



Reform of Controlled Foreign Companies (CFC): Policy principles document

A. Aim

- 1 The aim of this document is to outline the current thinking on policy drivers, objectives and principles that will support the reform of the CFC rules. This will be used to facilitate discussion over the coming months.
- 2 Alongside this document, HM Treasury have also released a questionnaire (accessed at http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm) and would encourage businesses, representative groups, advisors and other interested parties, to complete this. The questions focus firstly on the workings of the current CFC rules and secondly on options and considerations for a new regime. Sharing views at an early stage should help to identify the key issues that need to be addressed.

B. Background

- 3 PBR 2008 announced significant changes to the taxation of foreign profits, including the introduction of an exemption from UK tax for foreign dividends repatriated to the UK. At the same time a commitment was made to consult on the modernisation of the CFC regime.
- 4 Since the introduction of the CFC rules in 1984 the business landscape has significantly changed and large groups, both in the UK and worldwide, have become more focused on globally integrated functions and overseas expansion. Alongside this they now often manage their business regionally and globally. Any new rules need to take account of these changes.
- 5 The Financial Secretary's open letter to business representative bodies dated 24 November 2008 ('open letter'), stated that a reformed CFC regime would reflect a more territorial approach to taxing foreign subsidiaries. An essential part of this approach will be moving away from a default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location.
- 6 The drivers and principles below set certain key parameters within which this consultation should take place. Whilst broader discussion is encouraged, focus needs to be on the scope and mechanics of a new regime in order to deliver a package of reform in the expected timeframe set out in the stakeholder engagement document.

C. Policy drivers

7 There is a continuing need for rules to protect the UK tax base from erosion through the artificial diversion of profits not countered through other measures. However, we recognise that this protection must be balanced with the need to sustain UK competitiveness in a globalised economy. Therefore, the primary driving factors for reviewing the CFC rules are:

- Recognising and adapting to changes in the way that modern business operates globally.
- Making the rules consistent with the recent changes to the taxation of foreign profits.
- Targeting the rules as effectively as possible.

D. Policy objectives

Competitiveness

8 The UK is recognised as providing a competitive environment for ownership of multinational business and for location of business operations, where tax is one aspect of a much broader picture. The Government is committed to improving the competitiveness of the UK as a jurisdiction for businesses to locate and invest, as demonstrated by the introduction of a wide-ranging dividend exemption.

9 Reform must modernise the CFC rules in a way that enhances UK competitiveness, while providing adequate protection of the UK tax base. The CFC regime needs to avoid undue interference in groups' abilities to make decisions that best support their overall competitiveness in relation to the location and management of their business operations.

Protection

10 Introducing dividend exemption represents an important move towards a more territorial system of taxing foreign subsidiaries. Nevertheless, dividend exemption itself increases the risk to the UK tax base, as it enables any diverted profits to be repatriated to the UK more easily without incurring a UK tax charge. Any CFC rules must take account of this additional risk.

Commerciality

11 Business has raised concerns that the current rules are not always aligned with the reality of modern business. As a result commercial transactions can be hindered, delayed or unnecessarily complicated. To the extent that transactions do not represent an artificial diversion of UK profits, the reformed CFC rules should not obstruct them.

Simplicity and certainty

12 Since the CFC rules were introduced in 1984, there have been many changes to the tax and regulatory architecture, including the introduction of self-assessment. Over the years a number of amendments have been made to the CFC rules to ensure that they continue to target avoidance activity. Business has expressed concern about the complexity and scope of the CFC rules as they currently stand and whether they target avoidance effectively.

- 13 The new regime should, as far as possible, be easy to comply with and seek to provide taxpayers with certainty. To achieve this it is likely that a balance will need to be struck between the overarching principles and operational simplicity.

Scope

- 14 As set out in the open letter the new regime is not intended to increase the scope of the rules. Final decisions on the implementation of any revised CFC rules will need to be taken in the normal way as part of the Budget process, which takes into account the economic position and wider Government finances.

EU compliance

- 15 Any new regime must be compliant with EU law.

E. Policy principles

- 16 The current CFC regime is based upon a worldwide basis of taxation. The open letter announced that a reformed CFC regime would reflect a **more territorial approach** to taxing foreign subsidiaries and should target the artificial diversion of profits from the UK.
- 17 This does not mean that the UK is proposing to move to a pure territorial system. Such a system would involve an exemption for foreign source income, alongside symmetrical restrictions on all expenses attributable to the earning of that income. This would make the UK tax system more complex, and would not meet the policy objectives for the reform.
- 18 There is a continuing need for protection of the UK tax base from erosion, but the protection required cannot be provided through reliance on **transfer pricing rules** as tax avoidance is not their primary focus. These rules are concerned with the arm's length nature of transactions and allocation of profits.
- 19 Transfer pricing rules work where the issue is determining the price. But where the terms and conditions are fundamentally not those that would have arisen at arm's length, and the issue goes beyond pricing, complexities can arise in applying transfer pricing rules to prevent diversion of profits from the UK.
- 20 So, for example, the creation of a fully capitalised money box on arm's length terms cannot be challenged by transfer pricing rules even though it may result in the artificial diversion of profits from the UK. Building on this, the money box company could lend money, again on arm's length terms, to a UK subsidiary which would then use that money to acquire a new subsidiary from a third party. The resulting UK interest deduction would not be balanced by a UK interest receipt. These examples illustrate that the transfer pricing rules alone are not always sufficient to protect the UK tax base from the diversion of profits.
- 21 Similarly reliance on exit taxes does not necessarily offer the protection required because of, for example, the potential for long term or indefinite deferral.

- 22 Without additional protection rules there would be excessive pressure on the transfer pricing and exit tax rules, resulting in increased uncertainty and administrative burdens for both business and Government. In turn this could result in significantly longer and more difficult tax negotiations.
- 23 It has been suggested that adequate protection might instead be provided by an **anti diversion rule** that would apply equally to UK and foreign-headed groups. This would apply in principle to all UK profits where there was a risk of diversion.
- 24 In designing an anti-diversion rule it would be necessary to consider disallowing deductions in respect of payments made directly or indirectly to non-UK subsidiaries, or taxing some or all of the income received by non-UK subsidiaries. This would typically require complex tracing rules that would apply equally to non-UK and UK headed groups. As well as complexity and uncertainty, this would add an additional area of compliance that would impact adversely on the UK's relative attractiveness as a location for investment. Difficulties would also arise in respect of the UK's treaty obligations.
- 25 Although there are countries with anti-diversion rules, it is difficult to see these as a model for the UK. For example the rule applicable in Hong Kong, which is driven by the tax authority's subjective view of each transaction, operates in the context of a territorial system with low tax rates and very limited interest deductibility.
- 26 As explained, the transfer pricing rules and exit taxes do not deal fully with artificial diversion and there are significant policy and design difficulties with an anti-diversion rule. In contrast, there remain good reasons for retaining UK **ownership** and control as the principal determining factor in bringing an overseas company and activities within the scope of the UK tax base, so allowing diversion of profits from the UK to be targeted.
- 27 Adopting the ownership and control principle is simple. It also recognises the benefit gained from the rights and protections that residence in a state offers such as the broader legal framework. That is why it is not only the starting point for the current UK CFC rules, but also for CFC regimes in most other countries.
- 28 Beginning with ownership should allow practical rules to be developed that provide adequate protection of the UK tax base, whilst offering the flexibility to meet the wider policy objectives. This appears to be the right starting point for any new rules and should allow significant reform to take place.
- 29 **A move towards a more territorial approach, whilst retaining ownership as an underlying principle appears to be the optimal solution. This can be achieved by refocusing the CFC rules on artificial diversion of profits from the UK, moving away from a default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location. A CFC regime developed along these lines should achieve the policy objectives, set out above.**

F. Areas for discussion

- 30 Having set out the principles, the next question is how the proposed refocusing of the CFC regime could be achieved in practice.
- 31 Central to this will be the criteria applied to distinguish between profit genuinely earned and that which represents an artificial diversion from the UK. Given the extent of integrated activities in multinational businesses and the various contributions of activities from different locations, it may not be possible to precisely reflect this distinction in every circumstance.
- 32 The attribution of profits to those 'genuinely earned' in the UK may have to be based on rules that represent simplified approximations of those principles. These rules may depend not only on the specific circumstances but also on quantitative practical tests that provide sufficient certainty to business while minimising the administrative burdens and complexity involved.
- 33 In developing the criteria and tests, the more difficult issues are likely to arise in dealing with highly mobile, income generating assets and activities that require relatively little substance in terms of associated physical activity and employees. These pose the highest risk to the UK Exchequer in terms of artificial diversion of profits and include, but are not limited to, intellectual property and monetary assets.
- 34 It seems sensible to concentrate on money and intellectual property in the first instance, before turning to consider the treatment of other activities, for example intra group services. **Initial work will therefore focus on what the criteria should be in relation to offshore businesses whose level of profits is sufficiently different to their physical substance requirements**, although the amount of substance required varies for different activities and will require discussion.
- 35 The way that multinational groups manage their money and monetary assets will clearly raise particular difficulties in distinguishing between income genuinely earned and artificially diverted income.
- 36 A number of approaches are possible. In the context of financing group business, a treasury company exclusion could be revisited. Alternatively a broader alternative approach could be adopted, for example by seeking to identify excess capital allocated to overseas entities by the group. One approach would be to say that:
- there should be no automatic presumption that income from cash held by overseas operations should be taxed in the UK; but
 - where that income is a return on capital in excess of the capital required for those operations, then CFC rules would apply.
- This example is for illustrative purposes only - all approaches remain open for discussion.
- 37 Initial work should focus on the fundamental issues of monetary assets and intellectual property. The outcome of these discussions will help frame the approach for other areas.

G. Next steps

- 38 This document is intended to form the basis of discussion with stakeholders over the coming months. HMT and HMRC will be organising workshops shortly. Please refer to the stakeholder engagement strategy document (link http://www.hmtreasury.gov.uk/controlled_foreign_companies.htm) for more information on this process.
- 39 Should you want to take part in the consultation or if you have any other questions please contact Hannah Mitchell (hannah.mitchell@hm-treasury.x.gsi.gov.uk) or Jennifer Payne (jennifer.payne@hm-treasury.x.gsi.gov.uk).