Part IIA: Controlled Foreign Company (CFC) reform

1 Introduction

1.1 Reform of the UK's Controlled Foreign Company (CFC) rules is frequently identified by UK multinational businesses as the key priority needed to improve the UK's tax competitiveness. In common with other developed tax systems the UK needs CFC rules to protect against artificial diversion of UK profits to low tax jurisdictions, but there is scope for significant modernisation. The Government recognises that the current rules, which have been in place for more than 25 years, need to better reflect the way that businesses now operate in a globalised economy. The current rules can be seen as going further than what's needed to protect the UK tax base; new rules must instead minimise the impact on commercial decisions and not interfere with the efficient management of overseas operations.

1.2 This reform has been under discussion for several years. The Government recognises the adverse impact of the resulting uncertainty on businesses' ability to plan and invest in the UK and this uncertainty has been cited as the reason for some groups relocating the tax residence of their headquarters outside of the UK. The Government wants to use this document to provide as much certainty as is possible at this stage about the new CFC rules that will be legislated in Finance Bill 2012. In the meantime, interim improvements to the existing CFC rules as set out in Part IIIA will be introduced in Finance Bill 2011.

Direction of CFC reform

1.3 In pursuing this reform the Government will apply the principles set out in the Corporate Tax Road Map, Part I of this document.

1.4 To be more competitive, the UK's corporate tax system should focus more on taxing the profits from UK activity rather than attributing the worldwide income of a group to the UK to determine the tax base. Moving towards a more territorial system in this way will better reflect the global reality of modern business and will allow businesses based here to be more competitive on the world stage supporting UK investment and jobs. That is why in some areas of the corporate tax system the UK has already moved from a worldwide to a more territorial basis of taxation, for example by introducing a dividend exemption in 2009. As a further step, foreign branch opt-in exemption will be legislated in 2011 as set out in Part IIIB.

1.5 A CFC regime that is more territorial in its approach should:

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

1.6 The package of interim improvements proposed for Finance Bill 2011 is the first step to implementing changes that adopt this approach, for example by introducing an exemption for "foreign to foreign" intra-group transactions that do not pose a risk to the UK tax base. But the Government recognises that there is much more to do for full reform, and this document focuses on the two most important and difficult issues: monetary assets and intellectual property (IP).

1.7 The Government has spent time since the Budget analysing the responses from businesses and interested parties to the discussion document published in January 2010 (Annex B summarises the responses from business).[1] Following that analysis, the Government proposes to design new CFC rules as summarised in Box 1.A.

Box 1.A: Summary of proposals for new CFC rules

- Introduce a mainly entity based system that will operate in a targeted way by bringing within a CFC charge only the proportion of overseas profits that have been artificially diverted from the UK. A number of exemptions will be designed to minimise compliance burdens and focus attention on higher risk entities. In addition, where needed, rules will be designed to address specific sectors including banking, insurance and property. The Government will work to deliver these changes and will publish further details in spring 2011.
- Introduce a partial finance company exemption that allows groups to manage their overseas financing operations more efficiently while protecting the UK tax base. The exemption will work by considering the finance company's debt:equity ratio and applying a CFC charge to the extent that the company has excess equity. This is a pragmatic way of protecting the UK tax base while exempting a significant proportion of overseas finance income (Chapter 2);
- Exempt incidental or ancillary interest income which arises within trading companies. It is proposed to extend the finance company exemption proposals to apply to excess cash held in trading companies (Chapter 2); and
- Introduce a new approach to manage the risks arising from CFCs with IP related profits. This works by identifying those CFCs which present the highest potential risk and then determining whether "excessive profits" have arisen in those entities and, if so, what proportion represents artificially diverted UK profits (Chapter 3).

Consulting with business and other interested parties

1.8 The consultation is being conducted in line with the principles outlined in the document "Tax policy making: a new approach" published alongside the Budget.[2] This document sets out three stages for policy development:

- Stage 1 – set out objectives and identify options;
- Stage 2 – determine the best option and develop a framework for implementation, including detailed policy design; and
- Stage 3 – draft legislation to effect the proposed change.

1.9 This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views on the policy options proposed and the likely impacts of implementing these proposals, to input into more detailed policy design.

1.10 Discussions with business in this area are vital to ensure that new rules support a sustainable UK corporate tax base by focusing on taxing artificially diverted UK profits and not catching commercial operations. Officials will also discuss in the relevant working groups the

[1] *Proposals for controlled foreign companies (CFC) reform: discussion document*, HM Treasury and HMRC, January 2010 (www.hm-treasury.gov.uk/d/cfc_discussiondoc_260110.pdf)
[2] *Tax policy making: A new approach*, HM Treasury and HMRC, June 2010 (http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm)

likely behavioural responses and tax revenue impacts of these proposals to ensure that the Government introduces a competitive but affordable new CFC regime.

Next steps

1.11 The Government welcomes responses to this consultation by 22 February 2011. Details on how to get involved with this and the wider corporate tax reform consultation are in Chapter 4 of this Part of the document and Chapter 5 of Part I: The Corporate Tax Road Map. This consultation will be focused on developing further the new CFC regime based on these proposals. The Government will publish further details on the new CFC regime for consultation in spring 2011.

2 New CFC rules for monetary assets

2.1 The Government is committed to delivering balanced and competitive CFC rules for monetary assets that make it easier for groups to manage the finances of their overseas operations, while maintaining protection of the UK tax base. Monetary assets are instruments that give rise to interest-like returns and include cash, cash equivalents, debt and debt equivalents.

2.2 The Government recognises that for banks and insurers, monetary assets are an intrinsic part of their trade and so different rules will be required. Specific working groups will be established (see the Engagement Strategy in Chapter 5, Part I) to consider what rules are appropriate for the banking and insurance sectors, and further details will published in spring 2011.

Issues to address

2.3 There are significant risks to the UK tax base associated with the use of monetary assets. When external debt is taken out by a multinational business it is often impossible or very difficult to identify where and how that money is then used, for example if the borrowing forms part of the structural financing for the whole group. This so called fungibility of monetary assets makes it difficult to distinguish between transactions that are wholly commercial, those that erode the UK tax base and those that have a dual purpose. The most obvious ways to strip profits out of the UK and artificially divert those profits offshore are:

- upstream loans made from an entity in a low tax jurisdiction to a UK entity. The worldwide debt cap provides some protection against this behaviour, but does not protect the UK tax base in all situations; and
- where a group takes out debt in the UK and that money is used to equity fund a low tax offshore investment. This can result in tax deductions being claimed in the UK for the interest paid on that debt, but the UK does not receive a taxable return on that investment.

2.4 Multinational businesses tend to manage their finances on a centralised or global basis to allow them to respond to the different needs of the group and to achieve the most efficient outcome overall. A group financing company can be used to advance long-term structural debt to other group companies and this can often exist alongside day-to-day treasury functions, such as cash pooling arrangements.

2.5 The risks associated with monetary assets identified in paragraph 2.3 mean that the current CFC rules do not include an exemption specifically aimed at companies that are involved in the financial management of the overseas operations of UK multinational businesses. The Government wants to deliver new CFC rules that give UK groups greater freedom to manage their overseas financing operations, but must find a solution that provides adequate protection of the UK tax base.

Rejected options

2.6 One option would be to apply tracing rules that try to identify which transactions have eroded the UK tax base. In practice the fungibility of monetary assets means that this would be very complex to operate and would not give any certainty over how overseas finance income would be taxed. Businesses agree that although principled, this approach could not provide a workable solution.

2.7 Some businesses have suggested that the UK should adopt a full territorial approach by addressing the risk at the source of the problem i.e. denying interest deductions in the UK when that money is used to finance offshore investments. This could allow UK taxing rights on offshore finance income to be entirely removed and deliver the "foreign to foreign" exemption on finance income that some businesses have called for.

2.8 The Government's view is that either CFC rules or a territorial approach to interest are needed to protect the UK tax base against risks of artificial diversion of profits from the UK involving monetary assets. After carefully considering the options, the Government has rejected changing the rules on interest deductibility as an alternative approach to delivering more competitive CFC rules for monetary assets. The Government has concluded that introducing a territorial interest restriction would not deliver a more competitive corporate tax system overall, even if it enabled CFC rules for monetary assets to be removed. The key reasons why such an approach has been rejected are:

- any fundamental changes to these rules would have disruptive and potentially damaging effects on existing arrangements and incentives to invest in the UK, and could undermine the Government's commitment to providing the stability and certainty needed to promote investment and growth;
- the UK's current interest rules, which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage and it is the Government's view that this advantage outweighs potential benefits from moving towards a more territorial system for interest; and
- the difficulty of designing workable rules to restrict relief for interest, which are fair to all businesses without creating complexity and uncertainty.

2.9 The Government does not therefore intend to pursue significant changes to the UK's competitive regime for interest. The Government will instead focus its attention on reforming the CFC rules. As ever, the Government does need to consider the potential for some businesses to seek to exploit the UK's current interest rules for avoidance purposes. The UK already has a series of rules designed to stop this but the Government will, as with other avoidance risks, continue to keep this area under review.

Proposed option: Finance company exemption

2.10 The Government believes that the best solution to make CFC rules for monetary assets more competitive is to introduce a partial finance company exemption that both delivers greater freedom to groups to manage overseas financing operations and provides protection of the UK tax base. It is proposed that this is delivered by exempting companies that are appropriately funded in terms of the mix of debt and equity. Where equity exceeds the set appropriate level, a proportional CFC charge will arise. Businesses have said that they support this approach as being a simple and certain way of making the CFC rules more competitive.

2.11 Adopting a debt:equity ratio provides a simple and pragmatic solution that recognises and overcomes the fungibility of monetary assets. The Government wants to deliver a ratio that is competitive, but must essentially provide adequate protection of the UK tax base. Discussions with business suggested that a debt:equity ratio of under 1:1 would be competitive if it delivered an effective tax rate of around and ideally less than 10 per cent.

2.12 The Government has used internal and publically available information in considering the likely cost of the proposed finance company exemption, but it is very difficult to assess the likely behavioural impact of this change on business and the resulting impact on tax revenue. Given the range of behavioural responses the Government would like to explore this further in consultation with business through the monetary assets working group.

2.13 Based on initial analysis the Government will consider the case for a minimum debt:equity ratio of 1:2. Assuming that the finance company is fully equity funded, this effectively excludes 66 per cent of overseas finance income from the scope of a CFC charge. In 2012, when the UK rate of corporation tax will be 26 per cent, that equates to an effective tax rate of less than nine per cent falling to eight per cent when the main rate reduces to 24 per cent. A final decision on the ratio will be announced in Budget 2011.

2.14 As identified in the January discussion document,[1] to prevent this exemption being abused it will need to include targeted anti-avoidance rules, for example to prevent groups artificially recycling money back to the UK to gain a tax advantage. Similarly if artificially diverted UK profits arise in a CFC these profits will not be able to benefit from the finance company exemption.

Questions for business:

Question 2A: Do you agree that our preferred option will deliver the best outcome for addressing monetary assets in the new regime? If not, what alternative approach do you favour that is consistent with the need to protect the UK tax base?

Question 2B: What would be the behavioural and tax impacts of such a change on your business?

Question 2C: What are your views on the ratio proposed, bearing in mind the fiscal constraints and need to protect the UK's corporate tax base?

Other areas: Excess cash and treasury companies

2.15 It is not unusual for overseas subsidiaries in a group to have a dual purpose, encompassing both trading activities and the management of funds that have accumulated over time. Because of the way that the current rules operate this has encouraged groups to "swamp" finance income with trading income. To avoid a potential CFC charge on finance income some businesses have organised their overseas operations so that financing operations are in the same entities as trading operations. The treatment of this so called excess cash needs to be addressed.

2.16 The Government proposes that the rules that apply to financing companies should be extended to apply to excess cash that is held alongside trading companies in low tax jurisdictions. This flexibility reflects the way that different businesses are structured and removes the need for groups to restructure current operations to fit within the new CFC rules. The Government proposes that:

- incidental or ancillary amounts of interest can be earned within those trading companies without giving rise to a CFC exposure;
- where cash in excess of this amount arises it will be treated as if it was held in a financing company, so applying a debt:equity ratio to that part of the company.

[1] Paragraphs 3.10 to 3.14, *Proposals for controlled foreign company (CFC) reform: discussion document*, HM Treasury and HMRC, January 2010

2.17 Taking an illustrative example, assume that a CFC is 100 per cent equity financed, with £1m of trading profits and £1m interest income. If £100k of the interest income is ancillary to the trade, then £900k of the interest income would be treated as if it had arisen in a finance company. By applying a 1:2 debt:equity ratio in 2014, tax at eight per cent would arise on that income, resulting in a £72k UK tax charge. This approach gives a proportional response to the risk, but this is at the expense of introducing some additional complexity to the new rules.

Questions for business:

Question 2D: Does this approach deliver a competitive and fair approach by applying the same tax treatment to finance income held offshore?

Question 2E: Weighing up the additional complexity, do businesses support this proposal?

Question 2F: How should the debt and equity of a company be apportioned between the activities of a company that engage in both trading and financing transactions?

2.18 Treasury operations that involve the day-to-day management of a business' monetary assets and only make a small interest turn are unlikely to pose a risk to the UK tax base. The Government wants to exempt such activities from the new CFC rules, but businesses acknowledge that in practice treasury operations often exist alongside higher risk financing activities. Further discussion needs to be had with business about how to treat mixed entities and whether, for simplicity, they could be treated in the same way as a financing company.

3 New CFC rules for intellectual property

3.1 When the current CFC rules were designed over 25 years ago, IP was managed and developed by businesses in a very different way to today. The Government recognises that these rules no longer reflect modern business practice, and may be seen as going beyond what is needed to protect the UK tax base. For example, they can result in a CFC charge on profits that arise from IP that was developed entirely outside of the UK.

3.2 The Government is committed to designing more competitive CFC rules for IP by refocusing the rules on taxing artificially diverted UK profits. This will deliver a more territorial approach to the taxation of IP. IP encompasses certain intangible assets and associated rights including industrial, commercial or scientific information, knowledge or expertise; patents, trademarks, brands, copyrights, invention and design rights; and licences or other rights in respect of intellectual property.

3.3 The UK tax base can be eroded by businesses artificially diverting UK profits derived from IP to low tax jurisdictions. IP can be a highly valuable and mobile asset that can fairly readily be relocated for wholly commercial reasons, to generate tax savings, or a combination of both. In an increasingly globalised business environment, IP is often the result of a collaborative effort involving people and teams operating in different territories. To attribute the profits generated by that IP, and any consequent tax liability, between the different territories poses a difficult challenge for tax authorities and businesses.

Interaction with transfer pricing

3.4 New CFC rules will be targeted at artificially diverted UK profit. Some businesses argue that transfer pricing rules and exit tax rules should provide sufficient protection of the UK tax base and that CFC rules are not required. Although transfer pricing rules can help combat tax avoidance, they are not specifically designed to do so. In some situations certain structures and transactions can result in an inappropriate allocation of profits even after the application of transfer pricing rules.

3.5 It is generally acknowledged by both governments and businesses, as well as in the OECD's Transfer Pricing Guidelines themselves, that the application of transfer pricing to transactions involving intangible property presents particular difficulties. Although the OECD is currently undertaking a project to improve the Guidelines in this respect,[1] it is expected that the application of transfer pricing rules to intangibles will remain problematic in practice. The Guidelines contemplate that, even after they have been applied to allocate profits, those profits will be taxed in accordance with CFC and anti-abuse rules, which are commonplace in the tax codes of OECD countries.

3.6 The Government believes therefore that CFC rules are required to provide necessary protection of the UK tax base and to avoid excessive pressure on the transfer pricing and exit tax rules. The existence of relatively simple but effective CFC rules should reduce uncertainty and administrative burdens for both business and Government. The Government recognises that

[1] Relevant OECD webpage: http://www.oecd.org/document/3/0,3343,en_2649_45675105_46376835_1_1_1_1,00.html

there is a potential for there to be an overlap between CFC rules and transfer pricing rules, and will not impose a double tax charge on the same profits.

Designing new CFC rules for IP

3.7 CFC protection is needed to ensure that if IP profits are artificially diverted to a low tax jurisdiction the UK can continue to tax those profits. Designing certain and simple rules for IP is not easy given the different ways that businesses and sectors use, manage and hold IP. The Government wants to work with businesses to design rules that protect the UK tax base but equally do not distort or inhibit the way in which groups manage their commercial operations overseas. The Government recognises that consultation in this area is vital to delivering rules that work for both the Exchequer and UK multinational businesses.

3.8 As a first step to making the CFC rules that apply to IP more competitive, the Government proposes to exempt foreign IP with minimal UK connection from any potential CFC charge as part of the interim improvements to be legislated in Finance Bill 2011 (see Chapter 2, Part IIIA). The Government recognises that this change does not deal with common and more difficult situations where IP has been developed cross-border and/or where IP has significant connection to the UK.

3.9 The proposals set out in the January discussion document received a mixed response from the business community (see Annex B) which saw them as a step in the right direction, but raised particular concerns about the details of the proposals. The Government's view is that the introduction of an earn-out charge could add uncertainty to the corporate tax system and therefore does not intend to introduce such a charge. The Government is also not attracted to an active management exemption that could force economic activity out of the UK or businesses to restructure in a non-commercial manner.

Proposed option

3.10 The Government recognises that it is essential for the board of a UK multinational to exercise strategic oversight of its overseas commercial operations and this would not of itself give rise to a CFC charge under the new rules. There are other situations that the Government would want to exclude from the new CFC rules at the outset as they pose little or no risk to the UK tax base, for example where trading entities have an incidental or ancillary amount of IP income with a UK connection. Similarly where entities only make small amounts of profit on IP with a UK connection (below a de-minimis amount), these situations will be outside the scope of the new CFC rules.

3.11 The Government wants to encourage innovative activities to take place in the UK, and Part IIB of this document explains the Government's approach to achieving this, including the introduction of a patent box. When designing the new CFC rules for IP the Government does not want to discourage groups that hold foreign IP from sub-contracting activities back to the UK. Provided that these activities do not represent a high risk to the UK tax base they will fall outside the scope of new CFC rules.

Target of rules

3.12 The Government proposes to design rules that target high-risk areas and has identified three areas where CFC protection is required:

- The highest risk arises from circumstances where IP that has been developed in the UK is transferred to a low tax jurisdiction. Without CFC rules this can result in the UK not receiving tax on profits that have in reality been created by UK activity;
- When the IP held offshore is effectively managed in the UK. This would not include all situations where there is UK involvement, but for example, if 90 per cent of the

activity that generates increased IP value takes place in the UK but most of the profits arise in an entity in a low tax jurisdiction, then it is likely that UK profit has been artificially diverted; and

- When UK funds are used to invest in IP that is held offshore as an investment, but the UK does not receive a return on that investment.

How could this work?

3.13 More targeted CFC rules could be designed by firstly identifying the potential high-risk entities located in low tax jurisdictions and then by assessing whether "excessive profits" have arisen in that entity and, if so, what proportion of those represents artificially diverted UK profits.

Step 1: Identify high risk entities that hold IP with a substantial UK connection

3.14 Firstly IP that has a substantial UK connection and could pose a risk to the UK tax base will be defined. If an entity holds IP that falls within this definition that does not necessarily mean that a CFC charge applies. Adopting this approach allows attention to be focused on higher risk entities and should result in a large proportion of genuine foreign IP being outside the scope of new CFC rules. Such a definition could include:

1. IP that has been transferred from the UK within the last 10 years;
2. IP where significant amounts of activity to maintain and/or generate the IP value are undertaken in the UK. Subcontracting discrete functions to the UK would not give rise to a substantial connection, providing that the discrete functions do not in aggregate constitute significant amounts of activity to maintain and/or generate IP value;
3. IP that is effectively held as an offshore investment (see paragraphs 3.17 and 3.18).

Step 2: Assess whether excessive profits have arisen, and if so what proportion represents artificially diverted UK profits

3.15 The next step would be to identify whether excessive profits have arisen in the entity, and if so, what proportion of those profits represents artificially diverted UK profit. These rules must ensure that genuine economic activities undertaken offshore are fully recognised.

3.16 For situations 1 and 2 identified in Step 1, it is proposed that rules based on the following approach could be designed:

- to remove low-risk entities, a safe-harbour test is applied that relates to the return earned in the overseas entities. The Government wants to discuss with businesses what might be an appropriate safe harbour, for example this could be a maximum percentage return based on specified costs and/or assets. A CFC which met the safe-harbour conditions would be exempt.

- for a CFC which failed the safe-harbour test, the key issue will be the proper allocation of profits. Consideration of the allocation of profits should account for various business models, but because it is a subjective test the aim is to limit the number of entities that would have to apply it to minimise compliance burdens and deliver more certainty. A number of factors could be considered to determine whether excessive profits have arisen, including substance (in terms of expertise and/or numbers of employees), the actual activity undertaken offshore, how much finance income is generated, how the entity is funded, and if the IP has been transferred from the UK, how long ago that transfer took place. A CFC which fully meets this test would be entirely exempt; if the CFC partially meets the test then some 'excessive profit' has arisen.

- Finally the rules would need to identify what proportion of those excessive profits are artificially diverted UK profits. Where several territories are involved in developing the IP, then only the proportion of profits that relates to UK activity would give rise to a CFC charge. A just and reasonable basis of apportionment would be applied to the excessive profits for example profits could be allocated based on costs incurred or sales made. <u>It is only then that a CFC charge would arise on the proportion of excessive profits that are identified as profits artificially diverted from the UK.</u>

3.17 For situation 3 identified in Step 1, when IP is held as an offshore investment, this is somewhat analogous to a finance investment such as an interest-bearing loan. If an offshore IP investment is equity funded from the UK then in a commercial situation it would expect to receive a return on that investment. Therefore in this situation it is appropriate to apply a UK tax charge to the proportion of profits that represents a return on that investment.

3.18 Rather than tracing how the offshore IP investment was funded to identify those situations where funding is provided from the UK, which would be complex and difficult to assess, the Government believes that a simpler approach would be to apply a debt:equity ratio test. A UK CFC charge would apply if the entity is equity funded in excess of this ratio; this approach is similar to that proposed for monetary assets (see paragraph 2.10). The Government would like to discuss this approach with business and what ratio would be appropriate to apply to identify non-commercial funding arrangements and it may be that a different ratio to that proposed for financing companies is appropriate.

3.19 The Government believes that the proposed option has the potential to deliver a workable solution, but further work is needed to design rules that are fairly targeted, provide as much certainty as possible and are delivered within an affordable cost. The Government also recognises that careful thought would need to be given to implement rules based on these proposals and specifically what transitional rules should be applied. Similarly, any new rules need to make clear the interaction with transfer pricing, to address the possibility of double taxation on the same profits.

Questions for business:

Question 3A: Could the proposed option produce a workable set of new CFC rules?

Question 3B: Does this provide more certainty and flexibility compared to the previous proposal to deal with real-life commercial situations?

Question 3C: Could the compliance burden of this approach be reduced by applying the safe-harbours and carve-outs identified?

Question 3D: What are appropriate measures to use for the safe-harbours identified and are there any others that could be included to minimise compliance costs without opening up a risk to the UK tax base?

Question 3E: When the holding of IP as an investment is one of a range of activities carried on by a company how could a debt:equity approach discussed in paragraph 3.18 apply?

4 Next steps

4.1 The Government welcomes views by Tuesday 22 February on the issues raised in this discussion document, in particular:

- whether the proposed finance company exemption strikes the right balance between making the CFC rules more competitive and protecting the UK tax base;
- whether the new IP proposals produce a workable solution that protects the UK tax base and exempts genuine commercial operations; and
- the detailed questions raised throughout the document that are summarised in Annex A.

4.2 The Government would also appreciate views on the impact and compliance cost to business of the proposals including the impact of the application for larger and small businesses.

4.3 Details of the Government's wider engagement strategy for corporate tax reform, including consultation and working groups, are given in Chapter 5 of the Corporate Tax Road Map. Officials will spend time between now and Budget 2011 consulting with business on these proposals. New CFC working groups will be established under the following headings: monetary assets, IP, insurance, banking and property to take this work forward. Nominations for working group membership should be sent to corporatetaxreform@hmtreasury.gsi.gov.uk by 9 December 2010.

How to respond

4.4 Any comments or technical queries on the proposals in this Part of the document should be addressed to:

Jennifer Payne or Robert Edwards

Corporate Tax Team
HM Treasury
1 Horse Guard's Road
London
SW1A 2HQ

E-mail: Jennifer.payne@hmtreasury.gsi.gov.uk; Robert.edwards@hmtreasury.gsi.gov.uk; or corporatetaxreform@hmtreasury.gsi.gov.uk
Telephone: 020 7270 5072 or 020 7270 5276

Confidentiality

4.5 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOI), the Data Protection Act 1998 (DPA) and the Environmental Information regulations 2004.

4.6 If you want the information that you provide to be treated as confidential, please be aware that, under the FOI, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) and HM Revenue and Customs (HMRC).

4.7 HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Summary of questions

A.1 Chapter 2: Monetary assets

Partial finance company exemption

- Question 2A: Do you agree that our preferred option will deliver the best outcome for addressing monetary assets in the new regime? If not, what alternative approach do you favour that is consistent with the need to protect the UK tax base?
- Question 2B: What would be the behavioural and tax impacts of such a change on your business?
- Question 2C: What are your views on the ratio proposed, bearing in mind the fiscal constraints and need to protect the UK's corporate tax base?

Excess cash

- Question 2D: Does this approach deliver a competitive and fair approach by applying the same tax treatment to finance income held offshore?
- Question 2E: Weighing up the additional complexity, do businesses support this proposal?
- Question 2F: How should the debt and equity of a company be apportioned between the activities of a company that engage in both trading and financing transactions?

A.2 Chapter 3: Intellectual property

- Question 3A: Could the proposed option produce a workable set of new CFC rules?
- Question 3B: Does this provide more certainty and flexibility compared to the previous proposal to deal with real-life commercial situations?
- Question 3C: Could the compliance burden of this approach be reduced by applying the safe-harbours and carve-outs identified?
- Question 3D: What are appropriate measures to use for the safe-harbours identified and are there any others that could be included to minimise compliance costs without opening up a risk to the UK tax base?
- Question 3E: When the holding of IP as an investment is one of a range of activities carried on by a company how could a debt:equity approach discussed in paragraph 3.18 apply?

B Summary of responses to January 2010 document

Question	Issue	Summary of business response	Government position
2A	Lower level of taxation exemption/white list	Preferred option is a white list of high tax jurisdictions. A tax base test is considered more burdensome by businesses. If a lower level of taxation test is retained (by itself or in conjunction with a new white list), some suggested having a tax rate comparison of 50 per cent of UK tax. Any white list should be simpler to operate than the current Excluded Countries Regulations. Some businesses considered that recent ECJ law means that all EU countries should be included on a white list.	To be considered as part of full CFC reform
2B	Intra group transactions	Most businesses believe that transfer pricing rules should adequately protect the UK tax base in most circumstances and therefore, CFC rules should not apply to intra group activities unless tax avoidance occurs. Businesses do not believe that CFC rules should apply where the CFC has transactions with UK connected persons provided that the CFC is adequately established there (i.e. the CFC undertakes genuine economic activity with sufficient local substance) to earn those profits.	An intra-group foreign to foreign trading exemption will be introduced in Finance Bill 2011 (Chapter 2, Part IIIA). To avoid pre-empting decisions on wider reform, this new exemption does not deal with financing and most cases involving IP. These will be considered as part of full CFC reform.
2C	Insurance/property sectors	Insurance groups are of the view that reinsurance subsidiaries reinsuring both UK and non UK risks should be exempt provided they have an appropriate level of capital and substance. Property groups reiterated that property is not a moveable asset and so there is no diversion of profits from the UK where the CFC's main business involves ownership of physical property to make a profit. It was also suggested that holding companies of exempt property companies should be excluded/exempt unless the holding company has a main business that consists of financing.	An intra group foreign to foreign trading exemption will be introduced in Finance Bill 2011 (Chapter 2, Part IIIA). This should exempt trading profits arising on a reinsurance business and those arising on the provision of intra-group property management services. The Government will discuss whether the CFC interim improvements or full reform can assist reinsurers on interest income arising on capital/premiums. Property investment and holding companies will be considered as part of full reform.

2D	Period of Grace	Most businesses would welcome an extension of the current period of grace to a period between 2 to 5 accounting periods following an acquisition of overseas subsidiaries that come under the control of the UK for the first time. There is a general preference to legislate these changes to provide greater certainty. Some businesses suggested that when the period of grace expires, CFC apportionment should only apply if something is done by the acquired companies to create an artificial diversion of profits from the UK.	As part of interim improvements Finance Bill 2011 will extend the length and scope of this (Chapter 2, Part IIIA).
3A	Treasury company exemption	Treasury company activities should not erode the UK tax base where debt funded. Businesses noted that minimal substance is required in practise to operate a group treasury company. Exemption should include long term intra group loans provided the CFC only makes a small margin on these (i.e. term of borrowing is irrelevant provided the treasury company only makes a small margin). In practise, it is unlikely that treasury companies will be solely debt funded, they may have equity and indeed retained profits are likely to accrue. Therefore, a treasury company exemption may not be of significant benefit by itself.	An update is provided in Chapter 2. To be consulted on as part of full CFC reform.
3B	Finance company exemption	Businesses noted that a debt:equity restriction for companies providing finance is a pragmatic approach to the taxation of interest arising overseas as tracing rules are hugely complex and generally disliked. Some groups would like the option to elect to use tracing rules (i.e. accept the additional compliance requirements as could give a more equitable result on certain transactions). Some commented that the proposals encourage multinationals to set up overseas finance companies and suggested that a UK interest box regime could be explored.	An update is provided in Chapter 2. To be consulted on as part of full CFC reform.
3C	Level of equity funding of finance companies	Whilst pragmatic, the approach was considered arbitrary, particularly as it could vary from year to year. There were mixed views as to whether it should be a fixed ratio or based on an alternative measure, e.g. the debt:equity position of the UK multinational Most businesses suggested that a fair debt:equity would give an effective tax rate of around and if possible less than 10 per cent.	An update is provided in Chapter 2. To be consulted on as part of full CFC reform
3D	Combined Finance and Treasury companies	Mixed response as to whether activities should be treated as separate or treated as solely of a finance company for simplicity Some businesses noted that an election to treat treasury company and finance company activities separately would be more equitable although more complex.	To be consulted on as part of full CFC reform

3E	Excess cash	The proposed treatment of excess cash in overseas trading companies was considered to be contrary to a more territorial approach. A more targeted approach would be to exempt interest on cash which has no UK connection.	An update is provided in Chapter 2. To be consulted on as part of full CFC reform.
4A	Transfer of IP from UK	Businesses opposed an earn out charge as they viewed it as uncompetitive and introducing uncertainty. Some think it is unnecessary as they believe transfer pricing/exit charges provide adequate protection to the UK tax base.	An update is provided in Chapter 3. To be consulted on as part of full CFC reform.
4B	Active management of IP	An actively managed IP exemption was welcomed as a move in the right direction, although there were concerns that it would be difficult to agree an appropriate definition that suited all businesses. Some businesses understand that IP with a UK connection should in principle remain subject to the UK CFC rules to protect the UK tax base, while others argue the actively managed exemption should be available Business emphasised that a patent box (or an advantageous innovation regime) would encourage groups to keep patents/innovation in the UK	An update is provided in Chapter 3. To be consulted on as part of full CFC reform.
4C	IP that is not actively managed	Most businesses did not think that IP would fall within this definition as it was always actively managed. Most liked the simplicity of a debt:equity approach. Some suggested that where such a CFC licences the IP to the UK, disallowing a royalty deduction in the UK on the upstream license would be more targeted than using a debt:equity approach.	An update is provided in Chapter 3. To be consulted on as part of full CFC reform.