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Corporate Tax Reform: Delivering a More Competitive System

Open Event

11 January 2011

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Agenda

1. Part I: The Corporate Tax Road Map
2. Part II A: Controlled Foreign Company (CFC) reforms
3. Part II B: Innovation and IP – the Patent Box
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Part I: The Corporate Tax Road Map

Corporate tax reform: aims and objectives

"Our tax system was once an asset. And it needs to be an asset again."

Exchequer Secretary's foreword, Corporate Tax Road Map

Corporate Tax Reform: delivering a more competitive system shows how the Government will work with business to enhance UK tax competitiveness.

It contains a programme of corporate tax reforms that has been designed to restore the UK's tax competitiveness and provide certainty to business:

- creating the right conditions for business investment and growth;
- responding to business concerns over instability and unpredictability;
- reversing trend of businesses leaving the UK

The Road Map provides aframework for this programme including the Government's principles, timetable and approach to stakeholder engagement

Principles for corporate tax reform

To provide a clear and consistent direction for reform the Government has committed to the following principles:

- **Lowering rates while maintaining the tax base** – 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
- **Being aligned with modern business practice –** The tax system needs to keep pace with global developments and not stifle adaptation or create perverse incentives for business
- **Avoiding complexity –** Simplicity to be a feature of good tax policy, seek to avoid complexity where possible
- **Maintaining a level playing field for taxpayers –** The tax system should be fair across tax payers without distorting commercial decisions

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The Corporate Tax Road Map: Key elements of reform

- As previously announced, the main rate of corporation tax will be reduced from 28% to 24% by 2014
- Reform of the CFC rules for 2012 to make them more competitive with CFC interim improvements in 2011 (Part II A and III A)
- Introduction of a 10% Patent Box to encourage innovative business to invest in the UK and reaffirming the Government's commitment to retain and build on the support R&D tax credits provide for innovation, including consideration of the proposals of the Dyson Review (Part II B)
- An opt-in exemption for corporate tax on the profits of foreign branches (Part IIIB)
- Commitment to open and transparent tax policy making and tax simplification

The Corporate Tax Road Map – summary of timetable for reform

Autumn 2010

- Publish papers covering CFC reform, IP, the Patent Box and R&D tax credits
- Publish further details followed by draft legislation on the CFC interim improvements and on chosen option for foreign branch reform

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 and details of the Patent Box for consultation
- Legislate for foreign branch reform, CFC interim improvements and capital allowances reductions in FB2011

Autumn 2011

- Publish draft legislation on new CFC rules and the Patent Box

Spring 2012

- Introduce further cut in main rate to 26 per cent and reductions to capital allowances
- Legislate outcomes following consultation on new CFC rules and R&D and the Patent Box in FB2012

Spring 2013

- Introduce further cut in main rate to 25 per cent and the Patent Box

Spring 2014

- Introduce further cut in main rate to 24 per cent

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The Corporate Tax Road Map – Engagement Strategy

- Nominations for proposed working groups closed on 9 December 2010 – hope to confirm membership shortly

Business Forum on Tax and Competitiveness

CT Liaison Committee

CFCs

Money | IP | Interim

Insurance | Banking | Property

Patent Box

Branches

R&D

Comments on full CFC reform and taxation of innovation and IP are required by 22 Feb

Comments on CFC interim improvements and foreign branches are required by 9 Feb

Full details (including full engagement strategy and contact details) can be found on http://www.hm-treasury.gov.uk/corporate_tax_reform.htm

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Part II A: CFC reform

CFC reform: Overview

- CFC rules have been in place since 1984 – current rules can go further than protecting corporate tax revenues. Significant modernisation needed
- **More territorial approach** to be adopted to better reflect global reality of modern business
- **Aims.** New CFC regime should:
  - Target and impose a CFC charge on artificially diverted UK profits;
  - Exempt foreign profits where no risk to UK tax base; and
  - Not tax profits from genuine economic activities
- New rules will work on a **mainly entity based system that will operate in a targeted way** so a proportional CFC charge applies

CFC reform: Aim of CFC proposals for finance companies

- To deliver balanced and competitive CFC rules for monetary assets that **make it easier for groups to manage overseas operations while protecting the UK tax base**
- **Government is ruling out fundamental changes to interest deductibility** that could be used to address the risk of artificial diversion of UK profits when money is borrowed in the UK to finance offshore investment
- Fungibility of monetary assets makes it difficult to distinguish between finance used for wholly commercial transactions and that which erodes UK tax base. As a result of these difficulties, **tracing rules have been rejected**
- Monetary assets are intrinsic to the trade of banks and insurers and will require different rules

CFC reform: Finance company – proposals

- Introduce a finance exemption to exempt companies that are appropriately funded in terms of debt and equity. This approach is a simple and pragmatic solution that recognises the fungibility of monetary assets
- Where equity exceeds the set level, a proportional CFC charge will arise
- **The Government will consider the case for a minimum debt:equity ratio of 1:2 and will discuss behavioural and tax impacts with businesses**
- Incidental or ancillary interest earned within trading companies should not give rise to a CFC charge
- Finance company exemption should also apply to interest arising on excess cash held alongside trading activity in CFCs

CFC reform: Aim of CFC proposals for intellectual property

- To make the CFC rules more competitive by **not inhibiting how a group manages commercial operations overseas and foreign IP whilst protecting the UK tax base**
- The rules should target the behaviour that gives rise to the highest risk of artificial diversion of UK as follows:
  - Where IP has been developed in the UK and transferred to low tax jurisdiction
  - Where IP held offshore is effectively managed in the UK
  - Where UK funds are used to invest in IP is held offshore as an investment

CFC reform: Intellectual property – proposals

- Rules aim to be targeted and flexible to fit different businesses and sectors
- Step 1: Identify high risk entities that hold IP with a substantial UK connection (e.g. IP transferred from UK within last 10 years, significant activity subcontracted to UK, funding from UK)
- Step 2: Identify entities with excessive profits and determine what proportion, if any, of those profits have been artificially diverted from the UK
- A safe harbour will remove low risk entities from a potential CFC charge
- In determining cases in which CFCs have excessive profits, consideration will be given to substance, the actual activity undertaken by the CFC, how the CFC is funded and other factors. Because of this subjectivity, the aim is to limit the cases when consideration of this test is required

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Part II B: The taxation of innovation and intellectual property

Patent Box

The Government will introduce a preferential regime for profits arising from patents

Aims

- To encourage innovative business to invest in the UK.
- To encourage companies to locate the high-value jobs and activity associated with the development, manufacture and exploitation of patents in the UK.
- To enhance the competitiveness of the UK tax system, recognising that patents are mobile and that multinational groups have a choice as to where to locate ownership and activity.

Patent Box – why patents?

- The majority of businesses hold some IP. Consistent with the direction set in the Road Map, the Government believes that rate cuts which benefit all should be prioritised over broadening reliefs.
- Given the amount of IP in the UK, a general relief would be expensive.
- Patents have a strong link to scientific and high-tech R&D and to technological innovation activities.
- Patents are readily identifiable and legally protected.

Patent Box – design principles

- To avoid unnecessary compliance burdens on business that will not benefit significantly, the regime will be optional.
- Profits in the box will be taxed at a 10% rate. The Government wants to provide an effective incentive to create and retain patents in the UK but believes it is not necessary to match the rates offered by other countries. A 10% rate strikes a good balance between affordability and competitiveness
- All patents first commercialised after 29 November 2010 will qualify for inclusion. More detailed qualification and transitional rules will be discussed in consultation.

Patent Box – design principles II

- The Government intends to make the Patent box available to both royalty income and 'embedded' income included in the price of patented products.
- Valuing individual patents using an arm's length standard is likely to impose an excessive administrative burden and the Government therefore intends to adopt a largely formulaic approach.
- The Patent Box will apply to net patent income after associated expenses, including precommercialisation expenses. However, the Government does not intend to restrict deductibility of expenses before companies benefit from the lower rate.
- The practicality and effectiveness of different design options will be discussed fully with business during consultation.

R&D Tax Credits

R&D tax credits

- Introduced to correct market failure where companies tend to under invest in R&D
- 2000 – **SME scheme** – 175% superdeduction, plus payable credit worth 24.5% of qualifying expenditure
- 2002 – **Large Company Scheme** – 130% superdeduction
- 2003 – **Vaccine Research Relief** – 140% superdeduction for R&D on drugs/vaccines for TB, malaria and HIV/AIDs

2008/9 statistics

- Around 8,350 companies claimed £980m of support
- Since introduction schemes have supported nearly £52bn of R&D by UK companies

R&D Tax Credits

Objective

- “Review the support R&D tax credits provide for innovation and the proposals of the Dyson review” (June Budget)

Key questions

- Are the schemes effective in supporting and stimulating additional R&D by UK companies?
- Are there elements of the schemes – e.g. qualifying costs/ definition – which could be reformed to ensure the relief is better targeted?
- Dyson proposals – refocus the schemes on high tech companies, small businesses and new start-ups. Increase the rate of relief to 200% (when public finances allow
- Claims process – streamlining/simplifying (& further Dyson proposals)

R&D Tax Credits

Structure and scope

- 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 CT reforms?

Qualifying costs and activities

- Are there additional costs that should be eligible for relief?
- Are there costs, such as internal use software, which could be limited or excluded from being eligible for relief?
- Is the R&D definition contained in the BIS guidelines effective for recognising genuine R&D activity?
- Would respondents welcome a statutory definition of ‘production’? If so what should it include or exclude?

R&D Tax Credits

Refocusing

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

Vaccine Research Relief

- Is VRR an effective intervention or would it be more effective to deliver the support through other mechanisms?

Claims process

- 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 projects with HMRC?

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Part III A: CFC interim improvements

CFC interim improvements: Aims

- Are the first step to CFC reform to be introduced in 2011, followed by full reform in 2012. Draft legislation was published on 9 December
- Consistent with the direction of travel of full reform, but do not pre-empt decisions on full reform
- Affordable to the Exchequer and should not require extensive legislative changes that would divert businesses and Government resource from full reform
- Financing and most situations involving IP are not in scope
- Further improvements to the measures adopted will be considered at full reform. Other improvements suggested during consultation but not adopted at this stage will also be reconsidered as part of full reform

CFC interim improvements - proposals

- **A foreign to foreign intra-group trading activities exemption** provided there is minimal connection with the UK and little risk of artificial diversion of UK profits
- An exemption for a CFC with a main business of **IP exploitation** where the IP and the CFC have **minimal connection with the UK**
- **Extension of current period of grace** by exempting for up to three years 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
- Improvement to the **de minimis exemption** and deferral of the withdrawal of the exemption for certain **holding companies**
- For simplicity, it is proposed to commence for accounting periods beginning on or after 1 April 2011 although this is subject to consultation and Ministerial approval

CFC interim improvements: Intra-group trading activities exemption

- A full exemption will be available for a CFC, if it meets the following conditions:
  - a business establishment in its territory of residence
  - mainly undertakes trading activities
  - minimal finance income and income arising from IP
  - minimal UK business connection
- Where the UK business connection is more than minimal and the safe harbour does not apply, or where the finance income condition is exceeded, then **a proportionate CFC charge will apply**
- The safe harbour is included to reduce compliance costs and increase certainty by excluding CFCs on the basis of their relative profitability

CFC interim improvements: Non UK IP holding exemption

- An exemption for CFCs with a main business of IP exploitation where
  - the CFC has a business establishment in its territory of residence
  - the CFC has minimal UK business connection and minimal finance income
  - the IP exploited has minimal UK connection
- This is first step to reduce impact of CFC rules on non-UK IP, ahead of full reform in 2012. The Government recognises that this first step does not deal with common and complex business situations

CFC interim improvements: Temporary exemption following acquisitions and reorganisations

- Extend the current period of grace by introducing a suspension of the CFC rules **for up to 3 years** which, in particular, applies in the following cases:
  - A UK group acquires a non-UK group
  - A non-UK headed group restructures to become a UK-headed group, and
  - A non-UK headed group places a sub-group under the control of a UK intermediate holding company
- The temporary exemption will apply on a CFC by CFC basis, and unlike the current arrangements, **changes in the main business or activities of the CFC will not affect the exemption unless, and to the extent, that they erode the UK tax base**
- Issues to consult on - ability to apply for an extension in exceptional cases, interaction with clearances under existing period of grace

CFC interim improvements: Other improvements

- Amend the conditions of the current de minimis exemption, to increase the limit for large groups from £50,000 to £200,000 profits per annum, and to replace the need to calculate chargeable tax profits with an accounts based test
- Extend the transitional rules for superior and non local holding companies until July 2012

Foreign branch taxation (Part III B)

Foreign branch taxation reform: Overview

- **Aims:** New foreign branch regime should:
  - Enhance the overall **competitiveness** of the UK tax system; and
  - Achieve **greater alignment of tax treatment** between foreign branches and foreign subsidiaries of UK companies

- New rules will involve an **irrevocable opt-in election** at company level

Foreign branch taxation reform: Aims of proposals

- A competitive regime allowing businesses to make greater use of foreign branch structures
- The new regime should continue to allow loss relief for those businesses who wish to make use of it
- To replace credit relief with exemption
- To include chargeable gains within the profits to be exempted
- To ensure that the regime is affordable

Proposals – scope and basis of the regime

- The regime will involve an irrevocable opt-in election, to be made at company level. This is consistent with the principle of only giving loss relief where profits are taxed

- The quantification of profits to be exempted will be based on treaty principles for the attribution of profit to Permanent Establishments. Where a full treaty is not in place, the OECD model treaty will apply

- Exemption to extend to chargeable gains in the same way

Proposals – anti-diversion and transitional rules

- The new CFC rules in 2012 will apply to exempt foreign branches as well as to subsidiaries. Until then, an anti-diversion rule is based on the following exemptions: de minimis, lower level of taxation and motive test

- Special rules will limit the cost to the Exchequer arising on transition into exemption.
  - Exemption will be available once branch losses brought forward from the immediately preceding 6 years have been matched by branch profits.
  - The time limit will be extended for very large losses (c£50m).

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