interest. We do not agree with this analysis since this argument does not apply where there is less than 100% ownership. Furthermore, this would create significant distortions. For example, a US company that has a UK subsidiary competing with similar companies that are UK owned, would want to put itself in the same debt:equity position as those UK companies and hence would normally borrow from the parent. The US group may have a more prudent approach on regulatory capital because it is targeting a different set of risks.

Similarly, a foreign owned company may want to make acquisitions, competing with private equity houses. If the foreign company is a trading house that potentially has surplus cash, these rules could affect the terms of the deal that they are able to offer and might also stop them doing business here altogether.

Treasury operations in the commercial sector are far more complex than envisaged by the discussion document. There can be genuine commercial reasons for having different debt:equity ratios at different levels within the group and hence we do not agree that higher funding costs than the overall group 'strongly indicates that the UK sub-group's finance costs are not commercial'.

At the most basic level we support the logic of wanting to prevent organisations getting tax relief simply for moving things from one place to another but think that distinguishing such actions from genuine commercial realities will be extremely difficult. There are likely to be a number of unforeseen and unjustified consequences.

These rules would overrule the ability of UK companies to obtain tax relief on interest payable on borrowings which were on arm's length terms. For the above reasons, we do not believe this is justified and consider that the protection of the UK's transfer pricing regime should be sufficient. We have yet to see a convincing case as to why additional rules are needed to deter the tax motivated leverage of UK subsidiaries. In particular, it is not clear why the current legislation is not effective or not entirely effective in deterring avoidance

using cross-border interest flows. The proposed cap on interest deductions would introduce an arbitrary limit on interest deductions not necessarily related to arm's length borrowing capacity of UK companies.

If the Government does proceed with these rules, we believe that transitional rules for overseas investors are an absolute necessity.

### **Unallowable purpose**

The extension of the 'unallowable purpose' rule causes some concern, as the move from an objective test to a subjective test is likely to result in a greater degree of uncertainty with regard to the deductibility of interest relief in the UK, which in turn raises concerns in terms of the competitiveness of the UK tax system.

We would encourage the Government to consider the repeal of anti-arbitrage rules, since the widening of the unallowable purpose test as proposed would potentially replicate the effect of those rules. We would also recommend that purpose should be judged by reference to benefit. Finally, we would ask the Government to evaluate fully and consult further on the possible adverse effects of any new or more complex legislation on UK inward investment.

We question whether additional anti-avoidance provision is needed at all, given the purpose test already inherent in Schedule 28AA ICTA 1988, and the existence of the anti-arbitrage rules, which permit consideration of the group purpose for debt. The anti-arbitrage rules only apply where the relevant arrangements include hybrid entities or entities where the main or a main purpose for the inclusion of those entities or instruments within those arrangements is to obtain a UK tax advantage. However, when these rules were introduced they were presented as a proportionate measure which would suffice to limit cases of tax-motivated UK leveraging. If the unallowable purpose test is to be widened to allow consideration of the group purpose (rather than solely that of the immediate borrower) then we suggest that the anti-arbitrage rules should be repealed, as they will potentially be replicated in the wider unallowable purpose test.

We consider that there is a risk that, if additional anti-avoidance legislation is introduced and there are no modifications to existing legislation, the UK legislative environment will be overly complex, and that this will discourage inward investment, with possible disadvantageous consequences for the group as a whole.

We are concerned that the Government is in danger of defining purpose by reference to benefit, whereas it has always been important in tax case law to distinguish between the two. A UK tax advantage may arise where it was not the main or a main purpose of the making of the loan to obtain such an advantage.

If the Government introduces any additional rules or amendments to the unallowable purpose test, it needs to offer an integrated clearance procedure so that taxpayers can obtain certainty as to their interest costs under all potentially applicable legislation.

## **TREASURY CONSENT**

We are unable to see any justification for the introduction of another information power, particularly when the existing disclosure regime would appear to fulfil this purpose. It is our view that HMRC already has all the information and information powers necessary. There is no case for a new information power but if one is going to be introduced to enable real time reporting, it is our view that something along the lines of S765A ICTA 1988 would be the kind of benchmark to follow.



12 September 2007

Dear [redacted]

**Taxation of companies' foreign profits: discussion document**

**Introduction**

As I am sure that you are already aware, ExxonMobil has a significant presence in the UK and on the UK Continental Shelf. We have been operating in the UK for well over a hundred years and we are the largest foreign inward investor in the UK, having invested more than £30 billion in the UK. We are also responsible for the payment of over £5 billion of taxes each year which makes us one of the largest taxpayers in the UK.

As a general rule, ExxonMobil does not run its foreign operations through the UK. Accordingly, we had not expected to be much affected by the June 2007 discussion document on the taxation of foreign profits of companies. However, there are two aspects of the proposals that worry us greatly. These are (1) the proposed new restriction on the deductibility of interest by reference to the group's total consolidated external finance costs and (2) the proposed extension of the new controlled company (CC) rules to UK subsidiaries.

**(1) Restriction on interest deductibility**

The proposal to limit interest deductions in the UK by reference to a group's total consolidated external finance costs is presented in the discussion document as a limited, targeted reform designed especially (but admittedly not exclusively) to ensure the robustness of the rules following the introduction of an exemption system for foreign dividends (para 1.7). It is stated that no wide-ranging changes to the regime for the relief of interest are envisaged but only some limited, targeted changes to tackle abuse (para 1.18). Great play is made of the point that the proposals do not include any general restriction on the amount of interest relief currently given (para 5.1) and that in particular the idea of interest apportionment is not being pursued (para 5.6).

These changes may be welcomed by some parts of UK industry but they cannot be welcomed by ExxonMobil. In particular, what is being proposed here by way of a new worldwide restriction on interest deductibility is totally arbitrary and unprincipled. It is directly contrary to all of the arm's length principles that lie at the heart of much of the UK tax system - and indeed the tax systems of most (if not all) of the OECD countries. It penalises UK subsidiaries for the financial structure of their parent companies, over which they can exert no control, and alters the competitive balance between them and local companies that have adopted different capital structures. It would have



Registered in England  
Number: 1589650  
Registered Office

the effect of increasing the cost of investment, both past and future. The present UK tax rules on thin capitalisation work perfectly adequately by restricting the deductions available to a UK taxpayer by reference to the commercial level of debt that would be available on an arm's length basis. This has a firm basis in logic and fairness and avoids discrimination based on factors outside the UK over which the taxpayer has no influence. The proposed new restriction would deviate significantly from that basis and would serve to undermine the inherent trust that multinationals have in tax regimes that are rooted fairly in arm's length principles.

Put another way, the new restriction would totally ignore the wide financial and commercial variations that exist across both countries and industry segments. These variations result in a variety of different capital structures designed to achieve an acceptable and competitive cost of capital. In this context, whether or not all these structures are or are not tax defensible should depend on the application of well understood and trusted arm's length principles rather than on an arbitrary reference to a parent's accounts.

The proposed new restriction would also lead to uncertainty and unpredictability. A non-UK group's total consolidated external finance costs could well fluctuate significantly from year to year for reasons unrelated to the UK environment and this would lead to instability and turbulence within the tax system for its UK subsidiaries.

In terms of establishing a fair system of taxation, the arm's length principle can be applied equally well to UK parented and non-UK parented multinationals in contrast with the proposed new rule. In this context, it is interesting to note the fierce opposition of UK PLC to the then proposed earnings stripping rules in the US which would have similarly introduced arbitrary and formulaic restrictions on UK companies investing in the US. It seems that the boot is on the other foot now.

In ExxonMobil's case, the immediate effect of the proposed new restriction would be to put in jeopardy UK tax deductions of hundreds of millions of pounds. As we stand to receive little or no benefit from the other proposed tax changes, this would be of great concern. It also raises serious questions about the stated aim of the package of structural reform which is to deliver a balanced, broadly revenue-neutral package (para 1.10). Longer term, it would also raise the cost of capital for doing business in the UK.

If it is the case that some additional restriction on interest deductions needs to be introduced to counter tax abuse that might otherwise accompany the introduction of an exemption system for foreign profits, then something more principled should be designed for that specific purpose.

## **(2) Extension of the CC rules to UK subsidiaries**

It is assumed that the proposed extension of the new CC rules to the income of UK subsidiaries is designed to ensure compliance of the new rules with EU law. Indeed, when account is taken of the proposed system of compensating adjustments (as also used in the UK to UK transfer pricing context), it is clear that no UK tax is here at stake. It seems to be equally clear that the compliance burden associated with this proposal would be totally disproportionate to the amount of tax at stake (being presumably nil in most - if not all - cases).

Even if such rules are required to ensure EU compliance (which some commentators doubt), there should be introduced some sort of effective carve-out - as indeed currently exists in the present controlled foreign company regime. For example, a carve-out for income that is already subject to a threshold rate of tax would have the effect of excluding the mobile income of UK subsidiaries at

a stroke. If for whatever reason this is not acceptable, some other solution needs to be found which has the practical effect of eliminating the need for a huge unproductive compliance cost.

In ExxonMobil's case, we have recently established in the UK financing arrangements which involve two separate companies whose total borrowings exceed US\$9,000 million. The scope of their activities includes the lending of monies to one of our major joint venture projects in Qatar. We have discussed and agreed with HMRC exactly how these entities should be subject to UK tax. If the income of these two companies were to be subject to the proposed new CC rules - and given that they would also be caught up by the introduction of the sort of arbitrary interest restriction discussed at (1) above - it is likely that consideration would have to be given to moving all their activities from the UK.

In this respect, it is noted that there is envisaged an exemption for income from genuine active finance business (para 4.23 and 4.24). Whether or not this exemption would apply to our two finance companies would depend on how the exemption were to be drafted. We would advocate that this exemption should be framed in as generous a fashion as possible and we would be happy to offer any assistance that we can in this respect.

## Conclusion

The government's aim to modernise the UK tax regime in its application to the taxation of foreign profits is a laudable one. As such, it should be supported by taxpayers who also want the UK to have an internationally competitive system of taxation. And this discussion document contains many bold proposals which would represent a step forward for the UK. However, at present, they are accompanied by certain aspects which cause us considerable concern - as described in more detail above.

The result, as it stands, would be the creation of an uncompetitive tax regime weighed down by a disproportionately heavy compliance burden. This is not where government nor industry wants to be.

We are reassured that HM Treasury and HMRC appear to be positively encouraging dialogue in this area. As a multinational company which appears to be caught in the backwash of the proposed changes, we hope that you will listen sympathetically to our concerns and we shall of course be more than happy to be fully involved in any further discussions on the subject.

Yours sincerely

Head of Tax

Cc: Client Relationship Manager, Large Business Service, HMRC

Registered in England  
Number: 1589650  
Registered Office: \_\_\_\_\_



## FLA RESPONSE TO THE HM TREASURY/HMRC CONSULTATION ON TAXATION OF COMPANIES' FOREIGN PROFITS

1. This is the response of the Finance & Leasing Association (FLA) to the HMT/HMRC consultation document 'Taxation of companies' foreign profits: discussion document' issued in June.
2. FLA members provided £27.1 billion of new finance in 2006 to the business sector and UK public services, representing 30% of all fixed capital investment in the UK in 2006 (excluding real property). £18.4 billion of finance was provided to the motor sector. FLA members financed at least 50% of all new car registrations in the UK in 2006. A number of FLA members do significant business overseas and pay UK corporation tax.
3. As a general point, the proposals set out in the document would lead to a significantly increased compliance burden compared with the present system.
4. Leasing figures in at least two ways in the new regime outlined in the consultation document.
5. First, the new Controlled Companies (CC) regime will be targeting in a more focussed way income that the current CFC rules already aim to capture. The main category of targeted income will be so-called passive (or investment) income. The definition of that includes 'rent' (see paragraph 4.20 of the condoc). HMRC said at the June London open meeting on 9 July that 'rent' includes "rents for the use of any property or equipment or other assets you might rent **or lease**."
6. Second, to avoid capturing genuine commercial income that would otherwise fall within this definition, the condoc proposes exemptions, including an "active finance exemption", which would exempt certain income from genuine active banking, financial, insurance activity and property investment businesses. HMRC has e-mailed the FLA on leasing in this context:

"The proposals for a new Controlled Companies regime in the discussion document include an exemption for certain income from genuine active finance business. In principle this would include some full service third party leasing business, for example leasing undertaken for foreign customers by a controlled company which bears its own financing costs and is appropriately capitalised. ...

We would welcome any material they would like to provide on this issue, to inform detailed design work."



INVESTOR IN PEOPLE

All limited companies  
Registered in England No 2931348

REGISTERED OFFICE: FLA, IMPERIAL HOUSE,

Te.

Fax: [REDACTED]

E-mail:

Web:

7. The condoc acknowledges that the Government's thinking is at an early stage. Correspondingly the FLA can also see a number of possible ways forward, and we will use our best endeavours to collect relevant material once the picture becomes clearer.
8. The FLA's position is that genuine active leasing businesses should be treated on all fours with other financial businesses in terms of appropriate reliefs from the new CC regime. Our specific suggestions in 10 and 11 below are designed to achieve this. The suggestion at 12 deals with an important issue for rents not qualifying for any relief,
9. We understand from our US colleagues that the temporary US active financing exemption from Subpart F, mentioned in the discussion document condoc as an inspiration for the ideas on a UK active finance exemption, is an important source from a general policy perspective. However, the US active financing exemption, along with other Subpart F exemption provisions relevant for financial services organizations, has significant restrictions and complexities which are limiting to cross-border financial services businesses. Subpart F and the various exemptions are being reviewed by the US Treasury as part of a desire to enhance US competitiveness and reduce complexity. We support the policy goal of developing an active financing exemption. We understand that US financial services providers are lobbying hard for the US version to be made permanent. We find that reassuring, though we have not yet explored the US legislation in detail and, therefore, are unable to provide specific comments or concerns. But we would certainly urge HMT/HMRC to consider expanding the currently envisaged exemption to include an active rent exemption for commercial leasing businesses, consistent with the US policy of including active rents within the US active financing exemption, but expanded to encompass cross border commercial leasing activities, as provided for in Subpart F. The FLA is keen to work with HMRC to assist in scoping the exemption.
10. In addition, we believe that there should be an exemption for rent paid out of active income. It is proposed in the condoc that interest paid out by an active business conducted elsewhere in the group should be exempt. This should be extended to rent so paid. It is relevant that HMRC said at the 9 July meeting that in calculating how UK net finance costs would be capped, they would include the interest element of finance leases.
11. In addition we believe that:
  - i. Rent should be one of the specified classes of income for the proposed "same country" exemption; and
  - ii. capital gains on actively rented assets should be exempt.

12. Clearly there will be circumstances where lease rents will not be exempt and will fall within the CC regime. In such circumstances, we consider that the new CC regime should not bring within the scope of UK tax more than the commercial income earned. In the case of leasing, it is essential that in computing income for CC purposes, the overseas leasing (OL) rules are disapplied in respect of pre-April 2006 leases to which they might otherwise apply. There is no need for the OL rules to apply, assuming that - like CFC losses - CC losses will not be relievable against other income. And they would potentially operate very unfairly, in particular where companies become Controlled Companies as a result of the change of law. Since HMRC made clear in the consultations on the leasing regime in FA 2006 that the latter eased cross border leasing taxation, it would be ironic if the new CC proposals caused taxation on far more than the commercial profits on pre-April 2006 leases within its scope.
13. We would also appreciate some clarification of what HMT/HMRC has in mind by the expression "full service third party leasing business". What criteria would be used to establish whether a leasing business qualifies as a "genuine active finance business". Bearing its own finance costs and being appropriately capitalised are fairly easy tests to satisfy but would HMRC expect the company to have its own full-time employees, for example?
14. We have a number of more specific points, which we would like to explore with officials:
- (i) The banking exemption to be provided from the controlled companies rules should embrace leasing activity which takes place within an ordinary banking business). (And other companies' position correspondingly needs to be clarified.)
  - (ii) The position of operating leasing needs to be clarified, judging by US experience.
  - (iii) On interest relief there needs to be an exclusion for leasing companies within manufacturing groups.
  - (iv) It is proposed in the discussion document that interest claimed by the UK members of a multi-national group should be restricted by reference to the group's total consolidated external finance. The FLA considers that further consideration should be given to assess the implications on, for example, manufacturing groups with captive finance companies, seeking to use the UK as a European holding location for European vendor finance programmes. The arm's length debt/equity ratio in the UK may be higher than that for the worldwide group due to the relatively higher proportion of finance business held through the UK compared to manufacturing business.

Contact: : ~~\_\_\_\_\_~~

For more about FLA please visit our e-politix micro-site at  
~~\_\_\_\_\_~~

Head of Taxation

Direct Tel:  
Secretary:  
Direct Fax:  
Email:14<sup>th</sup> September 2007

By e-mail and letter

Dear \_\_\_\_\_

I write on behalf of GKN plc in response to the Discussion Document entitled "Taxation of the foreign profits of companies: a discussion document".

GKN plc is a FTSE250 global engineering Group focused on the automotive and aerospace sectors with sales of over £3.8billion in more than 30 countries and employs over 40,000 employees worldwide. The comments in this letter are therefore provided by a global manufacturing group with a UK base but with the majority of its income and profits earned outside the UK.

Overall we support the need to reform the current system for taxing foreign profits to ensure that the UK remains fiscally competitive but the proposals outlined (so far as we can understand them from the limited outline provided) are disappointing and potentially damaging for several reasons:-

- The treatment of dividends may not go far enough soon enough to make the UK competitive
- The outline of the interest and CC changes are too arbitrary in nature in that they appear to move away from a system based on "arm's length"/OECD principles and commercial substance. The concept of worldwide taxation of intangible income is a case in point.
- Whilst the use of an "income" based CC system has the potential to be more targeted than an "entity" based CFC system the discussion document hints at extending the reach of the UK tax system to overseas profits which, without adequate and sensible checks and balances, would not be subject to such jurisdiction under normal tax and commercial principles.
- The document appears to confuse a simple system (e.g. for interest relief; the CC regime) with the compliance burden it engenders. It appears from discussions with HMT that the current Transfer Pricing rules are too difficult to invoke to protect the UK Exchequer from international tax planning structures – whilst this may be so it does not justify introducing an arbitrary system that has a disconnect with underlying facts and circumstances. It is better to have a system that is fair but complex to administer than have a simple system that



is unfair in the way it allocates taxing rights to one country from another with the potential for double taxation.

- In moving to an income based CC regime HMT need to recognise that the compliance burden will increase significantly for UK taxpayers and that this can only be removed or mitigated by a sensibly drawn system with appropriate exclusions and exemptions to ensure that only the material and "artificial" structures that adversely impact UK taxable income are targeted

Moving on to the questions raised in the discussion document:-

## Dividends

We welcome an exemption based system for taxing foreign dividends. We are disappointed that the change could not be considered for introduction earlier than FB2009. We accept that the existing CFC or a new CC income based regime may need to be amended/introduced to counteract some of the more extreme abuses that an exemption system could allow but the proposals for a CC regime go far beyond fiscal neutrality and require significant changes, exemptions and exclusions to be introduced before it is appropriate for the UK (see below).

- **Whether exemption of participation dividend income, coupled with the new CC regime and limited, targeted interest restriction, is more appropriate for large and medium business than the current approach of taxing dividends and giving credit for any foreign tax paid?;**

*GKN Response:*

*It is recognised that an increasing number of territories, particularly in Europe, have adopted a participation exemption in respect of dividends. In maintaining the competitiveness of the UK tax system, HM Treasury and HMRC are to be congratulated on proposing a full rather than partial exemption of participation dividend income.*

*It is important that such an exemption is as complete as possible with few exceptions. It should also apply to dividends paid after the effective date – with limited exceptions to reasonably counteract any "forestalling" activities by taxpayers.*

- **What dividends from controlled companies would it be appropriate to exclude from exemption?**

*GKN Response:*

*It is reasonable to exclude any ADP dividends paid under the current CFC regime from exemption. If there are to be forestalling countermeasures then we request that they are targeted and for a limited transition period. For the exemption to work and achieve a saving in compliance costs it is vital that substantially all dividends paid after an effective date are exempt even where they are paid out of*



*profits earned before that date – not to do this would require the simultaneous operation of two very different tax systems with a consequent substantial increase in tax compliance burden. The forestalling anti avoidance could, for example, only apply to profits earned in the period from the date of the discussion document or a date close to this (say) 30<sup>th</sup> June 2007 to a backstop date of (say) 30<sup>th</sup> June 2014. In that period the target should be artificial arrangements set-up to boost foreign profits in a tax effective CC environment – there would need to be grandfathering of arrangements already in place prior to 30<sup>th</sup> June 2007.*

*The treatment of UK to UK dividends is unclear especially where forestalling anti avoidance captures a purely UK to UK arrangement – would a dividend from the UK company become taxable under the proposed reform? How would underlying tax credits be calculated in cases where group relief applies to eradicate a tax liability in the paying company?*

- **Whether a simplified credit system, with a CC regime applying only to specifically defined passive income is a more appropriate approach for smaller business;**

*GKN Response:*

*Since GKN is a large taxpayer it is not appropriate to comment on this aspect of the outline reform.*

- **The likely behavioural consequences of the package, as context for decisions on what further anti-abuse rules, if any, may be necessary to prevent abuse of dividend exemption**

*GKN Response:*

*The welcome simplicity of a participation system could be tainted if it is accompanied by the introduction of onerous grandfathering or transition provisions, such as the participation exemption only applying to overseas profits earned after the introduction of the new regime.*

*We believe that a simple and comprehensive participation exemption will encourage UK parents to repatriate their low taxed overseas profits. GKN itself has significant overseas reserves which have a low underlying tax credit due to the impact of commercial reorganisations benefiting from local participation exemptions – we would want to remit these to the UK as soon as possible to increase UK earnings which will assist the parent company in funding future dividends payable to outside shareholders. GKN would not be alone in this regard and we believe HM Treasury and HMRC should encourage this as a consequence of a dividend participation exemption rather than seeking to penalise companies who defer the repatriation of overseas dividends until after the introduction of the exemption.*

*We believe that only in a small number of cases would taxpayers seek to abuse this system by over capitalising offshore companies and that targeted anti*



*avoidance measures are needed that address structures that are not arm's length or lack substance and are artificial in nature.*

- **In relation to portfolio dividends the Government welcomes comment on the three options, the likely behavioural response to these options, and whether other options are available.**

*GKN Response:*

*The Corpus of EU law that is building up suggests that it is discriminatory to treat the receipt of UK source dividends in a different manner to the receipt of overseas (particularly European) dividends. It is also recognised that in the interests of simplifying the tax system it is not desirable to create a system that could differentiate the taxation of dividends depending on whether they are EU or non EU source dividends, as this would simply add additional complexity to the tax system. It would therefore seem desirable to adopt a harmonised approach to all dividends.*

*Such an approach should meet the goals of creating a more straightforward system for the taxation of foreign profits.*

*One of the difficulties of taxing portfolio dividends is that the holding may be too small to be able to secure the information required to calculate underlying tax. For example, a holder of 1% of the Ordinary Share Capital of a company may have access to the financial statements of a company but not to the tax records required to calculate the underlying tax. It would therefore seem that introducing a system whereby portfolio dividends were taxable but received a credit for underlying tax, while appearing non-discriminatory from a cross-border perspective, could be disadvantageous depending on the size of holding, and could provide a disincentive to investment in portfolio dividends.*

*Again the treatment of UK to UK portfolio dividends is unclear under these proposals.*

*It would seem that the preferable approach to portfolio dividends, that would meet the objectives of being non-discriminatory and providing a competitive system, would be to provide an exemption for foreign dividends.*

## **Controlled companies regime**

We believe that an income based CC regime is appropriate provided the system is in accordance with OECD and arm's length principles, targets artificial structures and abuses and is fair and not over burdensome. The outline in the document does not achieve any of these requirements and a great deal of consultation with business is required to refine the proposals if they are not to damage UK industry's competitiveness with companies taxable under more favourable regimes.



The proposed rules will significantly increase the compliance burden for GKN because every company's income will need to be analysed with care and most of this may not be separately identified under current accounting reporting structures.

- **The overall approach of the proposed regime, including whether application to UK as well as foreign subsidiaries will be useful in preventing artificial location of profits within the UK and in limiting remaining uncertainties regarding the extent of EU law in the field of anti-avoidance, or how else these uncertainties might be addressed;**

*GKN Response:*

*It is understood that the controlled company regime will be focused on passive income and other mobile income that is within the control and disposition of the UK parent of the group and apply (in relation to the passive income part of the regime) to controlled UK subsidiaries as well as controlled foreign companies.*

*The proposal recognises that where controlled company income is apportioned from UK companies, relief would be provided by way of compensating adjustments. The method of applying the controlled company regime and operating compensating adjustments to UK companies could significantly disadvantage UK groups.*

### **Example**

*Most UK headquartered groups will have a listed top company with a number of other head office companies providing particular activities, such as a group Treasury activity, intra-group services or even a UK Intellectual Property company. It is likely that those services are provided for the benefit of group members and that the services are provided at an arm's length rate as required by Sch 28AA ICTA 1988.*

*In the light of economic conditions in recent years it is quite possible that UK groups have significant losses, for example arising from payments to reduce Pension Fund deficits. UK groups may have utilised the UK Group Relief provisions to ensure that any brought forward UK tax losses are carried forward as losses or non trading debits in companies that they expect to generate future taxable income (e.g. in the form of non trading credits or intra-group services).*

*Under the proposed regime all these sources of income would be allocated to the UK parent company. The companies that actually generate that income will be given a compensating credit so that they are not subject to double taxation. In this example the controlled company regime would generate taxable income in a company with no losses brought forward, while companies with tax losses brought forward would have no source of taxable income to utilise those losses. Effectively, significant and valuable tax assets (in the form of tax losses) would become locked into companies that may never be able to utilise them and significant assets would need to be written off in the accounts of the UK group. This would appear to apply to GKN and the effect would be very significant.*



- **The income categories covered under the regime, including the appropriate definitions of the various passive income categories, and in particular, how the "other mobile income" category might be framed in order to ensure the rules achieve sufficient certainty, without being too wide;**

*GKN Response:*

*The aim of the new controlled company rules is to prevent artificial location of profits. Artificial location by definition involves **mobile income** that can be located anywhere in the group.*

*It is critical that the mischief created by artificial location is well defined, as the current proposals seem to capture more scenarios than intended. In general the rules should only target mobile income that has been moved out of the UK in the first place.*

*1 Intangible assets acquired by acquisition*

*If a UK group were to purchase an overseas group of companies that owned intangible assets. It would appear that the current proposals would bring the income generated on those intangible assets within the scope of the controlled company regime.*

*Although those intangible assets were not owned in the UK, there would be nothing artificial about their overseas location, and it is not clear why they should fall within the scope of UK taxation.*

*2 Intangible assets created overseas*

*A UK group may perform a significant amount of R&D in a variety of markets. Those markets may vary in location and concentration, for example the automotive sector is heavily concentrated in Germany, Detroit and Japan. Where such a concentration occurs there is also a concentration of the relevant experience. A group may decide to undertake R&D using engineers with the appropriate experience where such experience is available, thus maximising the opportunity for a successful outcome.*

*It is likely that where the R&D occurs, so too will there be the greatest benefit arising from that R&D. For example, automotive R&D undertaken in Germany is likely to be for the benefit of Volkswagen and BMW while automotive R&D undertaken in Detroit is likely to be for the benefit of Ford, GM or Chrysler.*

*If those intangible assets were not generated in the UK, and are utilised in the territory where they are exploited there would be nothing artificial about their overseas location, and it is not clear why they should fall within the scope of UK taxation.*

*3 UK Taxation of worldwide intangible income*

*The Consultation Document proposes that mobile income will also include income to the extent that it derives from the ownership of – or rights over – intangible assets. There is a concern about the breadth that this definition implies and the complexity that this could cause.*

### **Example**

*A manufacturing company may own a patent (and use that patent solely in its business). Economic theory dictates that the company will derive a “routine” return on the functions it performs and it will also derive an enhanced return on the basis of that patent. It has been suggested that although from the company’s perspective it has embedded intellectual property which it only uses on its own behalf, the proposed definition could bring that intellectual property within the scope of the controlled company regime, and it would be necessary to calculate the income that derives from the ownership of the intellectual property. We presume that this is not the intention of the proposals since such an approach would be unworkable and lead to double taxation. Intangible income should be that generated by earning royalties or sub-licensing income only.*

- **The exemptions, in particular the design of the active finance and group treasury exemptions;**

*GKN Response:*

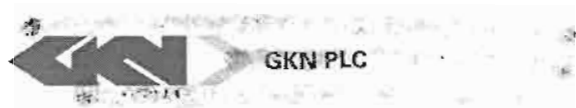
*It is recognised that the purpose of the Controlled Company regime is designed largely to prevent the artificial location of mobile passive income. However, there are scenarios where passive income is genuinely located within a territory and the exemptions need to be drafted appropriately to recognise this.*

*The proposed exemptions go somewhat towards this goal, but they will need to be drafted wider, perhaps recognising some element of the current CFC regimes non-local source income test, in that assets employed solely within a territory for the benefit of the company or other group members in that territory are unlikely to be artificial. It is vital that groups have the freedom to organise their affairs within a territory in the most effective manner (whether for local tax reasons or commercial reasons – e.g. the central ownership of property). This rule should also apply to the UK as a territory (it may go some way to addressing the issue of locked in tax losses mentioned above).*

- **Whether any underpinning is necessary to prevent avoidance of the proposed CC rules.**

*GKN Response:*

*The degree of underpinning required will need to be assessed once we are able to see and understand more detailed proposals for the new regime.*



- **The Government would also appreciate practical views on the question of measurement of income. A starting point might be that apportioned income should be calculated using UK GAAP rules to the local income, net of any expenditure laid out in earning the income (to the extent that this would be allowable for UK tax purposes)**

*GKN Response:*

*Any taxation of income needs to be assessed on net income and this will give rise to serious issues of apportioning costs to streams of income (which is not how companies keep their financial records at present). The compliance burden will be very high in this regard – it will impose an accounting burden that is purely tax driven.*

*We strongly recommend that the income is assessed by reference to the same income that is subject to tax in the local jurisdiction (i.e. local GAAP). This will avoid any tax nothings generated by differences between the two GAAP's that could be permanent since the tax credit for overseas taxes paid will relate to a different level of income.*

- **The Government would also appreciate views on the impact and cost to business of the proposed rules.**

*GKN Response:*

*We believe the administrative/compliance burden will be much higher than the CFC regime and it needs significant exclusions and tighter targeting to mitigate this.*

## **Interest and other elements**

**In relation to the paper's proposals on interest, the Government welcomes comment in particular on:**

- **How best to ensure the necessary certainty in respect of the proposed rules; and**
- **Whether the two changes proposed to the interest relief rules, combined with the controlled companies package, will be effective to deal with possible behavioural effects of a move to exemption.**

*GKN Response:*

*We understand that the amount of interest claimed by a UK sub-group will be restricted by reference to the group's total consolidated external finance costs. Para 5.7 notes that "if the UK sub-group has higher actual finance costs than the entire group's overall external finance costs, this strongly indicates the UK sub-group's finance costs are not commercial" This is too general in nature and should include certain safeguards for businesses including grandfathering, the*



*ability to demonstrate the commercial/economic justification for higher interest costs and where an adjustment is made the ability to carry forward disallowed interest to future periods.*

**For Treasury Consents, the Government welcomes views on whether the rules should be replaced with a modernised reporting regime, and if so what information companies should provide in respect of cross-border arrangements involving controlled companies.**

*GKN Response:*

*We welcome this proposal to remove the existing Treasury Consent rules but need clarification on what is meant by the real-time information-reporting requirement. We believe something modelled on the existing S765A system would work.*

Yours sincerely,

Head of Taxation

# Taxation of the foreign profits of companies: a discussion document

## A response from



### 1 General comments

- 1.1 Grant Thornton UK LLP (Grant Thornton) welcomes the Government's review of the taxation of foreign profits and the intention of creating a more straightforward regime in this area.
- 1.2 We note that the aim is to achieve a broadly revenue-neutral package, and understand the constraints that this imposes. However, we have a number of concerns about the basis on which the calculation of revenue neutrality has been (or will be) made. There is a need for Government to share its calculations in order that we can make meaningful comments on whether the proposals are likely to be neutral in practice.
- 1.3 We have major concerns about the proposed new Controlled Companies (CC) regime. The intended policy objectives are unclear and the measures, as we understand them, appear likely to be significantly revenue-raising. There is also a high risk that the proposals will impose a very significant administrative burden on businesses. Some of the proposals appear designed to claw back the impact of other factors that may have eroded the existing corporate tax base, such as the decision of the European Court of Justice in the case of *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [C-196/04] (*Cadbury Schweppes*) and failures in the current transfer pricing regime. We do not believe that the imposition of a new CC regime is the appropriate place to address these issues. In summary, we consider that the regime as currently outlined is unworkable and hence unlikely to get widespread support.
- 1.4 In relation to smaller businesses, we are disappointed that the proposals as currently outlined do not bring the benefit of major simplification, although we are encouraged from our participation in discussions concerning the proposals that there may be scope for further improvements in this area.

### 2 Dividends

- 2.1 The proposed participation exemption will be a welcome simplification, if it can be applied broadly without introducing unnecessary complexity. We believe that it should also be applied to smaller businesses, and to portfolio dividends: we consider that the costs of doing so would not be significant, and such a measure would eliminate major boundary issues.
- 2.2 We believe that the main behavioural change will be for significant funds to flow back to the UK, to the ultimate benefit of the UK Exchequer. At present, we understand the tax take in respect of foreign dividends paid to UK parent companies is relatively low: companies simply choose not to bring funds back to the UK where doing so would incur significant tax costs. We would encourage the Treasury to seek to quantify the likely impact on the flow of funds.
- 2.3 We note that there is considered to be a requirement to protect the Exchequer by excluding certain dividends from exemption. We have no major comments on the examples given at paragraph 3.11 of the discussion document, but would urge that any exceptions be clearly and narrowly defined on policy grounds.
- 2.4 Where the proposed CC rules do not apply solely because of a lack of UK control, the policy intention appears to be that exemption would still be available provided dividends are paid from profits that would be exempt under the CC rules (footnote 1 to page 14 of the discussion document). We welcome the policy intention, but are concerned that it will often be very difficult for a company with a minority shareholding to obtain the necessary information to establish whether a dividend would be exempt. In section 3 below, we have suggested that a number of reliefs will be necessary within the CC regime, and we consider that these should also be available for dividends paid in these circumstances.

- 2.4 Where a dividend does not qualify for exemption, will the existing credit regime continue to apply, or will it be simplified? What form will any simplification take? These issues are not addressed in the current document. Our view is that the participation exemption should be widely drawn, so that taxable dividends will arise only in limited circumstances and a simplified credit regime would then be feasible and appropriate.
- 2.5 Many companies will have Eligible Unrelieved Foreign Tax (EUFT) carried forward under the existing regime. We believe that such EUFT should continue to be available for offset against future taxable dividends.
- 2.6 The document does not contain any analysis of the potential transition to the new regime. One suggestion that has been made in discussion meetings is that, for any dividend paid after commencement, the source of the dividend would have to be reviewed in line with the requirements of the (new) CC regime. We consider that this would be wholly unworkable, since dividends may be paid out of many years' accumulated profits and the historical data is unlikely to be available.
- 2.7 We recommend that all dividends paid out of pre-commencement profits should qualify for exemption, subject to narrow exceptions (see 2.3 above). We also recognise that, for a short transitional period, any dividend that would have been required to be paid as an acceptable distribution policy (ADP) under the current controlled foreign company (CFC) regime should not qualify for exemption.

### 3 Controlled Companies' regime

#### **General comments**

- 3.1 We accept the need for some form of CFC regime and welcome the intention of a move towards an income-based approach. However, the current outline (as we understand it from the document and discussions with HM Revenue & Customs (HMRC) and HM Treasury (HMT)) is fundamentally flawed: it will harm UK competitiveness, impede investment in intellectual property (IP) in the UK, and be inoperable administratively.
- 3.2 Many of the perceived issues that the CC regime appears to seek to address relate to transfer pricing, and to specific reliefs for reorganisations. We believe that, if the Government does wish to address such issues, it should do so within the framework of existing legislation rather than imposing new and onerous requirements via a CC regime. We also question how such issues have been dealt with in calculating the overall aim for the package to be revenue-neutral.
- 3.3 The regime prior to 2007 has been held not to be compliant with European Union (EU) law in the Cadbury Schweppes decision. We believe that there needs to be full acceptance of the UK's EU obligations, by respecting the spirit of the "four freedoms" contained in the EU Treaty, and we do not consider that the changes introduced by the Finance Act 2007 achieve this. In particular, we consider the distinction between labour and capital to be an arbitrary one, and contrary to long-accepted practice in relation to transfer pricing. Genuine commercial operations within the EU (and arguably in a wider area) should not be subject to a CC regime.
- 3.4 Embracing the need to comply fully with the Cadbury Schweppes decision would also obviate the need to impose a significant burden on UK/UK transactions, which we consider unnecessary and impractical. We strongly disagree with the comment (Box 1, page 19 of the discussion document) that it would be helpful to reduce uncertainty by applying the rules to UK/UK transactions.
- 3.5 There is a need to identify much more clearly the mischief that the CC regime aims to prevent, and to target the provisions more narrowly. We particularly support the comment at paragraph 4.5 of the discussion document, that "Governments need to be sure that the rules do not over-reach their objectives in preventing artificial avoidance".

#### **Control and apportionment**

- 3.6 We assume that the definition of control, currently contained in section 755D ICTA 1988, will carry over to the new CC regime. This is not clear from the discussion document.

3.7 It is proposed that the threshold for apportionment should be reduced to 10%, in line with the threshold that will apply for the participation exemption (although note our comments at 2.1 above). We consider that, on balance, this is reasonable, provided that our other concerns about the CC regime can be addressed. However, we note that the apportionment threshold for the current CFC regime was increased from 10% to 25% in the Finance Act 1998, and that this increase "was made to reduce compliance costs" (HMRC's International Manual at INTM210030). What would be the expected Exchequer cost of a similar increase under the new regime?

***Passive income***

- 3.8 The description of passive income at paragraph 4.20 of the discussion document is very brief. Paragraph 4.21 then says that the category "will also include any active income to the extent that it is, in substance, passive income". It is very unclear what the true target is here: this is an area where further, detailed, discussion is needed. The examples provided during discussion meetings to date have not, in our view, reflected commercial reality, and in some instances contradictory answers have been given.
- 3.9 We believe that a key issue is the need for there to be an "effectively connected" income exemption: where a controlled subsidiary has commercial economic activities, that are primarily active in nature, there should not be an artificial calculation of a deemed passive element. This would be, in effect, the converse of the anti-avoidance test in paragraph 4.21 of the discussion document: income which is, in substance, active should not be regarded as passive. We also note that such a test is likely to be wider than a mere "incidental income" test.
- 3.10 For example, an overseas manufacturing company that benefits from the use of group intellectual property (IP) would have a wholly active trade. The question of whether, under transfer pricing rules, an arm's length price is being paid for the use of the IP is a separate question. Issues relating to IP are considered in more detail below.
- 3.11 We note the comments in paragraph 4.22 of the discussion document concerning capital gains. Again, we think that it is important to identify the mischief: where a passive income stream has been converted into a capital asset, an anti-avoidance rule may be appropriate; however we would not consider it to be acceptable to have to apportion a gain on the sale of a factory or office premises between active and passive elements.
- 3.12 We welcome the proposed exemptions for active finance business and certain intra-group interest. However, in order to determine whether these would be workable in practice, more detail is needed concerning the intended restrictions, summarised briefly in paragraph 4.25 of the discussion document.
- 3.13 We think that a specific exemption for active management of intellectual property should also be considered. For example, a pharmaceutical company may centralise the management of its patents and trademark registrations in a location (such as Switzerland) where the necessary legal and technical expertise is available. Provided genuine economic activity is being carried on, and being remunerated on an arm's length basis, we think an exemption would be appropriate.
- 3.14 In relation to all of the proposed exemptions, we do not think that it should be necessary for the relevant local staff to be employed by the group, provided any outsourcing arrangements are on an arm's length basis.
- 3.15 We welcome the proposal that there would be an exemption within the CC regime for participation dividends within the controlled group. However, we think that more clarification needs to be given to how this would work in the situation outlined at 2.4 above. For example, suppose UK company A plc controls a foreign subsidiary, B Ltd, that has a 20% interest in an active foreign company C Ltd. We consider that dividends from C to B should fall within this exemption, although as noted at 2.4 there may be practical difficulties in establishing the nature of C's income.

***Other mobile income***

- 3.16 We are concerned that the new rules will be drawn too widely in targeting "other mobile income". We accept that there are legitimate concerns over the artificial location of profits. We believe it would be entirely appropriate to apply the CC regime to any such arrangements which do not involve genuine economic substance in the overseas territory. Otherwise, as noted above, we consider that these should primarily be tackled by the application of transfer pricing rules.
- 3.17 We are particularly concerned by the reference in 4.29 of the discussion document to the types of trading income currently not exempted by the Exempt Activities Test in the current CFC regime. In particular, any system which would seek to tax income arising from trading with related overseas companies, without providing for exemptions, would be far too widely drawn.

***Intellectual property***

- 3.18 Major concerns have been expressed concerning the impact on IP. The requirement to analyse all elements of a subsidiary's income, in order to identify a passive element, would be completely unworkable.
- 3.19 During discussion meetings, views have been expressed by representatives from HMRC/HMT that the worldwide IP of a UK parented group has been, in some way, financed by the UK parent (partly as a result of the availability of a full UK interest deduction in most circumstances) and hence all income generated should be within the UK CC net. We find this argument wholly lacking in intellectual rigour and such a regime would be deeply uncompetitive. If the proposals as a whole are supposed to be a "balanced package", we suspect that they would be comprehensively rejected if they were to be so widely drafted. We would welcome clarity that HMRC will not be pursuing such a contentious approach.
- 3.20 Such an argument also leads to potential major anomalies. For example:
- a UK group acquires a German company, that has developed its own IP. The acquisition is for shares (ie no debt finance). If the German company continues to exploit the IP, why should this result in an amount of CC income for the UK parent?
  - a UK group, that has developed IP, is acquired by a German parent for debt. Does the IP now become allocable wholly to the German parent, as it has now provided the relevant finance?
- 3.21 There are two fundamental situations that need to be addressed:
- the transfer of intellectual property by a UK group; and
  - the use of UK-owned intellectual property by a related party.
- 3.22 Where intellectual property is transferred to a foreign entity in a taxable transaction, there would appear to be no substantive mischief provided the price used is an arm's length one. This is an issue for the transfer pricing regime and not for a new CC regime.
- 3.23 We understand that an area of perceived mischief is the transfer of intellectual property in a non-taxable transaction. Where no tax arises owing to the availability of genuine tax attributes (such as commercially-arising capital losses), or as a result of specific reliefs, we do not agree that there is any policy objective that would be achieved by bringing such transfers within the CC regime. If the Government does not like the result that arises from the proper application of existing law, the remedy is to amend the existing law rather than to seek to claw back relief by another route.
- 3.24 Where IP remains in the UK and is used by a related party, we believe that this is entirely a matter for the existing transfer pricing regime and should not be brought within the ambit of the CC regime.
- 3.25 For completeness, we think it axiomatic that a foreign to foreign transfer of IP (or any other asset) within a group should not be within the scope of the CC regime.
- 3.26 In summary, we consider that the perceived mischief in this area needs to be clearly identified so that a targeted solution can be found. Where the underlying problem is with the application of existing legislation (such as the transfer pricing regime) the development of the CC regime should not be used as a proxy for the existing legislation.

### ***Administrative burdens***

- 3.27 As discussed above, we believe it is important for the regime to be properly targeted, rather than to have an unnecessarily wide regime with measures then taken to reduce the administrative impact. However, we have identified a number of key areas that will need to be addressed.
- 3.28 The inclusion of UK/UK transactions within the CC regime will result in no increase in the UK tax base but will impose a significant burden on business. We think strenuous efforts should be made to find a better solution. As noted above, our strong preference would be for EU/EU transactions to be exempted from the CC regime, subject to a "commercial substance" test.
- 3.29 As an alternative, we think that the use of a UK consolidated return should be reconsidered. We are aware that when this was last reviewed, it was thought to impose excessive burdens, but believe that this should now be revisited. In particular, we believe it should not be necessary to prepare a UK consolidated set of accounts figures: it would be preferable for computations to be prepared on an entity basis (as now) but for the tax results then to be consolidated. The overall result would then be taxed on a single entity basis. This would obviate the need for any UK/UK adjustments, not only for CC purposes but also more generally for transfer pricing.
- 3.30 We recognise that this could have wider consequences, particularly in relation to the use of losses within a group, but believe this is worth more detailed discussion.
- 3.31 In order to reduce administrative burdens more generally, "escape routes" are required whereby business can demonstrate either commercial operations (a revised motive test) or that the potential erosion of the UK tax base is minimal. We believe that consideration should be given to a "white list" approach (similar to the current excluded countries list) and/or to a "high tax kickout" test, as is used in the US. We also believe that the public quotation test should be retained, since an interest in a quoted subsidiary is unlikely to amount to "artificial avoidance" (paragraph 4.5 of the discussion document). Businesses should be able to apply for advance clearance for each of these exemptions to apply.
- 3.32 Overall, we are of the view that without significant amendment, the regime as currently drafted will be unworkable. We therefore see this as a critical area for further discussion.

### ***Interest relief***

- 4.1 Overall, we welcome the simplicity of the proposed approach. We are pleased that there are no proposals to introduce apportionment calculations or other complex measures.
- 4.2 We are, however, concerned that the proposed test could operate in an arbitrary manner, for example for inbound operations where the UK operations are not homogenous with the rest of the group. Rather than making the test more complex, we think that groups should be given the opportunity to demonstrate that the UK financing is commercially-driven rather than intended to gain a UK tax advantage. Thus the disallowance of UK interest in excess of the group cost should operate as a rebuttable presumption, with companies being able to submit a clearance application in order to gain an increased deduction.
- 4.3 Particular issues are likely to arise in respect of capital intensive industries (particular in relation to private finance initiative projects) and foreign banking groups, that may have a UK capital markets operation but primarily retail banking operations elsewhere.
- 4.4 We are also aware of commercial situations where, for example, the group as a whole may be generally cash positive but short term borrowings may be taken out in order to finance an acquisition. We do not think that an automatic disallowance would be appropriate in such circumstances.
- 4.5 Where a UK parented group has an upstream loan from a foreign subsidiary, it would be necessary to ensure that double taxation did not result. Potentially, the subsidiary's interest income could be regarded as passive income under the CC regime, and the parent could also suffer a disallowance of UK interest costs. This would clearly be inequitable. (We note, however, that we would expect the use of upstream loans to reduce significantly if the participation exemption is successful, since companies will simply repatriate the funds to the UK as exempt dividends).

4.6 In summary, we consider a commercial override to be a necessary and workable solution to our concerns. Without this, the proposals could breach UK treaty obligations (if the interest would otherwise satisfy the arm's length requirement) and could give rise to the risk of reciprocal measures in other jurisdictions, that in the long term would damage the interests of UK groups.

## 5 Abolition of treasury consent

5.1 We welcome the proposed repeal of sections 765 and 765A ICTA 1988.

5.2 We note the proposal that there should be a "modernised reporting requirement". We are uncertain as to what benefits are envisaged from this, given the recent extensions to the disclosure rules, and question whether any further reporting is necessary. We would expect that most companies would discuss significant transactions with their client relationship manager as part of the regular meetings held under the real-time auditing approach.

5.3 If reporting requirements are to be introduced, we consider that a reasonable period for compliance would be within 180 days of a transaction, as currently applies under section 765A. Any shorter period would impose undue administrative burdens.

5.4 We also consider that exemptions, similar to the current General Consents, should be retained, again in order to reduce administrative burdens.

5.5 The initial information reporting requirement should be as brief as possible and could be modelled on the information required for under the disclosure regime.

## 6 Smaller companies

6.1 We welcome the statement at paragraph 3.13 of the discussion document that, as far as possible, the Government does not wish to increase the compliance burden on smaller businesses through imposition of the CC regime.

6.2 We are disappointed that the exemption regime is not proposed to be extended to smaller companies. A continuing credit regime, even if "simplified", will not significantly reduce the compliance burden. We believe the cost of extending the exemption system to smaller companies (without imposing the CC regime) would not be significant and hope that this can be reconsidered. It is important that new compliance burdens are not created, and any gateway test should mirror existing thresholds - for instance, Schedule 28AA ICTA 1988.

6.3 Nevertheless, boundary issues may arise (as groups change in size over time) and hence it would be appropriate for there to be reliefs so that a group would not fall within the regime merely by virtue of having, say, one year of exceptional profits.

6.4 Consideration should be given to the position of companies that are medium-sized. These companies typically face the same compliance issues as smaller companies and are unlikely to have sufficient resource to deal with an increased burden. However, there are increasing numbers of multinational groups that are medium-sized, including many listed on the UK stock markets. An exemption system would be of considerable attraction. If it is not possible to offer exemption without imposing the CC regime, we would suggest that an election be considered, so that small- and medium-sized companies can access the exemption system if they choose - similar again to Schedule 28AA ICTA 1988.

## 7 Other points

7.1 The proposals set out in the discussion document leave the taxation of foreign branches unchanged. A UK company setting up operations in territories overseas will now have a choice between using a branch and a subsidiary where the result in tax terms may differ significantly. For example, a UK company setting up a subsidiary in Ireland to conduct an active trading business may expect, under the proposals, that it will suffer 12.5% Irish tax, but no UK tax, on the profits of that subsidiary, whether distributed or not. However, a UK company which chooses to conduct identical operations in Ireland using a branch would still be subject to UK corporation tax on its profits, subject only to double tax relief for the tax paid in Ireland. We cannot see any good policy reason for applying such differing tax treatment.

- 7.2 This issue is likely to be particularly important to the financial services industry, where branch structures are commonly used, often for regulatory reasons.
- 7.3 We recommend that consideration be given to introducing an exemption for the foreign profits of branches of UK companies at the same time as the introduction of dividend exemption.
- 7.4 We are happy to provide further details on any of the items raised above or other related matters.

Questions about this response to the discussion document can be addressed to:

(email:

or

(email:

**UK LLP**

Telephone:  
Fax:

### **Advisers to the independently minded**

© 2007  UK LLP. All rights reserved.

UK member of  
International is not a worldwide partnership.