HM TREASURY

HM Revenue & Customs

Corporate Tax Reform:

delivering a more competitive system

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Introduction to Corporate Tax Reform document

This document shows how the Government will work with business to enhance UK tax competitiveness. It is designed to provide business with certainty over the Government's plans and support the recovery by giving business the confidence needed to invest in the UK. By collecting a series of reforms into a single programme, it will allow Government and business to examine the interactions between different elements in a coherent and systematic manner.

- Part I: The Corporate Tax Road Map considers the reform plan as a whole and sets out how the Government will approach each element.
- Part II: Consultation on Controlled Foreign Company (CFC) reform and the taxation of innovation and intellectual property considers medium-term reform in two key areas, Part II A covers reform of the CFC rules and Part II B covers the taxation of intellectual property (IP) and Research and Development (R&D) tax credits. Here the Government intends to legislate resulting changes in Finance Bill 2012.
- Part III: Consultation on CFC interim improvements and reform of foreign branch taxation provides an update on reforms announced at the Budget for inclusion in Finance Bill 2011 ahead of publication of draft legislation. Part III A covers CFC interim improvements and Part III B covers foreign branch taxation.

Part I: The Corporate Tax Road Map

Foreword

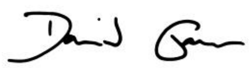
The Government wants to send out the signal loud and clear that Britain is open for business.

We must do all we can to support a private sector recovery. The UK is an open economy and many of the best known businesses in the world are located in the UK, generating growth, creating jobs and making a significant contribution to the public finances. We want to see those businesses grow strongly over the coming years, and attract new ones to join them.

In recent years too many businesses have left the UK amid concerns over tax competitiveness. It's time to reverse this trend. Our tax system was once viewed as an asset. And it needs to be an asset again.

That is why the Government is prioritising corporate tax reform. Responding to the concerns of business, the UK is headed for a more competitive, simpler, and more stable tax system in the future, creating the right conditions for business investment.

At the Budget, the Government set out a plan to reduce the main rate of corporation tax to 24 per cent, its lowest ever rate. This action will start to rebuild the UK's competitiveness. The Road Map sets out how the Government will build on this with a package of reforms to the UK's outdated Controlled Foreign Company rules and a commitment to introduce a Patent Box. We will work hard together with business to deliver them.



David Gauke

Exchequer Secretary to the Treasury

1 Introduction

The Corporate Tax Road Map

1.1 As set out in its Growth Paper, published alongside this document, the Government's priority is returning the UK economy to balanced, sustainable growth.[1] To achieve this, the Government is focusing on creating the conditions for private sector investment and growth. This means a competitive and stable tax system which provides business with the confidence to invest and expand.

1.2 The Coalition Agreement sets out the Government's aim to create the most competitive corporate tax regime in the G20. The primary aim of the tax system is to raise revenue, and therefore provide the fiscal stability that is a precondition for business success. At the same time, the Government believes that the corporate tax system can and should be an asset for the UK, improving the business environment and helping to attract multinational businesses and investment to the UK to support the recovery.

1.3 The Corporate Tax Road Map sets out how the Government intends to approach reform of the corporate tax system over the next five years. This involves open and transparent consultation with business and Chapter 5 sets out a clear plan of engagement so that business and other interested parties can input at each stage of policy development.

1.4 The approach in this Road Map builds on the discussion paper on improving tax policy development published alongside the Budget.[2] It aims to ensure greater stability and certainty in the tax system, and also a more consultative approach to policy making.

Why the UK needs a more competitive and stable corporate tax system

1.5 There are four key ways in which the corporation tax system impacts on business:

- the main rate of corporation tax;
- the definition of the corporation tax base;
- the quality of tax policy making; and
- the way in which corporation tax is administered and collected.

1.6 The UK's lead on corporation tax rates had been eroded, as other countries cut their corporation tax rates further and faster than the UK. In 1997 the UK had the tenth lowest main rate among the EU27 countries; by this year it had slipped to twentieth. The reduction in the main rate from 28 per cent to 24 per cent announced in the Budget demonstrates the Government's commitment to take action to improve UK competitiveness.

1.7 The definition of the corporation tax base is important as it determines the burden placed on businesses to compute their liabilities and also the scope and reach of the UK tax system. As such it has a significant impact on the decisions of global business based and investing here. The

[1] HM Treasury and BIS, November 2010

[2] *Tax Policy Making*, HM Treasury and HMRC, June 2010 (http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm)

Government wants to deliver a simpler tax system and ensure that the corporation tax system continues to place a relatively low compliance burden on business. In addition, its aim of creating the most competitive corporate tax system in the G20 means it should look at areas where the UK is uncompetitive or where legislation has not kept pace with wider developments. Two particular areas where business has concerns are the taxation of income that is earned abroad and income from intellectual property (IP). These are addressed in Part II of the Road Map.

1.8 The quality of tax policy making and the frequency and predictability of changes is a key concern of business and has the potential to undermine perceptions of stability, which can make businesses less likely to invest in the UK. In recent years the way that changes have been made to the tax system has damaged business confidence. Particular concerns have been raised about a lack of clear direction, the frequency of change and, on some occasions, the lack of attention paid to the real impacts on business.

1.9 Tax administration also plays a role, and developing and maintaining effective relationships, as HMRC are doing with their large business customers, enables a strong focus on the most significant issues and quicker resolution of tax disputes, helping to improve both tax compliance and the customer experience.

Other taxes

1.10 The Government understands that other taxes, and in particular personal taxes and environmental taxes, impact on business and competitiveness. It is the Government's intention to work with business to consider their impacts and where appropriate it will approach reforms in other areas in a way that is consistent with the principles set out in Chapter 2. For example, in its recent consultations on Pension Tax Reform, the Government prioritised avoiding complexity and maintaining stability as well as taking careful account of the impact on competitiveness.

1.11 The Government has already set out that its objective with regard to taxation of the banking industry is to maximise sustainable revenues.[3] The Government wants the UK to be one of the most competitive global centres for financial services. However it is only right that during difficult times, steps are taken to ensure that the banks make a full and fair contribution. The Government is taking forward its announcement in the Budget of a Bank Levy as an additional and permanent tax on the industry.

The Corporate Tax Road Map: How the Government will apply the new approach

1.12 The remainder of the Corporate Tax Road Map sets out how the Government intends to address these issues; Chapter 2 of the Road Map provides the principles that the Government will apply to all areas of corporate tax reform; Chapter 3 sets out how the Government will approach each of the key areas of the corporate tax system identified above; Chapter 4 provides a timetable for reform and Chapter 5 sets out how the Government will engage with business to help develop corporate tax reforms.

3*The Chancellor's statement on the Comprehensive Spending Review*, Official Report, 20 Oct 2010 : Column 956

2 Principles for corporate tax reform

2.1 The Government's aim is to create the most competitive corporate tax regime in the G20. It will adopt the principles set out below (in Box 2.A) to give business the certainty it needs to invest in the UK and to provide a clear and consistent direction for reform.

Box 2.A: Principles for corporate tax reform

Lowering rates while maintaining the tax base – It is the Government's view that in general a low corporate tax rate with fewer reliefs and allowances will provide the best incentive for business investment with the fewest distortions.

Maintaining stability – A stable tax system is vital to business. The Government will avoid unnecessary changes to tax legislation. In bringing forward reform, the Government will work with business to ensure that any changes improve the sustainability and long-term stability of the corporate tax system.

Being aligned with modern business practice – The way businesses operate changes over time, and with globalisation and technological development the pace of change over the last 20 years has accelerated. The tax system needs to keep pace with these developments and not stifle adaptation or create perverse incentives for business.

Avoiding complexity – The Government considers simplicity to be a feature of good tax policy. However, complexity in how businesses operate and the diversity of the business population will mean some complexity in the corporate tax system is unavoidable. In bringing forward reforms, the Government will seek to avoid complexity where it can.

Maintaining a level playing field for taxpayers – The tax system should be fair across corporate tax payers without distorting commercial decisions. This can support a limited number of special allowances and reliefs, for example where there are market failures.

2.2 In practice, there will be a degree of tension between these principles. For example, the pace of change in business practices can mean that there is pressure to make quick changes to the tax system, which can affect its stability. Similarly, widespread grandfathering of existing arrangements, while improving stability, may create excessive complexity. Government and business need to debate these trade-offs openly in order to get the balance right.

3 The Government's approach

3.1 This chapter sets out in more detail how the Government intends to approach the corporate tax system over the next five years. It is structured around the four areas in which the corporate tax system affects business, as identified in Chapter 1. These are the main corporation tax rate, the corporation tax base, tax policy making and tax administration. The approach set out here is consistent with the principles of Chapter 2.

The main corporation tax rate

3.2 The Government believes that the headline rate of corporation tax is important to the UK's competitiveness. Reducing corporation tax rates benefits businesses across the economy and can boost investment and growth. The Budget announced a phased reduction in the main rate to 24 per cent, its lowest ever rate. This was funded through other changes announced in the Budget including changes to capital allowances. The reductions in the main rate continue to lower effective tax rates for business even after the reductions in capital allowances take effect in April 2012. Based on announced plans in other jurisdictions, these reforms will give the UK the lowest main rate in the G7 and the fifth lowest in the G20 and are a clear sign that the UK is open for business. The Government's direction of reform is clear – to prioritise rate reductions, which will benefit all businesses, over introducing or broadening reliefs.

The corporation tax base

How territorial should the UK corporate tax system be?

3.3 Globalisation has meant that the world's markets have become more open and competitive. As a result companies increasingly operate across national borders and the ownership of UK businesses has become more internationally diverse. A competitive tax system should recognise this. In particular, the Government needs to ensure that the way the tax system operates for UK headquartered multinationals does not inhibit commercial business practices or make them unattractive to international investment.

3.4 To be more competitive, the UK's corporate tax system should focus more on profits from UK activity in determining the tax base rather than attributing the worldwide income of a group to the UK. 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.

3.5 Some aspects of the UK corporate tax system have changed in recent years to become more territorial, but in key areas it operates on the same basis as when the world economy was significantly less globalised. Accordingly, to address this, the Road Map confirms that the Government will take action to reform the Controlled Foreign Company (CFC) regime and the taxation of foreign branches by adopting a more territorial approach.

The UK's regime for interest deductibility

3.6 As part of its assessment of the potential benefits of moving towards a more territorial system, the Government has considered options for restricting the corporation tax deduction given for interest expenses. Some in business have suggested that a more territorial interest regime could help deliver fully territorial CFC rules (see Part IIA). Having considered this carefully, the Government does not intend to pursue significant changes to the UK's competitive regime for interest.

3.7 OECD countries' tax systems generally recognise the distinction between debt and equity and give deductions for interest as a business expense. This is also reflected in international accounting standards. The Government remains committed to interest being relieved as a normal business expense irrespective of where the proceeds of the loans are put to use. Any fundamental changes to these rules would have disruptive and potentially damaging effects on existing arrangements and could undermine the Government's commitment to providing the stability and certainty needed to promote investment and growth.

3.8 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. In coming to this conclusion, the Government has considered the difficulty of designing workable rules to restrict relief for interest, which are fair to all businesses without creating complexity and uncertainty.

3.9 As ever, the Government does need to consider the potential for some businesses to seek to exploit the UK's current 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.

Controlled Foreign Company (CFC) reform

3.10 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 is 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.

3.11 The Government wants to provide businesses with certainty on what it will deliver on the key issues of monetary assets and IP for CFC reform and this is set out in Part II A. The Government will introduce a simple partial finance company exemption that allows groups to manage their overseas financing operations more efficiently while protecting the UK tax base. It also proposes a new approach to managing the risks arising from CFCs with IP related profits. Discussions with business in this area are vital to ensuring that new rules support a sustainable UK corporate tax base by focusing on taxing artificially diverted UK profits and not catching commercial operations. The Government will publish further details on the new CFC rules in spring 2011, followed by publication of draft legislation in autumn 2011.

3.12 The Government recognised the importance of reforming CFC rules in the Budget and committed to introducing interim improvements to the existing CFC rules in 2011. These will provide improvements for business ahead of full reform and are discussed in Part III A.

Foreign Branch reform

3.13 Part III B contains details of the Government's plans to bring forward proposals in Finance Bill 2011 to reform the taxation of foreign branches in line with its aims to move towards a more territorial corporate tax system. The Government will introduce an opt-in exemption from corporation tax for the profits of foreign branches of UK companies.

Innovation and Intellectual Property (IP)

3.14 Over recent years businesses have become more focused on building and deriving value from creating and exploiting intangible assets. The taxation of intellectual property (IP), and the impact this has on attracting and encouraging further innovation to the UK therefore plays a key role in the Government's corporate tax system ambitions. The business community has identified the taxation of IP, and patents in particular, as a specific target for reform to enhance the competitiveness of the UK's tax system. Part II B of this document covers IP and R&D tax credits.

3.15 The Government intends to introduce a preferential regime for profits arising from patents, known as a Patent Box. Encouraging innovative business to invest in the UK will play a key part in securing a strong and growing private sector. The Patent Box will encourage companies to locate the high-value jobs and activity associated with the development, manufacture and exploitation of patents in the UK. It will also enhance the competitiveness of the UK tax system for high-tech companies that obtain profits from patents.

3.16 The Government believes that Research and Development (R&D) tax credits play a valuable role in supporting innovation and productivity in the UK. The Government wants to ensure that the R&D tax credit schemes play their part in creating the right environment for such companies to prosper.

Tax Simplification

3.17 The Government has established the Office of Tax Simplification (OTS) to provide advice on where the tax system can be simplified to reduce compliance costs on business and individuals. The OTS will draw together expertise from across the tax and legal professions, the business community and other interested parties. Its first two reviews will cover tax reliefs, and small business tax and the intermediaries' legislation (IR35). An interim report on the reliefs review will be published in the autumn. At Budget 2011 the OTS will publish final recommendations on the reliefs review and interim findings on the review of small business tax and IR35. More information can be found at www.hm-treasury.gsi.gov.uk/ots.

Tax policy making

3.18 To demonstrate its commitment to improving levels of predictability and stability in the tax system the Government will ensure significant reforms are designed and planned effectively with fewer small changes, and commits to extensive and timely consultation with business. In Chapters 4 and 5 of the Road Map the Government has set out its timetable for reform and how it wants to involve business in reform.

3.19 The Government will adopt a more strategic response to the risk of avoidance to address increasing complexity and reduce the need for frequent legislative change.[1] This will include building in sustainable defences against avoidance when undertaking policy reform. It may still be necessary from time to time to introduce immediate changes to legislation in order to close off avoidance risks. However, to make clear the Government's commitment to stability, it will shortly publish for comment a draft Protocol setting out the circumstances in which it will consider making such changes.

The administration of business tax

3.20 The Government sees continuing to develop an enhanced relationship between HMRC and large businesses as a priority. Openness and transparency are not just important when

[1] See *Tax Policy Making*, HM Treasury and HMRC, June 2010 (http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm)

considering policy issues but also play a role in tax administration, in building an understanding of the framework within which businesses operate and make decisions on tax. HMRC and business have worked successfully over recent years to increase trust, transparency and open communication. This has led to more effective working relations, improving both tax compliance and customers' perceptions of HMRC's service. The Government will discuss with business how it can further strengthen this approach, consistent with the need to operate a cost-effective tax administration.

3.21 A stable and sustainable corporate tax system will also require responsible judgements from both large businesses and HMRC as to how the law is interpreted on a day-to-day basis. In complex areas of commercial life, particularly international corporate tax, the Government cannot legislate for complete certainty. HMRC should always seek to understand the commercial background to any tax issue before arriving at a view. Equally, businesses need to consider the wider impact on the tax system when arriving at decisions on particular tax arrangements and share these with HMRC where they believe that the law is unclear or uncertain. Stability and sustainability can only be achieved if there is a shared sense of responsibility for the overall health and competitiveness of the corporate tax system.

4 Timetable for reform

4.1 The Government intends to make fewer and better planned changes to corporate tax. It has set out below its plans for the next five years. While the Government is keen to hear representations from business where affordable changes can be made to improve UK competitiveness, it does not intend to make any further significant reforms over the first three years of the Road Map other than those below. The Government must though retain the ability to make certain changes, for example, to prevent revenue losses from avoidance or to ensure the corporate tax system keeps pace with wider events, such as legislative or regulatory changes.

Table 4.A: The Government's timetable for corporate tax reform.

Year 1	
Autumn 2010	• Publish paper on reforming CFC rules • Publish paper covering IP, the Patent Box and R&D tax credits • Publish further details on the CFC interim improvements and on chosen option for foreign branch reform
Year 2	
Spring 2011	• Introduce rate cuts in Small Profits Rate and the main rate to 27 per cent • Publish further details of new CFC rules for consultation • Publish further details of the Patent Box for consultation
Finance Bill 2011	• Legislate for capital allowances reductions • Legislate CFC rules interim improvements and foreign branch reform
Autumn 2011	• Publish draft legislation on (a) new CFC rules and (b) the Patent Box
Year 3	
Spring 2012	• Introduce further cut in main rate to 26 per cent and reductions to capital allowances
Finance Bill 2012	• Legislate outcomes following consultation on (a) new CFC rules and (b) the Patent Box
Year 4	
Spring 2013	• Introduce further cut in main rate to 25 per cent and the Patent Box
Year 5	
Spring 2014	• Introduce further cut in main rate to 24 per cent

5 Engagement strategy

5.1 As set out in *Tax Policy Making: a new approach*,[1] the Government recognises the value of effective consultation and this section sets out the Government's engagement strategy for corporate tax reform.

5.2 Businesses can and should play a key role in developing and testing tax policy. The Government wants to continue the dialogue with business and other interested parties to ensure it delivers on its objective to have a more competitive tax system. The Government encourages all interested parties to engage in consultation to ensure that a full range of views is heard.

5.3 An open and consultative approach to policy development must be balanced with a timetable that permits officials to undertake the work necessary to deliver these reforms. This document provides a framework for consulting with business, but it is not possible to set out a timetable of planned workshops or publication of more detailed policy papers at this stage. This approach needs to be flexible and adaptable to deal with the different issues that will arise as policy develops. For example, the working groups will meet when appropriate, not on a pre-set schedule.

5.4 The Government is committed to open and transparent consultation and will use its website http://www.hm-treasury.gov.uk/corporate_tax_reform.htm and email distribution lists to provide regular updates including dates and minutes of working groups and other publications, where possible. If you would like to be added to the email distribution list, please contact corporatetaxreform@hmtreasury.gsi.gov.uk.

5.5 If you have any comments on the material set out in this paper please email corporatetaxreform@hmtreasury.gsi.gov.uk by 22 February 2011.[2] Richard Williams (Corporate Taxes Team, HM Treasury) will coordinate this work and can be contacted via the email address above.

Consultation groups

5.6 Different levels of consultation will take place, to ensure that both strategic oversight and more detailed input is provided into policy development from business and other stakeholders:

- strategic oversight will be provided by the Corporate Tax Reform Liaison Committee; and
- policy development will be supported by working groups considering different areas of reform.

[1] *Tax Policy Making*, HM Treasury and HMRC, June 2010 (http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm)

2 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 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004. If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, 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 confidentially 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 and HM Revenue and Customs (HMRC). HM Treasury 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.

Strategic Oversight

5.7 The Government will establish a new Corporate Tax Reform Liaison Committee to provide strategic oversight of the overall corporate tax reform. This will be jointly chaired by HM Treasury and HMRC. The membership will include up to eight business representatives.

5.8 In addition the Government has established the Business Forum on Tax and Competitiveness, chaired by the Exchequer Secretary, to consult with large businesses on the UK's tax competitiveness, including the long term aims of reform of the corporate tax system. Details of the Forum are available on the HM Treasury website: http://www.hm-treasury.gov.uk/tax_forums_business_tax_competitiveness.htm.

Policy Development: Working Groups

5.9 This document discusses several specific areas of policy reform. While the Corporate Tax Reform liaison committee will maintain a strategic oversight of the overall, five self-contained consultations, some of which follow on from previous consultations, will focus on specific policy areas. These consultations are:

- Patent Box: Stage 1 consultation – developing policy proposals;
- Foreign Branches: Stage 3 consultation – final consultation on draft legislation;
- R&D tax credits: Stage 1 consultation – developing policy proposals;
- CFC full reform: Stage 2 consultation – determining the best option; and
- CFC interim reforms: Stage 3 consultation – final consultation on draft legislation.

5.10 A number of working groups will be established to focus on detailed policy issues. Working groups will work with officials to test policy as it develops and also to test the likely impacts of changes on business and the resulting impact on tax revenues. All working groups will have the same terms of reference, to be agreed at the first working group meetings, and will meet when appropriate.

5.11 A new working group will be established for the Patent Box while the Government will retain the existing working group for foreign branch reform. The R&D tax credits working group will be based on the existing R&D Consultative Committee.[3]

5.12 New CFC working groups will be established under the following headings: monetary assets, IP, insurance, banking and property. The existing CFC interim rules working group will continue in its current form.[4]

5.13 It is expected that there will be a high level of interest in working group membership. To permit an efficient policy development process, working groups will be limited to up to six representatives. To ensure a broad representation from a variety of sectors and businesses, the majority, if not all, members will be drawn directly from businesses. To ensure that the working group are as open as possible the Government will consider nominations from key representative bodies where nominees work for specific businesses or have other relevant experience.

[3] More information on the R&D Consultative Committee can be found at http://www.hmrc.gov.uk/consultations/rdcc.htm

[4] A list of members of the working group on CFC interim improvements can be found here: http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm

5.14 Nominations for working group membership should be sent to corporatetaxengagement@hmtreasury.gsi.gov.uk by 9 December 2010.

Wider Engagement

5.15 Alongside these consultation groups, officials will continue to meet separately with businesses, representative bodies and tax advisers. Given the impact on a wide and varied cross-section of businesses, the Government would welcome hearing a wide range of views.

5.16 The Government will also hold regular open events while consultations are live. The next open events will cover the entire programme of corporate tax reform and will be on:

(a) 13 December at 1pm

(b) 11 January at 4.30pm

5.17 To attend please email corporatetaxengagement@hmtreasury.gsi.gov.uk.

Timetable

5.18 For Stage 1 and 2 consultations focused on developing policy, the initial stage of consultation will occur between 29 November and 22 February 2011. Policy proposals will be published in spring 2011.

5.19 Following the Budget, a further period of consultation will build on these proposals to develop draft legislation. Consistent with the proposals set out in *Tax policy making: a new approach,* the Government will publish draft Finance Bill 2012 clauses in autumn 2011, ahead of introduction of the legislation in Finance Bill 2012.

5.20 Stage 3 consultations on draft legislation will close on 9 February in order to allow drafting changes to be made in advance of Finance Bill 2011.

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 trading 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. 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.

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.

Part IIB: The taxation of innovation and intellectual property

1 Introduction

1.1 The Government's aim is to provide the most competitive corporate tax system in the G20, in order to support strong and sustainable growth. The Government is committed to listening to business' concerns and responding to business' needs, and the Corporate Tax Road Map, Part I of this document, initiates an open and high level debate about the future of the corporate tax system.

1.2 In recent years businesses have become more focused on building and deriving value from creating and exploiting intangible assets. These form an increasing proportion of the new and future assets of many multinational businesses, and for some businesses a large part of their value is based on their ability to exploit patents, brands and other intangible assets. Consequently the taxation of intellectual property (IP), and its impact on attracting and encouraging further innovation in the UK, forms a key part of the Government's ambitions for the corporate tax system.

1.3 Although the Government recognises the value of all types of IP, it is focusing on scientific and high-tech IP because of their particularly strong link to Research and Development (R&D) and technical innovation activities and in order to protect the UK's status as a world leader in patented technologies. Patents on high-tech products and processes are identifiable and legally protected, and so can be easily traded or licensed between companies. Multinational groups therefore have a choice over where they locate work generating scientific and high-tech IP, and over where ownership of patents is located. The majority of businesses hold some intangibles, covering a variety of different types of assets, and the Government has set a clear direction for reform by prioritising rate reductions over broadening reliefs.

1.4 The Government intends to introduce a preferential regime for profits arising from patents, known as a Patent Box. Encouraging innovative business to invest in the UK will play a key part in supporting a strong, growing private sector. The Patent Box will encourage companies to locate the high-value jobs and activity associated with the development, manufacture and exploitation of patents in the UK. It will also enhance the competitiveness of the UK tax system for high-tech companies that obtain profits from patents.

1.5 Achieving a competitive corporate tax regime is not just about introducing new incentives; it is about ensuring the current set of rules are effective, and looking for ways to improve them. So the Government will also review the support R&D tax credits provide for innovation, including the proposals of the Dyson review[1].

1.6 This document will start the review and rebalancing of the UK's approach to the tax treatment of IP and innovation. In pursuing this reform the Government will apply the principles set out in the Corporate Tax Road Map. The key issues on which the Government is seeking business' views, which are discussed in chapters 2 – 4 below, are:

[1] *Ingenious Britain: Making the UK the leading high tech exporter in Europe,* James Dyson, March 2010.

- the current balance of incentives to attract and retain IP in the UK;
- the introduction of a Patent Box to improve the competitiveness of the system; and
- the support R&D tax credits provide for innovation.

1.7 The Government is also consulting on proposed reforms to the Controlled Foreign Company (CFC) rules, including rules on artificially diverted IP income, discussed in Part II A: Controlled Foreign Company reform.

Consulting with business and other stakeholders

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. 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 1 of the process. The purpose of the consultation is to seek views on the objectives and key design options for the reforms, and the Government is committed to an open discussion with business about the best way to proceed.

Next Steps

1.10 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 given in Chapter 5 of this document and Chapter 5 of the Corporate Tax Road Map. This consultation will be focused on developing a Patent Box based on these proposals. The Government will publish further details on the new Patent Box regime for consultation in spring 2011.

2 UK tax rules and the IP lifecycle

The IP Lifecycle – Beyond R&D

2.1 The process of innovation is far wider than R&D activities alone. The successful transformation of innovative R&D into a competitive marketed product requires a range of complementary activities. The Government has considered the support given to innovation during key phases of the lifecycle of high-tech IP.

2.2 The Government recognises that tax is not the only important factor in encouraging innovative firms to invest in the UK, and that a competitive tax system must be complemented by a world class science and skills base. To support long term innovation and growth the Government has prioritised support for the UK's world class science, maintaining ring fenced resource spending in cash terms at £4.6 billion in each of the Spending Review (SR) years. The Government will also provide funding of around £300 million over the SR period for extension of the cutting edge facilities of the Diamond Synchrotron and the new UK Centre for Medical Research and Innovation. Finally, to drive commercial investment in scientific knowledge the Government has announced reform of the Higher Education Innovation Fund.

Phase 1 - Creation

2.3 The creation of high-tech and scientific IP often involves intensive research activity, with businesses incurring substantial up-front cost with an uncertain future reward. The UK's R&D tax credits regimes are key elements of the Government's support to business during this phase. In Chapter 4 of this document the Government asks for business' views on the support provided by R&D tax credits, including the recommendations of the Dyson review.

Phase 2 - Development

2.4 Turning an initial patent or concept into a marketable product requires a range of complementary activities, including further R&D activity either on the IP itself or the processes required to manufacture or deliver the product or service. The R&D tax credits scheme provides further support during this phase, where the work is seeking to resolve scientific or technological uncertainty.

Phase 3 – Commercialisation

2.5 Successful exploitation in the global market requires significant further high value activity. There are currently no specific incentives for companies to retain IP in the UK during commercialisation. In contrast, several other jurisdictions provide incentives for companies to own and exploit IP, particularly patents, in addition to R&D incentives.

2.6 As a result, the UK tax regime can be uncompetitive for companies to hold and exploit patents. This provides incentives for businesses to transfer patents offshore prior to the full realisation of their value, in order to benefit from more advantageous regimes elsewhere. Rather than tightening exit rules, which could inhibit commercial transactions and risk making UK businesses uncompetitive on the global stage, the Government would prefer to encourage businesses to retain and exploit IP in the UK through the introduction of the Patent Box, discussed in Chapter 3. The UK would then benefit both from activities associated with the commercialisation of patents and from the additional tax on the consequential profits.

General tax treatment of IP

2.7 A new corporate tax regime was introduced in 2002 to modernise the tax treatment of IP throughout its life cycle[1]. HM Revenue and Customs (HMRC) recently published an external report on the impact of the introduction and operation of the corporate intangible assets regime on businesses' commercial decision-making[2]. Building on the findings of that report, the Government would like to explore with business how well the regime is working in delivering the Government's ambition for an efficient and competitive corporate tax regime.

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[1] Corporation Tax Act 2009, Part 8.

[2] *Decision making and Intangible Assets*, Ipsos MORI, November 2010 (http://www.hmrc.gov.uk/research/report100.pdf)

3 Patent Box

3.1 This chapter outlines a possible approach to the design of a Patent Box with the aim of creating an affordable regime which encourages investment in the UK. The Government intends to develop a detailed implementation strategy in partnership with business to enable this regime to apply to relevant profits arising from 1 April 2013.

3.2 The Government has used internal and publically available information to estimate the likely cost of the Patent Box, but it is very difficult to assess the likely behavioural impact of a Patent Box 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 Patent Box working group.

The Case for Reform

3.3 The Government also recognises that IP is mobile and that multinational groups have a choice as to where to locate their IP ownership. IP ownership is distinct from the R&D, management, and manufacturing activity necessary to develop and exploit it, but there are clear commercial links and IP ownership is frequently co-located with high value jobs and economic activity.

3.4 The Government recognises that some patent-rich UK businesses face a higher overall effective tax rate than their foreign competitors, who may benefit from special regimes available in other countries. While the Government does not feel that it is necessary to match these regimes, it does recognise that there is a need to improve the competitiveness of the UK corporate tax regime to complement the non-tax advantages of the UK as a leading location for R&D and IP.

Policy Aims

3.5 The Patent Box will aim to reward successful technical innovation. The Government believes that it is right to introduce this reform now in order to prevent movement of IP offshore and encourage the development of new patents by UK businesses, protecting and enhancing the status of the UK as a world leader in this field.

Options Available

3.6 The Government believes that specific reliefs should be targeted to produce the greatest benefit. For this reason it has decided that this regime should focus on patents rather than on other forms of IP. Patents have a particularly strong link to ongoing high-tech R&D and manufacturing activity which the Government sees as a priority to encourage in the UK. They are also clearly identifiable, and provide exclusive legally protected rights to exploit a novel product or process.

3.7 The Government recognises that not all forms of IP which share these characteristics are capable of being patented, and that there are genuine commercial reasons why some businesses may chose not to patent IP even where it is legally possible. Other forms of legally protected IP can also be extremely valuable and are critical to the success of many UK businesses. For example brand names and trademarks developed in the UK have been successfully exploited throughout the world. However, other forms of IP have a weaker or more variable link to R&D and high-tech manufacturing activity. R&D provides growth opportunities not only for the companies investing but also the wider economy though the development of new skills and technology, and improved products and services. Given the amount of IP in the UK a general relief would also be very expensive.

Design Principles

3.8 The Government will be consulting on the detailed design of the Patent Box through the consultation and working group process set out in the Corporate Tax Road Map. This document sets out the key high level principles that will guide the design process.

Election

3.9 The Government does not wish to place unnecessary compliance burdens on businesses that will not benefit significantly from the Patent Box, and the regime will therefore be optional.

Rate

3.10 The Government intends to introduce a 10 per cent rate for profits arising from patents, to apply from 1 April 2013. The Government wants to provide an effective incentive to create and retain IP in the UK, but believes that it is not necessary to match the rates offered by other countries in order to be competitive, given the significant non-tax strengths of the UK as a location for IP development and exploitation. A rate of 10 per cent strikes a good balance between affordability and competitiveness.

Qualifying date for eligible patents

3.11 There are two main options for identifying patents eligible for inclusion in the Patent Box. One is to use the date of grant of the patent and the other is to look at the date when the patent was first commercialised.

3.12 Some industries have very long development cycles and therefore hold existing valuable patents which have not yet been commercialised. The Government therefore intends that all patents first commercialised after 29 November 2010 will qualify for inclusion in the Patent Box. More detailed qualification and transitional rules will be discussed during the consultation period.

Question 3A: The Government welcomes views on appropriate conditions for patents to qualify for the regime, including the practicality of determining the date of initial commercialisation of a patent, and appropriate ownership criteria.

Income included in box

3.13 The form of income arising from patents differs depending on the type of patent and the commercial structure of the group. The policy should be aligned with the variety of modern business practices, and should not interfere with commercial business arrangements. The Government therefore intends to make the Patent Box available to both royalty income and 'embedded' income included in the price of patented products.

3.14 The identification and quantification of embedded income is a complex area, but the Government has identified two possible approaches. One is to use the "arm's length principle", as set out in the Organisation of Economic Co-operation and Development (OECD)'s Transfer Pricing Guidelines, to determine the proportion of income commercially related to patents. The second is to take a more formulaic approach, which should provide greater certainty and ease of administration, although at the cost of producing a less accurate estimation of the true value of a patent.

3.15 The Government aims to avoid complexity wherever possible while delivering its policy objectives, and currently thinks that to require businesses to value individual patents using an arm's length standard would impose an excessive administrative burden on both business and HMRC. There is no universally applicable method for patent valuation, and all methods, despite their complexity, provide uncertain estimates. The arm's length approach may therefore also fail to provide businesses with the certainty they require to base long term investment. The Government therefore intends to adopt a largely formulaic approach.

Question 3B: The Government would like to discuss with business the proposed approach to determining patent income, and the challenges of practical implementation.

Treatment of associated expenses

3.16 In order to align with policy objectives and remain affordable, the Government believes that the Patent Box should apply to net patent income after associated expenses, including pre-commercialisation expenses, rather than to gross income. The Government's view is shaped by three main considerations:

- a tax rate applicable to gross income would result in an effective tax rate well below the headline rate for the box, which would be very costly and create opportunities for artificial tax avoidance. The Government does not believe that an effective tax rate significantly below 10 per cent is required to make the UK a competitive location to hold patents;
- a Patent Box applying to gross income would encourage a focus on sales rather than profit, which could create perverse incentives for business rather than encouraging sustainable successful innovation; and
- excluding pre-commercialisation expenses would create a perverse incentive for businesses to delay commercialisation of a new product as long as possible in order to achieve a better overall tax rate.

3.17 However, the Government is committed to retaining full rate relief for the additional deduction available from the R&D tax credit regime. The Government is also aware of the need to avoid creating any barriers to patent development and does not intend to restrict deductibility for companies for any expenses before they benefit from the lower rate on the income received, and also recognises that tracking and assigning expenses to specific products can be very difficult. The design must also take into account deferred tax effects with the aim of ensuring that there is no unintentional short term increase in the effective tax rate during the transitional period.

3.18 During stage 2 of the consultation process the Government will set out design options which aim to reconcile these priorities and wishes to discuss the practicality and effectiveness of these fully with business before developing detailed proposals.

Question 3C: The Government welcomes views from business on whether the proposals are well aligned with commercial incentives to create profitable products.

Encouraging continuing innovation

3.19 The aim of the Patent Box is to encourage continuing successful development and exploitation of patents by UK businesses by rewarding successful patent innovation. The

Government does not wish to incentivise purely passive holding of IP, or to encourage artificial tax avoidance behaviours. An effective strategy to prevent abuse is a key requirement to maintain the long term stability of the Patent Box regime.

3.20 The Government is considering a number of ways to achieve this, such as linking the amount of income which can be attributed to the Patent Box to the level of ongoing R&D or associated manufacturing activity. The Government would not intend any such measures to limit the benefit of the box to those businesses actively engaged in the patent development cycle, and welcomes engagement from business on this or on other potential measures to prevent abuse.

Question 3D: The Government would like to discuss with business the most appropriate ways to prevent artificial tax avoidance or other types of abuse.

Question 3E: The Government welcomes any further general views on the Patent Box.

4 Research and Development Tax Credits

Introduction

4.1 The Government believes that business is the main driver of economic growth and innovation. The UK's R&D tax credit schemes have a key role to play in supporting innovative activity by UK companies, and are an important factor for companies when considering the competitiveness of the UK's corporate tax system. The Government will ensure that the R&D tax credit schemes continue to be effective in encouraging innovation by UK companies.

Research and Development

4.2 R&D drives innovation and provides growth opportunities not only for the companies undertaking such activity, but also for the wider economy through the development of new technology and improved products and services. However companies tend to under-invest in R&D because they are unable to fully appropriate all the benefits for themselves. The private returns on R&D are exceeded by the social returns due to the presence of positive externalities that benefit the wider economy. R&D tax credits were introduced to address this market failure. There are three separate R&D tax credit schemes in the UK, the Small and Medium sized Enterprise (SME) scheme[1], the large company scheme and Vaccine Research Relief (VRR).

4.3 The SME scheme, introduced in 2000, allows eligible companies to enhance qualifying R&D expenditure by 75 per cent in order to reduce tax liabilities. If a SME company is loss-making then it may be able to exchange the tax relief for a payable credit worth 24.5 per cent of qualifying expenditure.

4.4 The large company scheme, introduced in 2002, allows companies to enhance qualifying R&D expenditure by 30 per cent.

4.5 VRR, introduced in 2003, allows companies to enhance qualifying expenditure by an additional 40 per cent where R&D expenditure is on drugs and vaccines for strains of tuberculosis, malaria and HIV /AIDS prevalent in the developing world.

4.6 In 2008-09, the latest year for which statistics are available, around 8,350 companies claimed an estimated £980 million of support through the schemes. Since their introduction, the schemes have supported nearly £52 billion of R&D activity by UK companies.

Evaluation

4.7 Following a commitment to evaluate the R&D tax credit schemes by the end of 2010, HMRC commissioned independent research into their impact on the decision making processes of companies investing in R&D[2]. HMRC have also undertaken internal evaluation work assessing the impact of the schemes on the levels of R&D expenditure undertaken by companies.

[1] The European Commission has agreed an enhanced SME definition for the purposes of this scheme. Companies with up to 500 employees and either turnover under €100 million or balance sheet assets under €86 million are eligible. These thresholds are effectively double those of the normal EU SME definition.

[2] *Qualitative research into businesses' Research and Development (R&D) decision-making processes,* Databuild Research and Solutions Ltd, August 2010 (http://www.hmrc.gov.uk/research/report101.pdf)

4.8 The broad conclusions of the independent research are that the schemes are perceived by claimants to increase the overall amount of R&D they are able to undertake, although they have little effect on decisions to conduct particular projects. The cash flow benefit of the payable credit was cited by smaller companies as being of particular importance in enabling them to proceed with R&D projects. HMRC's internal economic analysis has concluded that the schemes have a positive impact on the levels of R&D expenditure by regular claimants. This is consistent with the findings of academic literature into the impact of fiscal incentives for R&D in a number of territories.

Objective

4.9 The Government has the aim of creating the most competitive corporate tax regime in the G20. As part of its approach to reform the Government announced in the June 2010 Budget that it would review the support R&D tax credits provide for innovation and the proposals of the Dyson Review[3].

Dyson Review

In March 2010 James Dyson published *Ingenious Britain: Making the UK the leading high tech exporter in Europe*. The report made two specific proposals for the R&D tax credit schemes, detailed below:

- Refocus the schemes on high tech companies, small businesses and new start-ups. When the public finances allow, the rate should be increased to 200 per cent.
- Improve the ease with which the R&D tax credit can be claimed.

4.10 A competitive tax system, together with a regulatory environment that encourages innovation and enterprise, and a skilled workforce are all important factors in the growth of innovative companies. Through this consultation the Government wants to ensure that the R&D tax credit schemes play their part in creating the right environment for such companies to prosper.

4.11 Stability and certainty are key factors for companies when making R&D investment decisions. Changes to the schemes would require companies to invest time and resources in adapting to new rules and processes. However, the Government welcomes views on any changes that respondents feel would significantly improve the impact or delivery of the schemes.

4.12 When considering responses to the consultation, the Government will assess whether proposals put forward enhance the effectiveness of the schemes in addressing the market failure in the provision of R&D, whether they represent value for money for the taxpayer and if they are affordable within the wider Government priority of reducing the deficit. The schemes must also remain compliant with European Commission rules, including those on the provision of State aid.

4.13 Given the current fiscal framework, it is important that where respondents suggest changes that will carry additional Exchequer cost, they also seek to identify areas where appropriate savings might be made.

[3] *Ingenious Britain: Making the UK the leading high tech exporter in Europe,* James Dyson, March 2010

Structure and scope

4.14 A number of countries offer support through their tax systems to promote R&D activity through a variety of mechanisms, including super deductions (as in the UK) and direct reductions of tax liability (as in Canada). The Government believes that the combination of low corporation tax rates, with the main rate of corporation tax falling to 24 per cent by 2014, and the presence of the R&D tax credit schemes, makes the UK an attractive location for UK companies and multinationals to undertake R&D activity.

Question 4A: Are there any changes to the structure of the schemes that would significantly improve their impact in stimulating investment in R&D by UK companies, in the context of the wider corporate tax reforms?

4.15 The Dyson report raised concerns that the schemes may not be sufficiently well targeted and proposed refocusing them on hi-tech companies. The Government does not intend to restrict qualification for R&D tax credits to specific sectors as the schemes are intended to remedy a market failure that exists for companies across the economy. Positive spillovers from R&D will be present in all sectors.

4.16 However, the Government will examine the extent to which the relief is appropriately targeted at those costs that are most closely linked to genuinely innovative activity. The relief is currently available for expenditure on staff, materials, power and software development.

Qualifying costs and activities

4.17 Adding further qualifying costs would increase both the impact on tax revenue and the complexity of the schemes but the Government is interested in views on whether there are any specific costs that should be brought within the scope of the schemes, although adding such costs will need to be rebalanced by savings elsewhere.

4.18 The Government is interested in views on whether there are any costs which do not genuinely contribute towards innovative activity but which are currently eligible for relief through the schemes. The Government is also interested in whether there are specific costs that are currently eligible for relief which could be limited in the context of refocusing the schemes on stimulating high tech companies to undertake greater levels of innovative activity. One example could be relief for expenditure on developing internal use software, which some countries exclude or limit under their R&D relief regimes.

Question 4B: Are there additional costs that should be eligible for relief under the schemes?

Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?

4.19 R&D tax credits use a definition of R&D contained in guidelines issued by the Department for Business, Innovation and Skills (BIS)[4]. The definition was last revised in 2004, following consultation. Whilst there are specific issues, such as 'production', the Government believes the R&D definition generally works well and accurately captures what is R&D for tax purposes.

[4] *Guidelines on the Meaning of Research and Development for Tax Purposes*, Secretary of State for Trade and Industry, March 2004 (http://www.bis.gov.uk/files/file13258.pdf)

Question 4D: Is the R&D definition contained in the guidelines issued by BIS an effective definition for recognising genuine R&D activity through the R&D tax credit schemes?

Production

4.20 Under the current definition, R&D activities must seek an advance in general knowledge or capability in science or technology through the resolution of scientific or technological uncertainty in order to be eligible. The BIS guidelines state that production and distribution of goods and services does not directly contribute to the resolution of such uncertainty. However, 'production' is not defined in legislation or the BIS guidelines, consequently there is a lack of clarity around exactly what constitutes production, particularly when the activity involves experimental trials and prototypes.

4.21 HMRC's approach so far has been to issue guidance and to seek to address the issue on a case by case basis. An alternative approach would be to legislate a statutory definition of production. This would provide certainty but might leave less flexibility around R&D claims for claimant companies. Any extension to the scope of allowable costs in this area will add to the overall cost of the scheme and will have to be balanced through savings elsewhere.

Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

Refocusing

4.22 The Dyson report proposed refocusing the schemes to specifically benefit start-ups and small companies[5]. The Government recognises the importance of cash flow for such companies, which may be undertaking significant amounts of R&D in advance of generating income. The SME scheme already acknowledges that smaller companies face additional barriers in financing R&D investment by offering an increased rate of relief and the option of claiming a payable credit, if a company is loss-making. In addition, as part of the Government's wider corporation tax reforms, the small profits rate of corporation tax is reducing from 21 per cent to 20 per cent with effect from April 2011, instead of the planned increase to 22 per cent.

Question 4F: What further enhancements would be most effective in promoting additional investment in R&D by the smallest companies, taking into account the risk of adding additional complexity to the schemes?

Vaccine Research Relief

4.23 VRR was introduced to incentivise investment in R&D into drugs and vaccines for strains of tuberculosis, malaria and HIV/AIDS which mainly occur in less-developed countries. Take up of VRR has been low, with around ten claims a year made through the scheme.

Question 4G: Is VRR an effective intervention for incentivising research into drugs and vaccines for the prevention and treatment of disease prevalent in less-developed countries, or would it be more effective to deliver the support through other mechanisms?

[5] The European Commission define a small company as one with up to 50 employees and either turnover of under €10 million or balance sheet assets under €10 million. A micro company is defined as one with up to 10 employees and either turnover of under €2 million or balance sheet assets under €2 million.

Claims process

4.24 The Dyson report suggested the cost of claiming the credits and the information obligation for claiming may act as a barrier to companies using the schemes. Administration costs incurred by companies in claiming reduce the value of the incentive, so the Government is keen, where possible, to reduce these costs for companies, particularly in the wider context of simplifying the tax regime.

4.25 In 2006, the Government introduced seven specialist units to handle R&D claims outside the Large Business Service in HMRC. The units aim to provide simplicity, consistency and certainty around the treatment of claims with the general consensus from business being that the process has greatly improved since their introduction.

4.26 The Dyson report suggested options for simplifying the claims process, including allowing external audits of claims or the pre-agreement of projects or activities with companies. External auditing of claims could provide a degree of expertise in analysing claims but has the potential to add significant cost and complexity to the administration of the scheme, both for claimant companies and for HMRC. Where requested, HMRC discuss potential projects with companies and offer guidance on the claiming process, but it does not operate a formal pre-clearance procedure. The additional resource issues that arise from these proposals will also need to be considered.

Question 4H: Are there improvements to the claims process that would make it more streamlined and certain for companies, particularly smaller companies with limited resources? Would there be significant benefits from an external auditing process for claims or a more formal pre-clearance procedure of R&D projects with HMRC?

5 Next steps

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

- the effectiveness of these proposals in improving the competitiveness of the UK's corporate tax regime in relation to IP and technical innovative activity;
- the priority of these proposals in comparison with other proposals, including those set out in other parts of this wider consultation; and
- the detailed questions raised throughout the document.

5.2 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.

5.3 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. A new Patent Box working group will be established 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

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

For general comments and comments on Patent Box

5.5 Anna Floyer-Lea or Richard Williams

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

E-mail: corporatetaxreform@ hmtreasury.gsi.gov.uk; or
anna.floyer-lea@hmtreasury.gsi.gov.uk or richard.williams@hmtreasury.gsi.gov.uk
Telephone (Treasury switchboard) 020 7270 5000

For comments on Research and Development Tax Credits

5.6 Mike Crabtree or James Perry:

R&D Tax Credits Reform
Excise and Enterprise Tax Team
HM Treasury
1 Horse Guards Rd
London
SW1A 2HQ

Email: corporatetaxreform@ hmtreasury.gsi.gov.uk; or
mike.crabtree@hmtreasury.gsi.gov.uk or james.perry@hmtreasury.gsi.gov.uk
Telephone (Treasury switchboard) 020 7270 5000

5.7 Details of the Government's wider engagement strategy for CT Reform, including consultation and working groups, are given in Chapter 5 of the Corporate Tax Road Map.

Confidentiality

5.8 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.

5.9 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).

5.10 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 The Government welcomes response to the questions put forward in the consultations on the Patent Box and the R&D tax credit schemes. Any proposals put forward by respondents will need to be considered alongside the following criteria:

- Do they enhance the competitiveness of the UK corporate tax regime as a location for businesses to develop, hold and exploit IP?
- Do they represent value for money for the taxpayer, and are they affordable within the wider Government priority of addressing the deficit?
- Where relevant, are they compliant with EU State aid rules?

Chapter 3: Patent Box

- Question 3A: The Government welcomes views on appropriate conditions for patents to qualify for the regime, including the practicality of determining the date of initial commercialisation of a patent, and appropriate ownership criteria.
- Question 3B: The Government would like to discuss with business the proposed approach to determining patent income, and the challenges of practical implementation.
- Question 3C: The Government welcomes views from business on whether the proposals are well aligned with commercial incentives to create profitable products.
- Question 3D: The Government would like to discuss with business the most appropriate ways to prevent artificial tax avoidance or other types of abuse.
- Question 3E: The Government welcomes any further general views on the Patent Box.

Chapter 4: Research and Development Tax Credits

- Question 4A: Are there any changes to the structure of the schemes that would significantly improve their impact in stimulating investment in R&D by UK companies, in the context of the wider corporate tax reforms?
- Question 4B: Are there additional costs that should be eligible for relief under the schemes?
- Question 4C: Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief under the schemes?
- Question 4D: Is the R&D definition contained in the guidelines issued by BIS an effective definition for recognising genuine R&D activity through the R&D tax credit schemes?
- Question 4E: Would respondents welcome a statutory definition of production? If so, what should it include and exclude?

- Question 4F: What further enhancements would be most effective in promoting additional investment in R&D by the smallest companies, taking into account the risk of adding additional complexity to the schemes?
- Question 4G: Is VRR an effective intervention for incentivising research into drugs and vaccines for the prevention and treatment of disease prevalent in less-developed countries, or would it be more effective to deliver the support through other mechanisms?
- Question 4H: Are there improvements to the claims process that would make it more streamlined and certain for companies, particularly smaller companies with limited resources? Would there be significant benefits from an external auditing process for claims or a more formal pre-clearance procedure of R&D projects with HMRC?

Part IIIA: Controlled Foreign Company (CFC) interim improvements

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. The Government announced in the Budget that a new CFC regime would be legislated in Finance Bill 2012, and that as a first step, improvements to the current CFC rules (referred to as 'interim improvements'), would be introduced in Finance Bill 2011.

1.2 The Government does not wish to pre-empt the outcome of consultation on wider corporate tax reforms. As a consequence, the treatment of financing and most situations involving intellectual property (IP) are outside the scope of the interim improvements and will be considered as part of full CFC reform. The current proposals for the treatment of monetary assets and IP as part of full reform are set out in Part II A.

1.3 This Part of the document sets out the package of proposals that the Government will introduce in Finance Bill 2011 to provide improvements to the current rules ahead of full reform.

Principles for reform

1.4 In pursuing this reform the Government will apply the principles set out in the Corporate Tax Road Map published, Part 1 of the Document.

Consultation to date

1.5 This consultation is being conducted in line with the principles outlined in the document "Tax policy making: a new approach" published alongside the Budget. 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

1.6 Chapter 2 includes the Government's detailed proposals on the package of interim improvements, which completes stage 2 of the process. The Government will publish draft legislation and an Explanatory Note on 9 December, which is stage 3 of the process. The purpose of the next stage of consultation is to seek views on the draft legislation and the implementation of the proposals.

Next Steps

1.7 Draft legislation and an Explanatory Note will be published on 9 December, alongside other draft clauses of Finance Bill 2011.

1.8 The Government welcomes responses to this consultation and draft clauses by 9 February 2011 in order to allow drafting changes to be made in advance of Finance Bill 2011. Details on how to respond are provided in paragraph 2.36 of this Part of the document.

2 Package of CFC interim improvements

Overview of package of CFC interim improvements

2.1 The Government announced in July 2010[1] that the aims of the interim improvements are to:

- modernise aspects of the CFC rules so as to exempt commercially justified activities that both business and HMRC agree do not erode the UK tax base but which could give rise to a CFC charge under the current rules;
- help UK businesses that wish to undertake overseas acquisitions and reorganisations; and
- make other worthwhile improvements suggested during consultation that are consistent with the aims of full CFC reform and do not require disproportionate amendment or revision of existing CFC legislation.

2.2 The Government established a working group of business representatives to help develop the package of interim improvements. Officials have been working with this group, the CFC Liaison Committee[2] and other advisers and businesses to develop these proposals. Further details on the discussions with the working group and the CFC Liaison Committee are provided in meeting notes (with supporting papers where appropriate) and can be found on the HM Treasury website.[3]

2.3 The package of interim improvements proposed for Finance Bill 2011 is designed to implement an initial set of changes consistent with the direction the Government has set for full CFC reform. The main change is to exempt a CFC which carries on a range of 'foreign to foreign' activities involving transactions wholly or partly with other group companies provided that there is little or no risk of erosion of the UK tax base. The exemption is designed to produce a proportionate outcome in contrast to the 'all or nothing' approach generally taken by the existing CFC exemptions. The specific changes are as follows:

- an exemption for a CFC carrying on intra-group trading activities where there is minimal connection with the UK and little risk that UK profits have been artificially diverted;
- an exemption for a CFC with a main business of IP exploitation where the IP and the CFC have minimal connection with the UK;
- an exemption which runs for three years for foreign subsidiaries that, as a consequence of a reorganisation or change to UK ownership, come within the scope of the CFC regime for the first time; and
- improve the de minimis exemption and deferral of the withdrawal of the exemption for certain holding companies.

[1] Outlined in the note entitled "Aim and scope of CFC interim improvements" published on 27 July 2010
[2] A small group of businesses representatives established in April 2009 to discuss CFC reform
[3] http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm

2.4 A brief description of these proposed improvements is provided below, with further details set out in Annex A. The draft clauses and explanatory notes will be published on 9 December.

New exemption for certain intra-group activities

2.5 The current CFC rules can affect how UK multinationals structure wholly commercial intra-group trading activities and may lead to a CFC charge in cases involving purely 'foreign to foreign' transactions where there is no risk of artificial diversion of UK profits. To address this issue, the Government is proposing to introduce a new exemption for CFCs that undertake certain intra-group transactions. This exemption, which applies regardless of the proportion of a CFC's transactions that take place with group companies, is aimed at UK multinationals whose CFCs are involved in the provision or consumption of intra-group goods and services, for example as part of a supply chain, and where the transactions do not involve the UK, or do so only to a limited extent. Such arrangements may either be caught by the existing CFC rules or involve disproportionate compliance efforts to establish their exempt status.

2.6 The new exemption should allow UK multinationals to manage overseas operations more efficiently than is possible under the current rules.

2.7 This exemption will be an additional exemption, so a CFC which does not meet its conditions may still meet the conditions of one of the other new or existing exemptions.

2.8 A full exemption will be available for a CFC, if it meets certain conditions in relation to:

- business establishment
- business activities
- amount of finance income and income arising from IP, and
- extent of connection with the UK

Business establishment condition

2.9 The CFC will be required to have a business establishment in its territory of residence. This condition is consistent with existing CFC exemptions (see A.2 in Annex A).

Business activities condition

2.10 The aim is to focus the exemption on trading companies while permitting some flexibility for CFCs with limited investment business. This condition for the new exemption will be satisfied if non-trading activities comprise less than a substantial part of the CFC's business (see A.3 in Annex A).

Finance income and IP condition

2.11 The treatment of finance income (interest and interest-like income) and income from the exploitation of IP are outside the scope of the interim improvements and will be dealt with in full CFC reform. To provide some flexibility, the receipt by a CFC of an incidental amount of total income as finance income or income from IP will not prevent the CFC from qualifying for full exemption (see A.5 in Annex A). To minimise the risk to the UK tax base, it is proposed to adopt a low per cent of total income test of 5%. The Government wants to discuss this with business to determine whether this limit provides sufficient flexibility for the purpose of interims, until the issues of finance income and IP are addressed in full reform.

2.12 If the amount of finance income exceeds this limit, then subject to meeting the other conditions, only the excess will be apportioned to the UK. The exemption provides for this more proportionate approach to determine the CFC charge and will allow a group to assess the profits to be apportioned through an application to HMRC. A CFC with IP income in excess of this limit is outside the scope of the new exemption, though it may qualify for one of the other new or existing exemptions.

2.13 It is recognised that there may be other circumstances in which greater flexibility would be helpful. An area for further discussion is whether finance income that arises as a necessary incident of the CFC's trading activity, or which is received as an integral part of its trading receipts, might be treated differently from finance income arising from investments.

2.14 A CFC which carries on an insurance business and is part of an insurance group will be subject to the 5% limit on finance income in the same way as any other trading company. The Government understands the integral role that interest plays in the insurance business, and as a part of the discussion mentioned in paragraph 2.13 above, the Government will continue to explore with the industry whether a straightforward and affordable solution can be found as part of the interim improvements or whether this should form part of full CFC reform.

UK business connection condition

2.15 Where a CFC enters into transactions with the UK there is a greater risk of artificial diversion of profit from the UK. But the Government accepts the need to take a proportionate approach depending on the level of such transactions (see A.6 to A.10 of Annex A). The UK business connection condition will therefore be treated as met in full where no more than 10% of the CFCs business income and no more than 10% of the CFC's business expenses are UK income or UK expenses. Where a CFC's business income and expenses are mainly (i.e. more than 50%) UK income or expenses, the CFC will be outside the scope of this exemption but these situations will be considered further as part of full reform.

2.16 Where the proportion of transactions with the UK is between 10% and 50%, a CFC charge may arise unless the CFC falls within a 'safe harbour'.

2.17 The conditions for the safe harbour are that:

- there is an appropriate level of effective management, and
- the CFC's profits fall within a set return on specified operating costs and/or assets.

The 'safe harbour' is designed to reduce compliance costs and increase certainty for CFCs in this position.

2.18 A CFC which does not meet the 'safe harbour' conditions may, by applying to HMRC, agree a reduced CFC charge. The amount of the charge will be determined by first excluding any profits that are fully commensurate with the CFC's economic activity. The remaining profits will then be further reduced to the extent that they arise from non-UK business transactions which do not erode the UK tax base (see A.33 to A.39 of Annex A).

Question 2A: Are the proposed parameters of the relevant conditions of the new exemption an appropriate response at the interim stage whilst still providing adequate protection of the UK tax base?

Question 2B: Is the proposed percentage limit for finance income sufficient and is there a case for providing greater flexibility for finance income that is a necessary incident or which is integral to the CFC's trade?

Question 2C: When considering UK connection, is there a case for distinguishing between transactions with connected parties and those with third parties? Are there circumstances in which third party transactions could be left out of account?

Question 2D: With regard to the 'safe harbour', are there alternative parameters which would be more effective? What might be the most suitable measure of such parameters?

Question 2E: The proposed approach to partial exemption is to ensure that the rules are more targeted, moving away from the all or nothing approach of the current rules. Is the approach suggested workable?

Exploitation of IP with no UK connection

2.19 The treatment of CFCs which receive income from the exploitation of IP is a matter for full reform, but the Government is proposing as part of the interim improvements a limited exemption for a CFC whose main business is to exploit IP. The aim of this change is to allow UK multinationals that hold foreign IP in circumstances that do not pose a risk to the UK tax base to fall outside the CFC rules.

2.20 To qualify, the IP being exploited must have minimal UK connection, and the CFC itself must have minimal UK business connection. The former will be determined by reference to whether the IP has been held or developed in the UK. The latter considers receipts from the UK or expenses incurred on research and development undertaken in the UK, and the nature and extent of any equity funding to determine whether the entity may have been funded from the UK (and hence there may be a risk to the UK tax base) (see A.11 to A.18 of Annex A).

2.21 A CFC which meets the two connection conditions and has minimal finance income will be fully exempt. As for the new intra-group activities exemption, where the minimal finance income limit is exceeded, only the excess income will be apportioned to the UK, with the amount being agreed through application to HMRC.

2.22 While recognising that these are tightly focused conditions, this is intended to be a first step to reduce the impact of the CFC regime on non-UK IP where there is little risk to the UK tax base. Like the intra-group activities exemption, CFCs which meet the conditions for this exemption should be able to manage overseas IP more efficiently than is possible under the current rules. The treatment of IP income under the CFC regime will be addressed fully in the second stage of reform in Finance Bill 2012. The Government's proposals are set out in chapter II A of this document.

Question 2F: Recognising that this IP exemption is intended to be narrow in scope, are there any changes to the design parameters that would make it more useful to business in advance of full reform but which would not increase the risk of UK tax base erosion?

Question 2G: Is the restriction in reference to research and development expenditure in the UK appropriate and is the proposed approach practical? If not, is there another more suitable parameter that could be used?

Temporary exemption following acquisition or reorganisation

2.23 The Government proposes to extend the scope and duration of the temporary exemption from the CFC rules currently provided where a UK multinational newly acquires foreign subsidiaries (often called the period of grace) to assist UK businesses that wish to undertake overseas acquisitions and reorganisations, and non UK businesses that want to invest in the UK (see A19 to A.26 of Annex A).

2.24 Where a UK group takes over an overseas group, it may inherit overseas companies that have not previously been subject to the UK's CFC rules. In such a case, it is unlikely that any of the subsidiaries that become CFC's will have been set up to avoid UK tax. HMRC currently accepts that the motive test exemption is satisfied by such CFCs up to the end of the first full accounting period following the accounting period in which the acquisition occurs. While this approach is designed to allow the UK group time to make any necessary changes to comply with the CFC regime, the Government recognises that it can be challenging for groups to restructure within this time frame and that an additional 12 months would be helpful in this regard.

2.25 The Government will therefore introduce a statutory exemption which runs for a period up to three years for foreign subsidiaries that come within the scope of the CFC regime for the first time as a consequence of a reorganisation or change to UK ownership. The Government is considering whether there are exceptional circumstances in which an application could be made to extend this period beyond 3 years and will consult which businesses in this regard.

2.26 This exemption will apply on a CFC by CFC basis. Unlike the current arrangements, a change in the main business or activities of the CFC will not affect the exemption unless, and to the extent that, it erodes the UK tax base. Where there is such a change, the CFC affected can apply to HMRC to agree a CFC charge which reflects only the profit relating to the change. This will ensure a proportionate response targeted at the risk of artificial diversion from the UK.

2.27 This should provide groups with greater freedom to reorganise in a commercial manner while still being outside the scope of the CFC rules.

2.28 Extending the circumstances in which the period of grace is available, and disregarding wholly commercial changes will provide greater certainty to UK multinationals on an overseas acquisition or restructuring, and to non-UK headed groups considering a move of group or regional headquarters to the UK.

Question 2H: The proposal will include the ability for businesses to apply to HMRC for an extension to the period of temporary exemption, in exceptional circumstances. What genuine reasons would there be for needing such an extension?

Other improvements

2.29 Businesses suggested additional improvements during the consultation process. The focus has been on measures that would benefit the greatest number of businesses without adding additional complexity and remaining consistent with what can be addressed ahead of full reform. It is proposed that the following improvements are included in the interim package:

- improve the de minimis exemption; and
- extend the transitional rules for superior and non local holding companies.

2.30 These areas will also be revisited as part of full reform to determine if further improvements can be made.

2.31 During consultation it was made clear that it can be difficult or burdensome in compliance terms to establish an exemption for US Limited Liability Company (LLC) (and similar entities) and joint ventures companies under existing rules. Whilst the new exemptions may provide assistance to joint ventures companies in appropriate cases, the Government will continue to explore whether these exemptions could assist trading US LLCs (and similar entities) in this regard. In addition, HMRC will consider how its published guidance could provide further certainty on the availability of the motive test exemption on these issues.

Improve the de minimis exemption

2.32 A CFC can qualify for exemption if its chargeable profits do not exceed £50,000 in a 12 month accounting period. There is a case for increasing the de minimis exemption limit for groups which include companies larger than those falling within the EU definition of small and medium sized enterprises. The Government therefore proposes to increase the limit for such groups from £50,000 to £200,000 (see A.27 to A.31 of Annex A).

2.33 The Government also proposed to change the measure of profits from one which requires the application of full UK tax law to the CFCs accounts ('chargeable profits') to one based on accounting profits. This should make it easier to identify whether the exemption applies and should reduce compliance burdens. Moving away from 'chargeable profits' makes it unnecessary to apply the existing detailed CFC rules, and removes the requirement for full UK tax rules to be applied. While greatly simplifying the process, this change is not without some avoidance risk, and so the measure includes limited anti-avoidance rules.

2.34 For SMEs, the de minimis limit will remain at £50,000. But the move from chargeable profits to an accounts based measure should make the exemption more useful to these groups.

Extend the transitional rules for superior and non local holding companies

2.35 Finance Act 2009 included transitional rules for superior and non local holding companies to ensure they could continue to qualify for exemption under the exempt activities test for the period to July 2011. The Government will extend these transitional rules for an additional 12 months to ensure that the exemption provided remains available until the completion of CFC reform in 2012 (see A.32 of Annex A).

Next steps for the consultation process

Responses and enquiries should be sent Robert Edwards or Jennifer Payne at:

CFC reform
Corporate tax team
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ.

Or alternatively:

Robert Edwards on Robert.edwards@hmtreasury.gsi.gov.uk or 020 7270 5276
Jennifer Payne on Jennifer.payne@hmtreasury.gsi.gov.uk or 020 7270 5072
HM Treasury Corporate Tax Reform team on corporatetaxreform@hmtreasury.gsi.gov.uk

Confidentiality

2.36 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.

2.37 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 HMRC.

2.38 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 Technical note on CFC interim improvements

Intra Group Activities Exemption

A.1 The legislation will include requirements in respect of the following :

- business establishment
- business activities
- amount of finance income and income arising from IP
- extent of connection with the UK

A.2 The business establishment condition will mirror that already included in the current exempt activities test. As with that test, the intention is to require sufficient substance in the territory of residence.

A.3 The business activities condition will require the majority of the CFC's business to be trading activity. As with the current exempt activities test, the approach will be to set out those activities which do not qualify as trading activities. The non-trading activities definitions will be similar to the definitions of "investment business" in the existing legislation. In order to meet this condition, no more than 10% of the business can consist of non-trading activities.

A.4 There will be a specific restriction in respect of insurance business carried out by non-insurance groups, often referred to as captive insurance arrangements.

A.5 Finance income and income from intellectual property condition: there will be a separate limitation in respect of this income. This will be set at 5% of total gross income. Finance and IP income in excess of this amount will be subject to a CFC charge.

A.6 UK business connection condition: as this new intra-group exemption is designed primarily for 'foreign to foreign' trading transactions, the legislation will limit the extent to which the CFC can have transactions or business connections with the UK.

A.7 The proposed approach is to test the gross income and the business expenditure of the CFC to measure to what extent that income arises from, or expenditure is incurred with, the UK. This UK connection condition will not distinguish between connected and unconnected parties.

A.8 The condition will be met if no more than 10% of the gross income or expenditure of the CFC arises from a UK connection.

A.9 Even if there is a connection with the UK of more than 10%, but not more than 50%, full exemption will be available to CFCs whose overall level of profitability is sufficiently low to indicate a limited Exchequer risk, and which is effectively managed in the territory. For this purpose, effective management means sufficient individuals working in the territory of residence, or in any other territory outside the UK, who have the competence and authority to undertake all, or substantially all, of the company's business. The profitability measure will be a mechanical test. If these conditions are not satisfied, then the UK company with a relevant interest in the CFC may apply to HMRC for a reduction in the CFC charge. Further detail is provided at paragraph A.33

A.10 If the level of UK connection exceeds 50%, this exemption will not be available.

Non-UK Intellectual Property Exemption

A.11 This exemption is designed to exclude from charge profits from intellectual property with little or no connection to the UK. The legislation will impose requirements in respect of the following :

- business establishment
- business activities
- UK connection
- finance income

A.12 The business establishment test will mirror that set out in the current legislation.

A.13 The business activities condition will require that the main business of the CFC is the exploitation of IP, and that any secondary activities would, if treated as the main business, satisfy either the existing exempt activities test, or the new intra-group exempt activities test.

A.14 In addition, the business activities condition will determine whether the IP has a UK connection. In this context, the UK connection will be measured by reference to the following factors :

- whether the IP has been held in the UK within the preceding 10 years
- whether activities in relation to the creation, development, maintenance or enhancement of the IP have been carried on in the UK

A.15 Failure of either condition will mean that the exemption is not available. These restrictions are intended to prevent IP diverted from the UK from benefiting from this exemption.

A.16 The UK connection condition: this condition will determine whether the level of UK connection is such that the IP cannot be considered to be remote from the UK. This will be measured by reference to the following factors :

- The extent to which funding to acquire, maintain or enhance the IP has been provided from the UK, other than by debt funding.
- The extent to which the income of the CFC is derived from sales in the UK
- The extent to which R&D expenditure is incurred in the UK – incidental or insignificant expenditure will be disregarded.

A.17 This condition will not be met unless the extent of UK connection is minimal.

A.18 Finance income is limited to 5% of gross income, with the excess subject to a CFC charge. The machinery by which the CFC charge is fixed by reference to the excess finance income is detailed at paragraph A33.

Suspension of CFC rules following acquisition or reorganisation

A.19 New rules will be introduced to formalise and expand the current ‘period of grace’ approach in respect of acquisitions and reorganisations.

A.20 The CFC rules will not apply to relevant companies for a period starting on the date of acquisition or reorganisation and ending 24 months after the end of the accounting period in which the acquisition takes place. In practice, this will be a period of up to 3 years.

A.21 The exemption will apply in relation to the following types of CFC :

- Companies not previously under UK control
- Acquisition vehicles set up in order to acquire such companies from third parties

A.22 The exemption will cover both acquisitions from third parties, and certain types of group reorganisations – for example, where a non-UK headed group sets up a regional holding company in the UK, and in doing so brings the group's subsidiaries held by that company within the scope of the UK CFC rules. Similarly, the exemption will apply to groups migrating into the UK.

A.23 For third party transfers of companies between UK groups during a period of temporary exemption, it is intended that the balance of the period will be available to the acquiring group.

A.24 The period of suspension will cease for a CFC if, during the period, there is a relevant change in the business of that CFC. Whether a change is relevant will be measured by reference to whether there is a reduction in UK tax as a result of that change.

A.25 For the accounting period in which a relevant change occurs, a partial CFC charge may arise in order to deal with the reduction in UK tax identified. The partial charge mechanism is covered below at paragraph A33.

A.26 For accounting periods outside this exemption period, the other CFC exemptions will apply in the usual way.

De Minimis Exemption

A.27 The computation of profits for the de minimis exemption will be simplified by replacing the current UK chargeable profits approach with an accounts based measure of profits.

A.28 In addition, for UK-headed groups with at least one large company as a member, the current £50,000 limit for a CFC in such a group will be replaced by a £200,000 limit. The smaller limit will remain for groups consisting only of small and medium sized companies. As currently, these limits will be proportionally reduced for accounting periods of less than 12 months. Small and medium sized companies are defined by reference to the EU definition.

A.29 The starting point for the profits calculation will be the total profits (excluding capital gains or losses) calculated in accordance with GAAP.

A.30 Those accounting profits will then need to be adjusted in line with the transfer pricing rules. However, if the difference between the accounts profits and the transfer pricing adjusted profits is less than £50,000, the transfer pricing adjustment can be disregarded. This approach is intended to provide some protection against manipulation of profits without imposing an undue compliance burden.

A.31 There will be anti-avoidance measures to ensure that groups do not arrange their affairs purely to take advantage of this exemption. Potential CFCs involved in such arrangements will be prevented from claiming the de minimis exemption.

Holding Company Exemption

A.32 The transitional holding company rules scheduled to expire in July 2011 will be extended until July 2012. This is intended to cover the period until full CFC reform takes place.

Partial exemption mechanism

A.33 A mechanism will be introduced to enable a partial CFC exemption for entities which do not meet the conditions for full exemption.

A.34 The mechanism will be similar in approach to that used by s751A in that the UK resident company with a relevant interest in the CFC will make an application to HMRC, , but rather than specify the amount that an apportionment can be reduced by, the new rules will enable groups to specify the amount of the CFC apportionment. In other words, the new rules will enable a group to assess the proportion of its profits which should be subject to a CFC charge.

A.35 Applications may be required in any of the following circumstances:

- IP and non-IP CFCs where financial income exceeds 5% of gross income.
- Non-IP CFCs where the combined financial and IP income exceeds 5% (in these circumstances the IP income will be deemed to be interest income)
- Non-IP CFCs where the level of UK connection exceeds 10% but not 50%.
- CFCs whose period of temporary exemption has ended due to a relevant business change

A.36 With regard to the first two bullet points above, the legislation will specify that the assessable profits cannot be less than the excess income. For example, assuming a 5% limit:

- finance income is 7% of gross income: 2% of financial income will be subject to a CFC charge.
- finance income is 6% of gross income ; income from IP is 4% of gross income. Of this 10% total, 5% will be subject to a CFC charge.

A.37 For simpler issues such as excess finance income, it is intended that the mechanism will be sufficiently certain to allow groups to determine their CFC liability.

A.38 With regard to non IP CFCs where the level of UK connection exceeds 10% but not 50%, the legislation will require an assessment of the economic value added by the CFC and the extent to which the profits of the CFC have arisen as a result of transactions with the UK. There will be an element of subjectivity in any such assessment – and for that reason the application mechanism will enable such cases to be discussed with HMRC.

A.39 With regard to a period of temporary exemption that has ended due to a relevant business change, the legislation will require an assessment of the extent to which profits are attributable to the relevant business change – again, there will be an element of subjectivity in any such assessment, and such cases can be discussed with HMRC.

B Summary of questions

This Annex summarises the questions raised throughout this Part of the Document

New exemption for certain intra group activities

- Question 2A: Are the proposed parameters of the relevant conditions of the new exemption an appropriate response at the interim stage whilst still providing adequate protection of the UK tax base?
- Question 2B: Is the proposed percentage limit for finance income sufficient and is there a case for providing greater flexibility for finance income that is a necessary incident or which is integral to the CFC's trade?
- Question 2C: When considering UK connection, is there a case for distinguishing between transactions with connected parties and those with third parties? Are there circumstances in which third party transactions could be left out of account?
- Question 2D: With regard to the 'safe harbour', are there alternative parameters which would be more effective? What might be the most suitable measure of such parameters?
- Question 2E: The proposed approach to partial exemption is to ensure that the rules are more targeted, moving away from the all or nothing approach of the current rules. Is the approach suggested workable?

Exploitation of IP with no UK connection

- Question 2F: Recognising that this IP exemption is intended to be narrow in scope, are there any changes to the design parameters that would make it more useful to business in advance of full reform but which would not increase the risk of UK tax base erosion?
- Question 2G: Is the restriction in reference to research and development expenditure in the UK appropriate and is the proposed approach practical? If not, is there another more suitable parameter that could be used?

Temporary exemption following acquisition or reorganisation

- Question 2H: The proposal will include the ability for businesses to apply to HMRC for an extension to the period of temporary exemption, in exceptional circumstances. What genuine reasons would there be for needing such an extension?

Part IIIB: Foreign branch taxation

1 Introduction

1.1 At the Budget, the Government announced its intention to make company taxation more territorial and to bring forward proposals in Finance Bill 2011 to reform the taxation of foreign branches in line with this. Broadly, a foreign branch is established by a UK company if it carries on part of its trade in another jurisdiction without establishing a separate trading subsidiary company there.

1.2 Following the Budget announcement, the Government published a discussion document in July setting out a number of options as to how reform of foreign branch taxation could best be achieved.[1]

Principles for reform

1.3 In pursuing this reform the Government will apply the principles set out in the Corporate Tax Road Map.

1.4 A key objective of reform to foreign branch taxation is to improve the overall competitiveness of the UK tax system.

1.5 In contrast to the current rules for foreign branch taxation, dividend income from the foreign subsidiaries of a UK parent company is generally exempt from UK corporation tax (CT), following a change to the rules in 2009. As a result of this, exempting foreign branch profits will ensure greater alignment between the taxation of foreign branches and foreign subsidiaries.

Consultation to date

1.6 The consultation is being conducted in line with the principles outlined in the document *Tax policy making: a new approach* published alongside the Budget. 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

1.7 The next chapter includes the Government's detailed proposals for reforming foreign branch taxation, which completes stage 2 of the process. The Government will shortly publish draft legislation, which is stage 3 of the process. The purpose of the next stage of consultation is to seek views on the draft legislation and the implementation of the proposals.

[1] *Foreign branch taxation: a discussion document,* HM Treasury, 27 July 2010.
http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm
More precisely, the reform is to the taxation of foreign permanent establishments.

Next steps

1.8 The Government welcomes responses by 9 February 2011 in order to allow drafting changes to be made in advance of Finance Bill 2011. Details on how to respond are provided at the end of the next chapter. Draft legislation and an Explanatory Note will shortly be published.

1.9 The Government will also shortly publish draft guidance on the rules preventing artificial diversion of profits to exempt branches, together with some more detailed questions on the draft legislation.[2]

1.10 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. The existing foreign branch taxation working group will continue to meet, to support the Government in developing final legislation.

[2] The draft guidance and questions will be available at http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm

2 Reforms to foreign branch taxation

2.1 This chapter sets out the main issues considered in the previous discussion document, a summary of the responses of interested parties to the document and the proposals which the Government is taking forward. At the end of the chapter there are some questions for interested parties on the proposals.

Issues considered in the discussion document

2.2 Under the present rules, UK companies are subject to CT on the profits of their foreign branches, with credit given for foreign tax paid on the same profits, in order to relieve double taxation. In cases where the foreign tax paid is less than the UK tax, then the company must pay a "top up" of UK tax, while under an exemption regime there would be no such tax. In addition, exempting foreign branch profits will ensure greater alignment between the taxation of foreign branches and foreign subsidiaries, following the introduction in 2009 of an exemption for dividend income from foreign subsidiaries.

2.3 The discussion document presented a number of options regarding the possible scope of a foreign branch exemption regime. Issues included:

- the basis for foreign branch exemption
- exemption for chargeable gains
- whether exemption should apply to air transport and shipping
- how the new regime should prevent artificial diversion of profits
- whether the scope of exemption should extend to countries with which the UK does not have a double taxation agreement

The discussion document also included several options to relieve losses incurred in foreign branches. Issues included:

- maintaining loss relief to various extents, either coupled with a profits exemption or as part of an elective regime
- mechanisms for the reclaim of any relief previously provided ("claw-back") in respect of branch losses once the branch moves into profit
- a transitional rule for losses carried forward that are derived from branch business, the subsequent profits of which become exempt from UK tax as a result of any change to the regime for taxing foreign branches of UK companies

Responses of interested parties to the discussion document

2.4 Responses to the discussion document focused on large businesses, and consultation to date has indicated that the reforms will not have a significant impact on small businesses.

2.5 A number of respondents regarded an elective exemption regime as the best approach to ensuring a competitive regime for all sectors. In particular, businesses currently making use of loss relief for foreign branch activity as part of their business model were generally in favour of an elective regime, and many were concerned that the alternative option of providing loss relief with claw-back alongside exemption could be complex. However, a number of other respondents preferred the latter option, as it would provide some extra benefit to generally profitable companies making unexpected losses.

2.6 On the issue of how to define the basis of exemption there were mixed views, with a slight overall preference among respondents for a treaty basis. A further option for defining the basis of exemption was put forward at the working group, which was to define those profits subject to CT – in effect, those arising from the UK 'permanent establishment' of the company – rather than those exempt from CT. However, discussions with businesses indicated that the unfamiliarity of this approach could make compliance more difficult for some businesses.

2.7 There was a strong message from many respondents that extending exemption to all countries and territories is important for the competitiveness of the new regime.

2.8 Exempting chargeable gains was generally felt to be less important for competitiveness than, for example, extending exemption to all countries and territories, but useful for businesses nonetheless. Respondents noted that exempting gains would achieve better alignment between taxation of branches and subsidiaries.

2.9 No concerns were raised over the Government's proposal not to extend exemption where the taxing rights of a branch territory are restricted by other treaty provisions such as a shipping, inland waterways transport and air transport article of a tax treaty.

2.10 Regarding the transitional rule, a number of respondents had concerns that the rule could introduce complexity into the regime. There was a mixture of views as to which of the options for a transitional rule provided in the discussion document was preferable.

The Government's proposals for reforming foreign branch taxation

2.11 The following section outlines the Government's proposals for reform. Further details will be provided in the Explanatory Note and draft legislation to be published shortly.

2.12 The Government proposes an **opt-in exemption regime** for foreign branch taxation. Companies within the exemption regime will not receive relief in respect of the foreign branch losses. This has a number of advantages over the alternative of exempting profits for all companies while giving some loss relief, including:

- consistency with the principle of providing loss relief only where profits are also taxed, as is the case for foreign subsidiaries;
- avoiding the need to introduce artificial "claw-back" of loss relief within an exemption regime; and
- continuity of treatment for companies choosing to remain in the current regime.

2.13 The election will be irrevocable, so that any company may elect for all its branches to be permanently exempt from UK CT. This means that no company will make a transition from branch exemption to worldwide taxation, making special rules to deal with such a transition unnecessary.

2.14 The opt-in exemption regime will apply to foreign branch trading profits and to investment income that is effectively connected to the branch.

2.15 Exempt profits will be defined by reference to individual treaties. For branches in territories where there is no treaty, the measure of exempt profits will be determined by the OECD model treaty.

2.16 The Government will extend the opt-in exemption regime for large and medium companies to **all countries and territories**, including those with which the UK has no tax treaty. The Government notes that this goes beyond the foreign branch exemption regimes of many other countries.

2.17 As indicated in the July discussion document, the Government will not extend exemption to non-treaty branches of small companies, because of the risk of loss of tax through diversion of personal income. This is in line with the treatment of foreign subsidiaries.

2.18 The Government proposes to extend exemption to **chargeable gains** by reference to the relevant treaty, or to the model treaty. That part of the gain which is (or was) taxable in accordance with the treaty will be exempt from CT. For example, if the host state taxes a gain arising on immovable property in the branch territory, that gain would be fully exempt from CT.

2.19 There will be a **transitional rule** as part of the exemption regime, because exemption would otherwise prevent the claw-back of relief already given for foreign branch losses, potentially resulting in significant costs for the Exchequer. When a company opts into exemption, the company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding 6 years have been matched by profits, except in the case of very large losses. Further details are provided in the Annex.

2.20 As a consequence of the EU Solvency II directive, the Government is working with industry to develop a new basis of taxation for **life insurance** companies from 2013 onwards. The Government will consult closely with industry on potential reform of foreign branch taxation in respect of life insurance companies and on when any such reform would be implemented.

Interaction with CFC regime and commencement

2.21 The Government will introduce the new regime for foreign branch taxation in Finance Bill 2011, and plans to make the new regime available for accounting periods commencing on or after a specified date in 2011.

2.22 Rules are needed to protect the UK tax base against the **artificial diversion of profits**. The Government proposes that, where a company opts in to the branch exemption regime, each of its branches will potentially be subject to anti-diversion rules. If a branch does not comply with the anti-diversion rule in any year, then the profits arising from that branch in the year will be subject to CT, with credit for foreign tax given in the usual way.

2.23 There is a question as to what form the anti-diversion rules should take. The Government will provide the same protection against artificial diversion of profits as applies to foreign subsidiaries. However, extending the current CFC regime to branches raises some significant challenges:

- the whole of the CFC regime will be reformed in 2012, so 2011 legislation applying existing rules to foreign branches will be repealed and replaced a year later; and
- because the current CFC rules apply on an entity basis, they do not form a natural test of branch income.

2.24 The full reforms to the CFC regime in 2012 will include changes to update protection in respect of foreign branches. Before then, for the first year of the new exemption regime there will be a CFC-type regime introduced for foreign branches with more limited carve-outs. This will reduce the length and complexity of temporary anti-diversion provisions in Finance Bill 2011, while allowing businesses the opportunity to benefit from branch exemption. Further details are provided in Annex A.

Questions for interested parties

How well does the draft legislation (to be published shortly on the HM Treasury website) put into effect the policy proposals set out above?

How could the legislation be improved?

What else should it include?

Do you agree that new regime should be available for accounting periods commencing on or after a specified date in 2011?

How to respond

2.25 Responses and enquiries should be sent to:

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Alternatively, please email: carol.johnson@hmtreasury.gsi.gov.uk

Further information may be found at:

http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm

Telephone enquiries: 0207 270 6032

Confidentiality disclosure

2.26 Information provided in response to this document, 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 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

2.27 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, 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 regarding as binding on HM Treasury or HM Revenue & Customs (HMRC).

2.28 HM Treasury 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 Technical note on reforms to foreign branch taxation

A.1 In broad terms, the Government proposes to provide companies with the option of exemption from CT for foreign branch profits, irrespective of the branch territory, subject to the same protection against artificial diversion of profits as applies to foreign subsidiaries.

Opt-in mechanism

A.2 Every UK-resident company will be able to make an irrevocable election for all of its foreign branches to be exempt from CT. The profit or loss arising in each foreign branch will then be deducted from the UK company's worldwide profit calculation to give a net amount that is subject to CT.

A.3 Branch exemption will prevent relief being given for branch losses, and so the regime will be optional. The election will cover only the company making the election, but will apply to all present and future branches of that company.

Transitional rule

A.4 A transitional rule will be applied when a company opts in to the branch exemption regime. Under this rule a company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding 6 years have been matched by profits (except in the case of very large losses, as explained below in paragraph A.7). This will help ensure the reforms are affordable, by preserving the Exchequer's ability to mitigate the cost of loss relief already given in respect of foreign branches. At the same time, the 6 year time limit will help manage compliance burdens.

A.5 When a loss arises in a foreign branch it is currently relievable against the overall profits of the company in the UK. At the same time the overseas territory usually allows the losses to be carried forward to be set against future profits to give relief from local taxation. This gives a lesser amount of foreign tax to be relieved against UK tax on the branch profits and therefore mitigates the cost to the Exchequer of the UK loss relief.

A.6 The transitional rule will defer entry into exemption to allow this recovery of value following loss relief to continue. It will look back to see what losses have arisen in foreign branches and whether those losses, taken together in aggregate, have subsequently been matched by foreign branch profits. If not, the commencement of exemption for the company opting in will be delayed until they are.

A.7 The rule will be based on a calculation of losses over this period that would have been carried forward by branches if they had been separate entities (the notional "carry forward") and a corresponding amount of profit will be taxed (with double taxation relief available) before exemption commences. In general the transitional rule will look back for 6 years from the date at which the election into exemption is made. However, there will be an exception where very large branch losses have been made in the six years preceding the introduction of the new regime. In those circumstances, the large loss must be carried forward until the aggregate of all the losses made in the foreign branches has been matched by profits made in the foreign branches. "Very large" will mean losses over a specified amount, say £50 million.

A treaty-based approach

A.8 The Government will provide exemption for profits defined by reference to individual treaties. For branches in territories where there is no treaty, the measure of exempt profits will be determined by the OECD model treaty.

A.9 Where a UK resident company has a foreign branch in a treaty jurisdiction, the treaty requires both states to compute the profits that are attributable to the permanent establishment. The UK computation provides the measure of CT which limits the company's entitlement to credit against CT in respect of the foreign tax. With certain exceptions, branch exemption will proceed in the same way, with the existing UK measure of branch profits representing the exempt amount. Where this measure produces a loss, it will be cancelled in the calculation of the company's profits that are subject to tax.

A.10 This approach ensures that, where it applies, exemption will be a complete replacement for credit relief as a means of relieving double taxation. The approach leaves the initial computation of worldwide profits unchanged, but modifies it by exclusion of the branch profit or loss.

Chargeable gains

A.11 A company within branch exemption should prepare a computation of all its chargeable gains and losses in the same way as it currently does. It will then deduct from the total any gain, or part of a gain, attributable to an exempt branch and add back any loss, or part of a loss, so attributable.

A.12 The attribution of chargeable gains and losses to exempt branches will follow the principles of the relevant tax treaty, so that relief from double taxation will be achieved as far as possible by exemption instead of credit relief. Where no full treaty is in force the attribution will follow the principles of the updated model treaty released by the OECD in July 2010.[1] The detail of the computation will follow UK rules.

A.13 Some specific chargeable gains rules, for example on transfers of assets to a non-resident company will need to be adapted. The Government will need to consider whether anti-avoidance rules are needed in respect of chargeable gains specifically, for example in relation to transfers of assets within a group.

Investment income

A.14 Investment income will be included in the exempt profits of a branch to the extent it is 'effectively connected' to the branch. The term 'effectively connected' is used in several model treaty articles.[2] Such sources of income must be 'genuinely connected' to the business i.e. the economic ownership of the assets that generate the income should lie with the branch rather than some other part of the enterprise.

A.15 Branch exemption will not be available to a company whose business is wholly or mainly investment business, as defined in section 1218 Corporation Tax Act 2009 (CTA 2009).

A.16 Some aspects of defining trade profits, such as capital attribution, raise particular issues. These are set out below.

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[1] *Model Tax Convention on Income and Capital*, OECD, 22 July 2010.
http://www.oecd.org/document/37/0,3343,en_2649_33747_1913957_1_1_1_1,00.html

[2] See 10(4) (Dividends), 11(4) (Interest), 12(3) (Royalties) and 21(2) (Other Income). The term 'effectively connected' is also relevant in relation to moveable property in articles 13 and 22 (Capital Gains and Capital).

Capital attribution

A.17 The treaty approach is based on the separate entity principle. This attributes to a branch the profits that it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing independently. The principle provides for the attribution of such equity and loan capital to the branch as it would reasonably be expected to have if it were a separate entity.

A.18 The issue was discussed separately in the discussion document as it is of particular significance in the banking and insurance sectors. For banks it is fundamental to the amount of interest expense to be deducted in calculating branch profits and for insurance companies to the attribution of "free assets".

A.19 To provide clarity and limit risk regarding over-attribution to exempt branches it is intended to make some principles explicit, including:

- Attribution should follow an allocation of the company's free capital / free assets based on a factual and functional analysis that takes into account the whole of the company's business. This will include consideration of the funding structure that would be reasonably expected to support the company's business other than those parts of it carried on through its foreign branches.
- Where a tax treaty is in place the principle above will be subject to the provisions of the Business Profits article of that treaty.
- If the amounts of free capital or free assets allotted to a branch are in excess of the arm's length range, the amount attributed to the branch will be adjusted to an amount within the limits set by the arm's length range.

Minimisation of branch profits

A.20 Companies will be expected to minimise the profits that are subject to tax in the branch jurisdiction, for example by taking full advantage of the extent to which the treaty limits that territory's taxing rights.

A.21 Companies should also make claims and elections that are available to reduce the corporation tax measure of profits arising in the branch. For example, capital allowances should be claimed.

Exceptions

Air and shipping

A.22 Foreign branch exemption will not extend to international air transport and shipping as these activities are generally not taxed by the foreign jurisdiction. Article 8 of the OECD model treaty restricts taxing rights over profits made in the foreign territory to the state where the effective management of the enterprise is situated, i.e. the state of residence.

No restriction for non-treaty jurisdictions

A.23 Exemption will still apply in the case of branches in states with which the UK has no double taxation agreement, or none with a non-discrimination article. Profits of such branches will be calculated by applying the updated OECD model treaty. The risk to the Exchequer from the artificial diversion of profits to such states which charge little or no taxation on branch profits will be countered by applying CFC concepts to particular income of a company that is attributed to the branch. Adaptation of the CFC rules is discussed below.

Protection against artificial profit diversion

A.24 Profits should not be exempt to the extent that they would have been subject to a CFC apportionment, had they arisen in a foreign subsidiary. This principle ensures that branch exemption does not undermine the protection of the CT base afforded by the CFC regime.

A.25 The current CFC regime is entity-based: generally it either exempts a company or applies a tax charge to the whole of its profits. In the branch context it is necessary instead to apply CFC concepts to particular income of a company that is attributed to the branch. This means that legislation to apply CFC concepts to branch income will be relatively long and detailed.

A.26 The CFC regime will be reformed in 2012 and so 2011 legislation applying existing CFC rules to foreign branches will be repealed and replaced a year later. To reduce the length and complexity of these temporary anti-diversion provisions in Finance Bill 2011, the Government proposes to include a CFC-type regime for foreign branches, with a motive test, a lower level of taxation test and a de minimis level of profit as the available carve-outs. The temporary anti-diversion provisions in Finance Bill 2011 will extend to small companies.

A.27 The Government continues to consult on proposals for the comprehensive reform of the CFC regime in Finance Bill 2012. These reformed rules will be written so as to apply equally to both foreign subsidiaries and exempt foreign branches.

A.28 It is anticipated that further specific rules will be needed to prevent abuse of branch exemption. Particular provisions are envisaged in respect of leasing activities as well as a more general rule regarding transfers between connected companies.

Commencement

A.29 The Government intends to give effect to the legislation for accounting periods commencing on or after a specified date in 2011. Once the legislation takes effect, a company will be entitled to opt into the exemption rules, which will apply from the beginning of the next accounting period, subject to the transitional rule described above.

HM Treasury contacts

This document can be found in full on our website at:
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