



The Law Society

## **Corporate tax reform: delivering a more competitive system**

### **Controlled Foreign Company (CFC) Interim Improvements – Part IIIA**

#### ***Comments of the International Tax Sub-Committee of the Law Society of England and Wales***

#### **Introduction**

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.
2. This response has been prepared on behalf of the Law Society by members of the International Tax Sub-Committee. The Sub-Committee is made up of senior and specialist international corporate tax lawyers from across the country.
3. The Law Society welcomes this opportunity to comment on the Corporate Tax Reform document (published November 2010) setting out the Government's proposals and principles for reforms aimed at making our corporate tax regime more competitive. In this respect we were pleased to note, in his Foreword, the observations made by the Exchequer Secretary to the Treasury that he wants our tax system, once viewed as an asset, to become an asset again. Many of our general and detailed comments set out below are informed by that objective.
4. This paper focuses on the Section (Part IIIA) dealing with the interim improvements proposed to the controlled foreign company legislation. References in this Paper to paragraph numbers are to paragraphs and their Sections in the Corporate Tax Reform document.

#### **General Comments**

5. **Territorial Approach.** We are pleased that the Government has decided to adopt the territorial approach to the taxation of CFCs focusing more on profits from UK activity in determining the tax base rather than attributing the worldwide income of a group to the UK. We welcome in particular the statement that no tax should arise on profits "*arising from genuine activities undertaken offshore*" (Section 1, para 1.5).
6. **Interest.** We are also pleased to note that the design of the new CFC Rules (as well as the interim improvements) will not involve any change to our competitive regime for interest and will therefore not introduce a territorial interest restriction. A number of our

members have been asked by non UK multi-nationals interested in our new corporate tax regime whether any such change was being contemplated and have reacted favourably to the position the Government is taking.

7. We support measures designed to impose a CFC charge on profits artificially diverted from the UK (or which cause an erosion of the UK tax base) provided such measures are properly and proportionately targeted at the “artificial” diversion of such profits.
8. However, we remain concerned as to the tension which has so far not been resolved between the scope of such rules and the position (required so that the provisions are compliant with EU law as far as EEA jurisdictions are concerned) that profits arising from genuine economic activities undertaken offshore should not be taxed. Although we expect this tension to be the focus of the further consultation process on the wider (not interim) CFC reforms, we are concerned that the overly prescriptive nature of the interim measures fails to signal a sufficiently positive attempt to address these tensions.
9. Our overall observation in respect of the interim measures is that whilst they might give encouragement to non UK based multi-national groups as to the territorial intentions of the Government and result in the UK once again being considered as a jurisdiction in which to base an intermediate holding company, the same cannot be said for existing UK based groups who will continue to see inversion exit strategies as the only method of achieving a clear territorial demarcation for the determination of taxable profits.
10. The starting point for a territorial test should be one based on where the genuine economic activities producing profits have been carried out. Tests designed to tax profits “*artificially diverted from the UK*” or resulting from the “*erosion of the UK tax base*” should be subject to the “*genuine economic activities*” test not the other way around.

## Specific Comments – Draft Legislation

11. New Exemptions. We welcome the principle of the two new exemptions from the CFC regime for trading companies with limited connections to the UK and those exploiting IP which has limited UK connection.
12. We also welcome the principle of allowing a partial exemption from charge for a trading company where the relevant economic tests of connection to the UK are failed by a certain defined margin (section 751 AB).
13. **Section 751 AB.** We believe the tests for calculating the “specified amount” are too complicated for the objectives they are designed to meet and are unnecessarily restrictive.

The introduction of the Net Economic Test (from section 751A) for measuring “net chargeable profits”, (section 751 AB(8)) perpetuates the concern we have held since the introduction of the original section 751 test that the provision is not compliant with the decision of the ECJ in the Cadbury Schweppes case. It relies on the same definition of “qualifying work” (subsection (9)) as is set out in section 751A (although extended to any territory, not just an EEA territory) but is more restrictive than the same test applied as one element for determining whether a trading company has a UK connection (section 12E(3)(A) and 4, part 2(A)). We appreciate the two definitions

might be used to achieve different objectives, but the prescriptive complexities will cause unnecessary confusion and possibly misunderstanding in their application.

14. **Section 751AB (8).** The definition of “net chargeable profits” is based on the structure set out in section 751A for determining what reduction in chargeable profits should be made for certain activities of EEA business establishments in calculating the CFC apportionment. We believe this test is too restrictive as it fails to take into account profits derived from not only the activities carried out by the individual but the whole business operation comprising those individuals, premises, equipment and assets used in the business by reference to which those profits should be measured. Such a failure makes this test vulnerable from an EU compliance point of view.

### **Trading Companies with Limited UK Connection**

15. **Paragraph 12(D)(1) (a).** Please provide a statutory definition for the phrase “substantial extent”. By way of example, will a manufacturer and seller of product using a manufacturing patent it develops and owns qualify as a “trading company”? How will that company determine whether the ownership of the manufacturing patents (and related IP) is a non exempt activity which is “to a substantial extent” included in its business? By value of assets? Or turnover? These being the suggested methods in the Guidance for a similar test in paragraph 12(J)(1).
16. **Paragraph 12 E (5).** The definitions of “UK related gross income “and” UK related business expenditure” would catch transactions between a non UK company and a UK person whether or not that person was connected to it. Is this intended? We would have thought an arm’s length transaction with a third party should not be caught; nor any transaction with a connected person to the extent the terms of the transaction (including price) met the arm’s length transfer pricing standard.
17. **Paragraph 12 F (4).** The definition of “relevant IP income” could potentially catch IP income “embedded” in the sale of a product (e.g. the manufacturer example given in point 15 above). Is this intended? We believe the objective of the draft provision was to capture royalties and not embedded IP profits or, to put it another way, “investment” IP rather than “trade” IP.

### **Companies exploiting IP with limited UK Connection – Part 2B**

18. As a general observation, as presently drafted we do not believe this exemption will be seen as having much benefit to multi-national organisations with interests throughout the world whether they are based in or outside the UK. By way of example, an organisation that manages its intellectual property on an active basis through a central location outside the UK will remain vulnerable to a CFC charge by reason of the definition (as currently drafted) in paragraph 12I (definition of intellectual property business). In those circumstances to avoid a charge in connection with its non-UK IP such an organisation would have to restructure business operations to divide its holding of IP between IP with a relevant UK connection and IP that did not have that connection, and then hold and exploit that IP through separate organisations. Commercially and legally this would not be desirable or satisfactory. Inversion (for UK based multi-nationals) would be a more attractive solution. This will particularly be the case if the drafting change we suggest to paragraph 12I(1) is not made.

19. **Paragraph 12 I(1).** As drafted, it is not clear whether the ownership of an insubstantial element of IP which satisfies a “relevant UK connection” test would result in the CFC not satisfying these provisions. Is this the intention? If it is, then its effect is to produce a “cliff edge” result in terms of taxation which we do not believe is the overall intention of the legislative reforms when compared with other proposed changes. We can provide a number of examples where the UK IP component in a holding of IP measured by value or royalty income is insubstantial but where it remains necessary still for that IP to be exploited as part of the business of the relevant company. If that company’s “main business” is the exploitation of any intellectual property then, as presently drafted, such a company would not satisfy this definition if any part of that IP had a UK connection. We would recommend that paragraph 12I(1) is amended so that it is clear that only where there is a material UK IP component in a business would a company not be able to fall within the safe harbour.
20. **Paragraph 12I(A2).** What do the words “*held by*” mean? Does it mean beneficially owned, controlled or some other measure of ownership? We are aware of examples of IP which for valid commercial and legal reasons is legally registered in the name of a corporate entity but whose economic and beneficial ownership lie elsewhere. What is intended to be caught in these circumstances? If such IP is transferred after 10 years of being “held” by a UK resident person, is it correct that in the twelfth year after the eleventh year ends (in which it will still have been held by a person resident in the UK some of the time during that accounting period) it will no longer satisfy this test of connection? Please confirm the justification for imposing a ten year time limit on past ownership of IP and explain why it is considered to be EU law compliant.
21. **Clause 12J(2)(a).** This paragraph refers to “secondary activities” which are not to constitute a “substantial” part of the activities. The draft Explanatory Note (at paragraph 27) explains that a “substantial part” will mean, in practice, more than 20% of total business measured by value or turnover. It would be helpful if this definition was specified in the legislation rather than relying on HMRC interpretation.
22. **Paragraph 12K (UK Connection).** There are references to “substantial proportion” in two places in sub-paragraph (2). Is that to be measured in the same way as “substantial part” in paragraph 12J?
23. **Paragraph 12K(2)(b).** The definition of “gross income” for the purposes of determining whether the CFC has a significant connection to the UK looks to income from any person within the charge to UK tax. Why is this not restricted to persons “related to” the CFC as defined in paragraph 12M(1). We believe income derived from third parties should be excluded as should income from connected/related persons which meets transfer pricing arm’s length tests.

#### **Contact details:**

If you have any questions concerning these representations or would like to discuss anything contained in them, please contact the Chair of the International Tax Sub-Committee, Mr Peter Nias (Tel: 020 7577 6920, E-mail: [pnias@europe.mwe.com](mailto:pnias@europe.mwe.com)).

**7 February 2011**

