Taxation of the foreign profits of companies: a discussion document

June 2007
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INTRODUCTION

1.1 Budget 2007 announced a major set of reforms to modernise the domestic corporation tax base, marking a further milestone in the Government’s objective to maintain a competitive tax system for business. Alongside domestic reform, the Government also committed to consult on reforming the taxation of foreign profits.

1.2 In the light of that commitment, this document sets out a package of proposals for modernising and creating a more straightforward regime for taxing foreign profits. The Government wishes to discuss this with business, in order to develop more detailed proposals for further consultation.

REFORMING THE TAXATION OF FOREIGN PROFITS

1.3 The pressures of globalisation create ongoing challenges for the corporate tax system. In responding to these, however, the Government also has an obligation to protect the tax base, which can be at risk if profits are divorced from economic activity with the aim of artificially reducing tax liabilities.

1.4 The current system of taxing foreign dividends and relieving double taxation through crediting foreign tax produces only a modest amount of direct tax yield, but together with the Controlled Foreign Companies (CFC) regime, provides safeguards to ensure that profits from economic activity are properly taxed in the UK. As a system of relieving double taxation, the credit system is inevitably less straightforward for large and medium business than dividend exemption.

1.5 The case for change rests largely on supporting large and medium business operating in rapidly growing global markets by simplifying and modernising the current regime for foreign dividends. In addition, changing patterns of share ownership of these businesses suggest a further case for reform, as a matter of principle.

1.6 In this discussion paper, the Government therefore seeks views on a move to a regime in which foreign dividends paid to large and medium UK-based businesses would be exempt from UK tax. An exemption regime, however, would need to be coupled with alternative means of protecting UK revenues. So the paper proposes a new income-based system for controlled companies (CC), which would distinguish mobile passive income from active income and enable the UK to tax artificially located profits that are effectively within the control of the UK parent.

1.7 In addition, the paper proposes some limited, targeted reforms to the UK’s interest relief rules – especially, but not exclusively, to ensure that the rules are robust following the introduction of exemption. As a final part of the package, the paper also proposes repeal of the current Treasury Consents rules, and their replacement by modernised reporting requirements.

1.8 The income-based CC regime and new, targeted anti-abuse interest provisions are intended to deliver essential Exchequer protection. On this basis, the Government sees no need for any general restriction of the UK’s generous regime for relief of interest.

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1 See 1.18 and Chapter 5. The changes proposed would counteract possible unwelcome behavioural effects of a move to dividend exemption. However, building on existing anti-avoidance rules means the changes would also encompass abuse that arises in situations other than those involving exemption.
1.9 The Government believes that reforms on the lines proposed would protect the UK tax base, while delivering administrative savings for business. However, smaller businesses (those with fewer than 50 employees and whose turnover or balance sheet does not exceed 10 million euros) do not generally face the same issues of complexity in relation to foreign subsidiaries. Also, the new CC regime would not be appropriate for them. So, for smaller businesses, the paper proposes simplifying the existing rules for taxing foreign dividends, and a more limited (or no) CC regime.

1.10 A summary of the package the Government wishes to discuss is set out below. The proposals are a package of structural reform, intended to modernise and create a more straightforward regime for taxing foreign profits. The aim is to achieve a balanced, broadly revenue-neutral package that meets the needs of both business and the Government.

1.11 The package raises some complex issues. The Government appreciates the input already given by business in this work, and will shortly be setting up a series of events to ensure that the discussion is widely based, and takes into account the needs of all sectors, including those companies without significant foreign business that may only be affected by the aspects of the proposals that cover UK business.

1.12 It is crucial to the ongoing competitiveness of the UK that reform of the taxation of foreign profits meets the needs of both business and Government; this objective can only be met through a continuation of open and constructive dialogue with business on these issues, and a shared understanding of the behavioural impacts of the proposed reforms.

SUMMARY OF PROPOSED PACKAGE

1.13 The tax treatment of dividends from controlled companies (CC) and the proposed new rules for taxing the profits of such companies are interdependent. Exemption provides a simpler tax treatment of foreign dividends, but also provides opportunities for artificial profit diversion. The new CC rules and limited, targeted interest changes are intended to prevent this abuse.

1.14 For participation holdings (defined as shareholdings of 10% or more), the discussion paper proposes that dividends received by large and medium business from the profits of foreign companies would be exempt from tax in those cases where the new CC rules apply to those foreign companies.

1.15 Small businesses do not face the same issues in relation to the existing credit system and generally do not have foreign shareholders. In addition, the Government does not believe it is appropriate to require them to operate the proposed controlled companies rules. The paper therefore proposes a simplified credit regime for small business, with simplified CC rules applying for a minority of small businesses and most small business exempt from the CC rules.

1.16 The proposed CC regime will refocus the current controlled foreign companies regime from an entity-based “all-or-nothing” regime to a targeted, income-based regime, which will tax the UK parent on specifically defined mobile income, that is effectively within the control and disposition of the UK parent. For the passive income category of mobile income, the rules will apply whether this income arises in UK or foreign subsidiaries.

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2 See Annex C.
1.17 The CC regime will apply to small businesses only where the consolidated group profits exceed a material amount. This will take many small businesses outside the scope of the rules entirely. The Government would be interested in exploring with business what would be an appropriate amount.

1.18 No wide-ranging changes to the regime for relief of interest are envisaged, but some limited, targeted changes are proposed to prevent abuse, namely:

- to restrict the amount of interest claimed by the UK members of a multinational group by reference to the group’s total consolidated external finance costs; and

- to strengthen the existing unallowable purposes rules for loan relationships and derivative contracts.

1.19 As a final element in the package, the paper proposes removing the existing Treasury Consents rules, and replacing them by a real-time information-reporting requirement to support the real-time auditing approach that is being developed under the Review of Links with Large Business.

1.20 The timing of any reform will depend on the outcome of this discussion. If this shows that legislative changes are necessary, the Government would intend to issue more detailed proposals for further consultation, and the most likely date for implementation would be Finance Bill 2009.

1.21 While not strictly part of the package, the Government would like to take this opportunity to explore with business options for the future taxation of portfolio dividends in light of the decision of the European Court of Justice in the Franked Investment Income Group Litigation. Chapter 3 sets out some options for discussion.
INTRODUCTION

2.1 To create and sustain the best possible environment for business, the Government has pursued a strategy designed to advance productivity and growth, based on two pillars:

- providing macroeconomic stability to allow firms and individuals to invest for the future; and

- making microeconomic reforms to ensure that markets function efficiently and that barriers to productivity growth are reduced.

2.2 Over the past ten years, the Government’s macroeconomic framework has delivered unprecedented stability and 58 consecutive quarters of growth in GDP. This low volatility has placed the UK in a strong position to respond to the global economic challenges of the next decade.

2.3 Since 1997 the Government has also implemented a series of reforms to the corporate tax system, to ensure the system continues to meet the challenges of the modern business environment and to encourage greater efficiency among all sectors of business.

2.4 In line with these objectives, Budget 2007 announced a major set of reforms to modernise the domestic corporation tax base. These reforms will lower the main rate of corporation tax from 30 per cent to 28 per cent, while broadening the corporate tax base and refocusing the tax system’s support for small businesses. Alongside the Budget announcement, an ongoing programme of work is pursuing the Government’s commitment to reduce administrative costs for business. HMRC have published a detailed delivery plan for the 2006 Review of Links with Large Business.

2.5 Multinational business has recently outlined three priorities for the Government in maintaining the UK’s international competitiveness. The Budget reforms – in further lowering the corporation tax main rate, and in delivering progress on reducing administrative costs, addressed two of these; the third priority is reform of the taxation of foreign profits.

DRIVERS FOR REFORM

2.6 Foremost among the range of factors driving reform of the taxation of foreign profits are the ongoing changes in both the global economic environment and international tax law.

Impact of Globalisation

2.7 The challenge of globalisation is not new and it has consistently influenced Government policy since 1997. The repeal of Advance Corporation Tax (ACT) was a response to the changing profile of income of UK business. Since then, equally striking changes have been taking place in the pattern of shareholdings as both the flow of foreign direct investment has increased and institutional equity investment has become more internationally diversified. Foreign ownership of the UK corporate sector (excluding domestic unquoted companies) has now reached around 50%.
2.8 At the same time, the focus of economic activity is changing. Business activity has evolved, with multinational business becoming increasingly important in the global economy (according to UNCTAD, one third of global trade is intra-firm trade), and profits growth is increasingly coming from new markets. These changes create a very different environment for business and increase the competitive pressures global businesses face.

**Developments in international tax law**

2.9 Alongside economic changes, there has been a marked growth in the corpus of international tax law flowing from the ECJ. In its more recent jurisprudence, however, the Court has demonstrated clearly that it is fundamental to the Treaty that tax rules should respect the balanced allocation of taxing rights between the Member States. Equally, the judgment in the recent Cadbury Schweppes case has endorsed the view, which the Government shares, that there is a legitimate place for legislation aimed at preventing artificial transfers of profits – so long as this is not protectionist.

**2006 informal dialogue with business**

2.10 In 2006 the Government held an informal dialogue with business stakeholders on the taxation of foreign dividends, CFCs and interest. In these discussions, business stakeholders confirmed that multinationals see the UK as an attractive place to invest but highlighted the application of the current credit system and the controlled foreign companies regime as priorities for future reform.

2.11 In the light of these factors, the Government now considers it is appropriate to look again at options for reform. A review is timely: exemption is a system increasingly employed in other EU Member States and the US Tax Panel\(^1\) has also recently considered the merits of exemption, as an option for radical reform.

**Policy framework**

2.12 The Government’s aim is to ensure that, for all companies operating internationally, a fair amount of tax should be paid; double taxation should be avoided.

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\(^1\) Report of the President’s Advisory Panel on Federal Tax Reform, of November 2005, entitled “Simple, Fair, & Pro-Growth: Proposals to Fix America’s Tax System.”
where possible; and economic distortions and administrative costs should be minimised.

2.13 The UK regime currently taxes all profits earned in the UK and the profits of UK companies, passive or active, earned here or overseas. However, the UK recognises that other countries also have taxing rights and that there should be a practical way of allocating taxing rights across borders. The international tax architecture\(^2\) recognises both exemption and credit methods as equally valid mechanisms for dealing with double taxation.

2.14 The UK system of double taxation relief (DTR) currently gives credit for foreign tax against UK tax. Direct investment (where the shareholding interest is 10% or more) qualifies for credit for underlying tax\(^3\) and withholding tax\(^4\); portfolio investment (where the holding is less than 10%) qualifies for credit for withholding tax only.

2.15 Taxation of profits with credit given for foreign tax ensures that a fair amount of tax is paid and double taxation is avoided. However, for larger businesses, there may be more straightforward ways of achieving the same objectives. In addition, the case for not taxing foreign dividends on a UK corporate recipient increases as the level of foreign ownership of UK companies increases.

2.16 Exemption of foreign dividends, for example, can also achieve the policy aims as long as the UK taxes under the controlled companies regime all the profits that it thinks should be viewed as taxable in the UK. So, given the increasing globalisation of multinational business and of the UK shareholder base, and the increasing move to exemption by other major trading economies, there may now be more reason to adopt exemption as a means of providing DTR for such business.

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\(^2\) OECD Model Tax Convention on Income and on Capital; the EU Parent-Subsidiary Directive.

\(^3\) Underlying tax is the tax paid on the profits out of which the dividend is paid.

\(^4\) Withholding tax is the tax charged on the dividend by the country of residence of the paying company.
2.17 The case for an exemption system is not clear-cut, however, as the benefits in terms of simplification and savings in administrative costs which exemption brings have to be weighed against the need for an exemption system to be accompanied by more effective controlled company rules and targeted interest changes, in order to prevent the artificial location of profits which could then be repatriated as exempt dividend income.

2.18 These proposed controlled companies rules would be more certain than the current CFC rules, and would apply (in respect of passive income) to UK as well as foreign subsidiaries in order to prevent the artificial location of profits within a UK group. This would have the advantage that it would also help reduce uncertainty about the application of the rules within the European Union.

Summary and objectives for reform

2.19 For large and medium business the Government believes that the balance of advantage now points to an exemption system, while for smaller business, with far more limited overseas operations and few foreign shareholders, it points to retaining a simplified version of the existing taxation with credit rules. The proposals set out in this discussion document are intended to:

- improve the competitiveness and attractiveness of the UK as a location for multinational business, while ensuring any new systems or structures that
are subsequently introduced cannot be used to undermine the UK tax base; and

- provide equally fair, but different approaches, tailored to the different sizes of companies, reflecting the different circumstances they face.

2.20 Large and medium business will benefit from simplification of the dividend taxation rules and from the increased levels of certainty and clarity that the new CC rules will provide. Small business will benefit from simplification of the tax credit rules and from the new CC rules, which will not impose any greater administrative costs than the present arrangements in the few cases that they will apply.

Discussion aims

2.21 The Government is very keen to develop the package to ensure that the proposals fulfil the Government’s objectives in a way that best fits with business and meets their needs, and achieves a balanced, broadly revenue-neutral outcome, in the context of a shared understanding of the behavioural impacts of the package.

2.22 The Government welcomes the opportunity to continue a constructive dialogue with business on these fundamental issues and will work with business to deliver the right regime for the future.
INTRODUCTION

3.1 Business made clear in the discussions of 2006 that it seeks a regime for foreign profits that enhances UK competitiveness, reduces compliance costs and delivers simplicity. Foreign profits that have been highly taxed abroad will often be remitted to the UK and, even though there is no additional tax to pay, the administrative costs for multinational business of complying with the credit regime can be material.

3.2 Business increasingly operates in a global marketplace, where many of the UK’s competitors already operate forms of an exemption regime, and more principled arguments also point to reform. The Government therefore believes it is now time to consider again the case for exemption.

POSSIBLE EXEMPTION FROM CORPORATION TAX OF FOREIGN DIVIDENDS ON PARTICIPATION HOLDINGS

3.3 The corporate structures adopted by large and multinational business are typically more complex than those adopted by small business. Small business has very few foreign subsidiaries and any such subsidiaries may be held directly by the parent company. Multinational business has more complex structures, which are likely to involve many tiers of companies and sub-groups. It also tends to have a much higher proportion of foreign shareholders.

3.4 Multinational/large business has told the Government that the inherent complexity of their group structures means that the application of the current credit regime to them is administratively complex. In contrast, the simplicity of small business’ structures means that applying the credit system is much more straightforward in the rarer circumstances in which it applies.

3.5 Exemption offers an alternative way of relieving economic double taxation. In place of complex calculations, flowing from the application of the current credit regime to complicated multinational group structures, groups could simply repatriate profits to the UK without concerns about relief for foreign taxes and a possible UK tax charge. Companies need no longer choose for tax reasons to leave lowly-taxed profits offshore to fund other foreign investment by the group. The profits could instead be repatriated, with the investment then made from the UK if that made more commercial sense. This would achieve the Government’s objective that the tax system should not distort commercial decisions.

3.6 The ECJ in its judgment in December 06 concerning the Franked Investment Income group litigation held that in principle the UK’s credit system for participation (i.e. holdings of 10% or more) dividends from foreign direct investment conforms to Treaty principles. Nonetheless, the Government is sensitive to the way in which the corporation tax system applies to companies with large amounts of foreign profits, and to UK multinational business concerns that the tax system should not damage their competitiveness.

3.7 Other countries have also considered whether, and in what circumstances, they might view exemption as appropriate. Although there is no consensus, in recent years there has been a move towards exemption in the EU. This is often applied with certain
conditions or only to particular dividends. Some other countries’ regimes also have accompanying restrictions on interest expense.

3.8 However, the taxation of foreign dividends affords a degree of protection to the tax base. Groups that artificially locate profits have to take account of the need to repatriate those profits. This protection needs to be maintained in any package of reforms, and this would be provided under an exemption regime by a modern income-based controlled companies regime and targeted interest relief changes. As any changes must meet the needs of all business from the largest to the smallest, whose circumstances, structures and methods of doing business vary, the Government does not consider it appropriate to take a uniform approach to foreign profits across all businesses.

3.9 Although there are clear links between the taxation of foreign dividends and of the overseas branches of UK companies, considering foreign permanent establishments now would raise a large number of additional issues, which would divert focus from the present discussion: so depending on the outcome, the Government considers it would be more appropriate to return to this question at a later date.

**PARTICIPATION DIVIDENDS: PROPOSED OPTION**

3.10 As set out in Chapter 1, for participation holdings (defined as shareholdings of 10% or more), the Government proposes that dividends received by large and medium business from the profits of foreign companies would be exempt from tax in those cases where the new CC rules apply to those foreign companies.

3.11 However, exemption would not be appropriate for all dividends from controlled companies because of the need to protect the Exchequer from avoidance and because not all foreign dividends are paid out of the profits of the paying company. Some dividends (for example, those in respect of which credit for underlying tax is not currently allowable) will therefore remain taxable on the recipient. The Government would be interested in exploring with business what dividends from controlled companies it would be appropriate to exclude from the participation exemption.

3.12 Participation dividend exemption for multinationals would provide the simplicity that business seeks, with clear benefits from reduced compliance costs. The Government thinks that the exemption offered to large business would be one of the most wide-ranging available. The exemption would apply to dividends received from the profits of companies to which the controlled companies (CC) rules apply. Thus for a UK-controlled foreign company, the exemption would apply to dividends paid by it to recipients with a shareholding of 10% or more¹.

3.13 So far as possible, the Government does not want to impose a CC regime on small business. The corporate structures adopted by small business are far simpler than those adopted by large business, where tiers of companies are the norm. Thus applying the credit rules to small businesses, where there are commonly very few foreign subsidiaries (and few if any foreign shareholders), does not result in the administrative complexity experienced by large business. The Government therefore

¹ For those circumstances in which the proposed CC rules do not apply solely because of a lack of UK control (for example in the case of a foreign company with five equal shareholders, only two of which are UK resident), exemption would still be provided to dividends paid from profits that would be exempt under the CC rules.
considers that a credit regime, largely without the new CC regime, is more appropriate for small business.

3.14 The credit regime for small business would no longer need to deal with multiple tiered multinational structures and could therefore be simplified. The passive income part of the controlled companies rules would apply to small business, to deter them from seeking to gain a tax advantage, but a gateway test, based on the group’s consolidated profits would apply, with the aim that most small business would be completely outside the scope of the CC regime.

PORTFOLIO DIVIDENDS

3.15 Portfolio dividends received by UK companies from other UK companies are currently exempt from tax (except as receipts from financial trades such as banking and life assurance). However, portfolio dividends received from foreign companies are taxable, with no credit given for underlying tax. The ECJ\(^2\) has held such treatment to be discriminatory in relation to dividends from companies in other Member States. The Government therefore intends to amend the tax treatment of portfolio dividends.

3.16 The Government has considered the following possible methods of achieving parity of treatment between UK and foreign portfolio dividends:

- Provide credit for underlying tax (as well as withholding tax) for foreign dividends;
- Provide exemption for foreign dividends;
- Charge to tax both UK and foreign dividends without giving credit for underlying tax (but giving credit for withholding tax) with a carve-out for certain bodies.

3.17 The Government would like to discuss these options with business – including the likely behaviourial response to these options – before deciding how to proceed. The Government would also welcome comments on any other options that business thinks might be viable.

\(^2\) Franked Investment Income Group Litigation decision December 2006.
INTRODUCTION

The current regime and the case for reform

4.1 The CFC rules have been part of the UK’s foreign profits regime since the 1980s. They were first introduced to counter “tax avoidance through the accumulation of income in subsidiaries in low tax areas … and the artificial diversion of business profits from the UK to such companies”\(^1\). The essential aim of the rules since then has been revenue protection, by preventing groups from locating profits artificially outside the UK.

4.2 The Government of the time recognised that it was important that the rules should keep step with what was happening in the UK’s major competitors and should not be protectionist, or harm the UK’s international competitiveness. Reflecting these concerns, the rules were based on an “all-or-nothing” approach, under which each CFC was assessed as an entity, and profits either exempted – through one of a number of broad-brush exemptions – or taxed in their entirety. This design originally suited business and was considered a practical way to meet the Government’s objectives.

4.3 However, the cumulative effect of liberalisation of trade rules, regulatory changes, and developments in business practices and technology means that the CFC rules have become increasingly unsuited to the needs of either business or Government. From a business perspective, the “all-or-nothing” approach inevitably leaves potential risks (because profits are either wholly taxed, or wholly exempt, depending on whether they meet the conditions in the rules for any given accounting period). In addition, the number of changes made to the rules over the years have, in business’ eyes, made the rules more complex and obscured the policy behind them.

4.4 The changing business environment and the difficulties of shaping the existing regime to meet the need for revenue protection provide some initial drivers for reform. There are also further considerations that suggest it may now be the time for a more radical approach.

4.5 First, the experience of other major countries with CFC rules (France, Germany and the US) confirms that, while there is clearly a continuing role for CFC rules, Governments need to be sure that the rules do not over-reach their objectives in preventing artificial avoidance\(^2\).

4.6 Second, it is clear that a move to exemption will open up new risks for diversion of profits: so if the UK adopts a form of exemption, the CFC rules will necessarily assume a greater importance in terms of protecting the UK tax base. (This will be especially true if exemption is not accompanied by any wide-ranging restriction of interest relief.) Exemption therefore points to the need for a different kind of regime – one that is both more targeted, but also more robust.

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\(^1\) Taxation of International Business: Consultation paper by the Board of Inland Revenue, December 1982

\(^2\) Recent changes to the US CFC (SubpartF) rules – as well as the German and French CFC rules – indicate that this is not just an EU issue, but an issue common to all major economies with CFC rules.
Objectives for CFC reform

4.7 In the light of the above, and in order to create a viable package of reform, the Government considers that the balance of arguments suggests it is now time to re-establish the CFC rules on a completely new basis. In particular, reform is needed to:

- improve the clarity and transparency of policy;
- ensure the rules provide appropriate protection for the UK base on any move to exemption; and
- make the rules more certain and straightforward in application.

These objectives reflect businesses’ concerns.

4.8 The proposals for a new controlled companies regime (set out below) seek to meet these objectives by refocusing the regime from an entity-based “all-or-nothing” regime to a targeted, income-based regime, which will tax the UK parent on specifically defined mobile income that is within the control and disposition of the UK head of the group and apply (in relation to the passive income part of the regime) to controlled UK subsidiaries as well as controlled foreign companies.

4.9 The Government believes that targeting this income (with appropriate exemptions to ensure that the rules do not over-extend their reach) is a clearer and more principled approach. It is also more certain in application, which benefits both business and Government.

4.10 In addition, an income approach is a more effective approach, because it means that multinational groups cannot artificially locate profits by, for example, divorcing profits from genuine activity, or embedding them artificially in the otherwise low-value business activity of a group subsidiary. This will provide a new kind of CFC regime that meets the UK’s revenue protection needs if the UK moves to exemption[^1].

4.11 The extension of the rules to UK subsidiaries will also help limit some of the uncertainties that remain about the extent of EU law in the field of anti-avoidance (see box).

[^1]: An income-based design could in theory accommodate a move to extend exemption as discussed at 3.9.
4.12 The aim of the new controlled companies rules is to prevent artificial location of profits. Artificial location by definition involves mobile income that can be located anywhere in the group. The Government therefore proposes that the new controlled companies rules should focus on the group’s mobile income – mainly passive income but also including the types of mobile active income covered by the current CFC rules. The regime would also include a full set of exemptions to ensure that income arising from commercial activity in the controlled subsidiary, and properly attributable to that activity, remains exempt from a tax charge under the rules.

4.13 As indicated in Chapter 1, however, the Government considers that for smaller business, this approach is not appropriate. For this reason, the package for small business is different – and the Government proposes that:

- most small business is excluded from the new controlled companies rules by a gateway test; and
- for those groups not excluded by the gateway test, only specifically defined passive income is covered.

4.14 The next section provides further details on:

- coverage, target income, and exemptions; and

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Box 1: the Cadbury Schweppes case

In Cadbury Schweppes, the ECJ confirmed that there is a legitimate role for CFC rules under the Treaty, so long as the rules do not tax the profits of genuine economic activities in overseas subsidiaries.

The Government considers that, in making this judgment, the Court intended to draw a meaningful distinction between profits from a genuine commercial activity and profits that have been artificially divorced from the activity that creates them. So CFC rules should not be protectionist: but at the same time they may permit the fair allocation of taxing rights between Member States, so respecting the Treaty.

Commentators who have criticised the changes the Government has made in Finance Bill 07 claim that in the light of Cadbury Schweppes only highly artificial transfers may be targeted by CFC rules. Subsequent rulings from the Court (e.g. on the thin capitalisation case) support the Government’s wider reading – but full certainty on this point is unlikely to be achieved in the short term.

This suggests that a new CFC model that applies rules in a non-discriminatory way as between UK and foreign subsidiaries could help reduce uncertainty, since it would remove some of the potential for challenge that such criticism might otherwise suggest.

The Government therefore proposes that the new CC rules should apply both to UK and to foreign controlled companies.

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4 Small groups are largely exempt from the current CFC rules through operation of the entity-based de minimis exemption. The gateway will apply for small business (see definitions in Appendix C) whose consolidated profits, as computed under UK GAAP, fall below a de minimis amount.
• the more practical aspects of the proposal (measurement of income, method of apportionment etc).

COVERAGE

4.15 In terms of coverage, the Government believes the rules should largely maintain the current position. However, as explained, for all businesses in the scope of the regime (i.e. larger businesses and those small business not exempt under the gateway test) the rules will apply to controlled UK companies for the specified passive income covered by the regime.

4.16 As now, the rules will include a full definition of control: but to reflect some of the additional risks that would arise on a move to exemption, the Government considers it would be appropriate to reduce the trigger for application of the rules to 10% and to modernise the definition of control. This new definition would provide greater certainty regarding control, where the company’s shares may in legal form be the property of another entity, including a non-UK company, or partnership, trusts or hybrid entities.

4.17 The improvements in the definition of control reflect the Government’s concern that the new rules should not be frustrated through the use of hybrid or transparent entities. Reflecting this, the income rules will also provide more certainty regarding the income that is in substance income of the controlled company, but in legal form may be the property of some other entity.

DEFINING CONTROLLED COMPANY INCOME

4.18 In targeting mobile income, the new regime will be targeting income that the current CFC rules already aim to capture. This is the income arising to the types of business typically excluded from the current exempt activities test. However, the income-based approach will enable the rules to be much more precisely targeted.

4.19 The rules will therefore provide a modular set of exclusive definitions which will then be further refined via a set of exemptions. This approach avoids any risk of being unclear, which could happen if the rules only prescribed general principles. The rules will cover two categories of income. The main category will be passive (or investment) income – reflecting the fact that mobile income most typically takes the form of passive income. In addition, the rules will cover other mobile income. This will include specific categories of active income, mainly intra-group income, and UK source income, which can be used to divert income from the UK.

PASSIVE (OR INVESTMENT) INCOME

4.20 The passive income category will cover all traditional types of passive income. Subject to the proposed exemptions (below) it will bring in:

• dividends;
• interest;
• annuities, and other purchased income streams;
• royalties;
• rents, and
• other income of a similar nature.
4.21 To prevent the new rules being side-stepped, the passive income category will also include any active income to the extent that it is, in substance, passive income. (This would include any income to the extent that it derives from the ownership of – or rights over – intangible assets – much as such income is deemed to arise from an investment business by virtue of the exempt activities test in the current CFC rules.)

4.22 Capital gains are not included in the current CFC regime, but this is largely because of the complications of dealing with capital gains under an “all-or-nothing” approach in which a foreign subsidiary might be a CFC one year, yet not the next. These difficulties do not exist under an income regime and, in the context of the proposed package of reform, it would be important to ensure that passive income could not be translated into a different form in order to avoid the new rules. The Government therefore proposes that the rules should include some capital gains, in particular, gains on the disposal of assets that would normally give rise to passive income or result from the conversion of passive income streams into capital assets.

GENERAL EXEMPTIONS FOR PASSIVE INCOME

4.23 To target the rules more precisely, the Government proposes a series of exemptions. The principal exemptions for the passive income category would be for:

- income from genuine active finance business; and
- certain intra-group interest.

4.24 The active finance exemption would exempt certain income from genuine active banking, financial, insurance activity and property investment businesses. The exemption would be similar in concept to the active finance exemption in the US Subpart F regime and involve tests concerning the nature of the overall business of the controlled company, as well as tests for the individual income-streams received by the company.

4.25 Separately, there would be an exemption for intra-group interest income (a group treasury exemption), which would apply for certain intra-group treasury activities. This would allow controlled companies to receive interest from overseas affiliates outside the controlled companies’ charge, provided that:

- the interest from the other affiliates was paid out of profits not covered by the controlled company rules; and
- the receiving company was appropriately capitalised and, for example, does not have more equity than would be expected for a typical intra-group lender.

4.26 Other exemptions would be for:

- certain specified income from intra-group transactions within the same country (to allow groups as much flexibility as possible to continue to organise their operations within a single territory);
- incidental income (to exempt from charge passive income that was incidental to a subsidiary’s main trade); and
- conduit income (to exempt passive income that was received in a fiduciary capacity for financing that does not involve the avoidance of UK withholding tax).
4.27 Finally, if the UK moves to an exemption system along the lines proposed in this discussion paper, there would be an exemption within the CC regime for participation dividends, covering dividends flowing within the controlled group. Exclusion of participation dividends would mean there was no longer any need for any complex rules governing intermediate holding companies and would remove most dividend income from the scope of the regime.

OTHER MOBILE INCOME

4.28 In general, active profits of a controlled company would not be taken into account in determining target income. However, the Government considers that it is necessary to cover some kinds of active income that lend themselves to the artificial location of profits (and gains on the sale of assets that give rise to that income). In support of the objective of ensuring the rules are as tightly targeted as possible, this part of the rules would only apply to large and medium business, and only cover controlled foreign companies.

4.29 The current CFC rules attempt to cover this type of income by excluding intra-group or UK-derived sales and service income from the exempt activities test specifically:

- sales income derived from dealing in goods for delivery to or from the UK or to or from affiliates where the goods are not delivered in to the CFC’s territory of residence; and
- intra-group/UK-derived sales or service income from “wholesale, distributive, financial or service” businesses.

4.30 As with the passive income category, the aim of the new rules would be to cover this kind of income more precisely. The Government recognises that it will be important to achieve a careful balance here in order to ensure the rules provide sufficient certainty without being drawn too wide. The Government would therefore be interested in views on how the rules might minimise uncertainty in this area.

PRACTICAL ISSUES

Measurement of income

4.31 In the interests of creating a level playing field, the paper proposes that calculations for measuring income to be apportioned under the CC rules should be based on UK GAAP. However, the Government would welcome views as to whether computations by other major international standards could be allowed without introducing an unacceptable risk to the new regime.

Apportionment, assessment and compliance

4.32 As with the current CFC regime, the new regime will operate by self-assessment. The Government has no decided view as to the best method of apportioning the income: it could either be attributed to the UK parent company as a deemed dividend or, as now, under an apportionment methodology.
In order to ensure income apportioned is not subject to double tax, however, the Government believes relief should be provided for any tax suffered, as now, by way of credit.

For income apportioned to the UK parent from UK subsidiaries, the Government proposes that relief should be provided by way of compensating adjustments. These methods have been chosen to ensure the system is as close as possible to the systems already existing for relief cross-border and intra-UK (as under the current thin cap rules), ensuring a degree of familiarity.

**BENEFITS AND IMPACT OF THE NEW APPROACH**

The approach outlined above represents a significant change to the UK rules for CFCs. The main benefit to multinational groups is that, by delivering a modernised and more targeted regime, the new rules would provide a framework that permits the proposed exemption system and is more secure longer-term. In addition, the new rules meet the specific policy objectives set for CFC reform in that they are:

- clearer and more transparent in policy terms (the rules target categories of income explicitly and the exemptions are focused so there are no unexpected consequences); and
- more certain and more straightforward (the rules leave less room for doubt as to when they will apply: groups already tell us that they track income on an income-stream basis, so this regularity should allow them to track the relevant income more easily).

The proposed group treasury exemption in particular, should also ensure that the new regime does not overreach its objectives.

The Government is conscious that administrative costs under the proposed controlled companies regime will be a key issue for groups, even though these changes should be considered in the light of the reduction in overall administrative costs that would flow from dividend exemption and removal of the Treasury Consents rules proposed in this paper.

Many multinationals, however, will already have reporting processes that give them most of the information they need to comply (unlike the current regime where knowledge of UK tax is often needed) and, as the rules will be more specific, capturing data should be easier. For smaller business, as noted, the intention is that most companies will be excluded from the new rules by a gateway test. (Under the current CFC rules, smaller businesses are generally exempt as a result of the entity-based de minimis exemption.) For those smaller businesses within the rules, the fact that the rules will only extend to specified passive income will help minimise any costs that they face.

The Government is nonetheless keen to understand how the administrative costs could be further lightened, and therefore welcomes discussion and comment on its partial impact assessment (see Annex B). Questions on this, and other issues on which the Government would particularly appreciate comment, are included in Chapter 7.
5.1 The Government believes that by adopting a package of targeted exemption, more targeted controlled companies (CC) rules and limited, targeted interest rules, it is possible to provide the widest dividend exemption without the need for complex interest restriction rules, such as those based on apportionment. The Government does not therefore see any need to generally restrict the amount of interest relief currently given and no major changes are proposed as part of this package. However, there is a need to ensure that the new rules do not encourage abuse in the field of foreign profits.

**Principled case for interest relief restriction and possible options**

5.2 If the UK gives up some of its taxing rights in respect of foreign dividends, the Government has considered whether interest relief for the costs of funding foreign activities and profits should continue to be allowed in the UK. Many other exemption regimes around the world utilise some form of interest apportionment or other expense matching rules as part of the mechanism of maintaining that policy coherence.

5.3 One option would be the adoption of a form of interest restriction based on allocation. Interest expenses would be more formally aligned to profits and, where profits are not taxed in the UK, there would similarly be no case for allowing the interest expense. Other countries such as the US already have such systems or are considering adopting systems that aim to achieve this type of matching. A principled case for such a change can be made, but such a system would introduce complexities and administrative costs.

5.4 Other options include:

- “thinner capitalisation” – an enhanced form of thin capitalisation rules, where the value of a company’s subsidiaries would be disregarded when determining the amount of allowable interest deduction; or
- “fat capitalisation”, where a subsidiary is funded with little or no debt. This would impose a deemed interest receipt on the parent to reflect the amount of debt that the subsidiary might be expected to have borrowed if it were an independent enterprise.

Again, these other two options give rise to some complexities.

5.5 All these options present difficulties in terms of complexity and compliance. Furthermore, the Exchequer currently receives little tax in respect of foreign profits and a move to exemption cannot of itself justify the introduction of interest apportionment or matching rules. Thus, in the context of seeking to achieve a balanced, broadly revenue-neutral outcome the Government does not see the need for material interest restriction if the new CC regime is effective.

**Proposed targeted interest changes**

5.6 The Government therefore considers that the way forward is for a balanced package of exemption and new CC rules with more targeted interest changes, rather than a package that includes interest apportionment. These more targeted interest changes would take the form of anti-avoidance measures to limit abuse of the UK’s
rules for interest relief following a move to dividend exemption, whilst retaining a
general allowance for interest. This package proposes two specific anti-avoidance
changes.

**5.7** The first change proposed is that interest claimed by the UK members of a
multi-national group should be restricted by reference to the group’s total consolidated
external finance costs\(^1\). In the Government’s view, if the UK sub-group has higher
actual finance costs than the entire group’s overall external finance costs, this strongly
indicates that the UK sub-group’s finance costs are not commercial.

**5.8** The second change would be to strengthen the rules that already exist to restrict
interest deductions under the unallowable purpose rules for loan relationships and
derivative contracts, in particular:

- to extend the definition of unallowable purpose to cover situations where a
  company is a party to a loan relationship or derivative contract as part of a
  scheme or arrangement; and
- to extend the definition of purpose so that where it is reasonable to assume
  that one of the main benefits that might be expected to arise from entering
  into a transaction or scheme or arrangement is a tax advantage, then that
  shall be taken to be one of the main purposes when applying the legislation.

**5.9** The Government recognises that building in this way on known and understood
anti-avoidance rules will encompass abuse that arises in situations other than those
involving exemption, but believes there may be already a case for making these
changes, irrespective of a move to exemption. However, these changes would
counteract possible unwelcome behavioural effects of a move to dividend exemption.
The Government is keen to discuss this and to work with business to ensure that the
legislation only covers what is intended and to provide clear guidance.

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\(^1\) Finance costs would include interest, payments in the nature of interest, and lending fees.
6.1 The proposals made in this paper seek to respond to the concerns of business by offering for discussion a package of reforms to modernise the taxation of foreign profits. The core proposals include the introduction of an exemption regime for multinational business, supported by a more targeted regime for controlled companies and limited, targeted tightening of the interest relief rules, but without a wide restriction for interest.

6.2 The Government wants to discuss with business what might be the behavioural consequences of the package as a context for decisions on what further anti-abuse protection, if any, may be needed.

6.3 As part of the package, the Government considers it is also possible to remove the Treasury Consents rules.

Treasury Consents: the current position

6.4 Section 765 ICTA 88 requires UK companies with overseas subsidiaries to obtain the consent of the Treasury before certain transactions involving those subsidiaries are carried out. Consent may be given specially or generally. For the former, application must be made to the Treasury before the transactions are carried out, otherwise they are unlawful. For the latter, no application is necessary and the transactions to which consent is given generally are described in ‘The Treasury Consents 1988’.

6.5 S.765A disapplies S.765 where the transactions are capital movements within the European Economic Area, substituting a reporting requirement instead.

6.6 Over time business has sought the repeal of S.765, in part because of the criminal sanction provision, but also because of the requirement to obtain the prior consent of the Treasury before carrying out commercial transactions – a process which also necessitates additional internal reporting within groups.

Possible reform

6.7 During informal consultation in 2006 between business and Government, business suggested that better-targeted rules on CFCs and interest relief, and better-targeted reporting requirements in respect of cross-border arrangements should enable the Government to dispense with both Section 765 and 765A. It was agreed that further consideration of the issue should await the outcome of the foreign profits review.

6.8 The Government considers that the proposed taxation of controlled companies, and appropriate rules on interest relief, with more targeted reporting requirements as discussed previously with business, should enable it to propose the repeal of both Section 765 and 765A. The Government welcomes comments on this and, in particular, on the information that it would be appropriate to require.

Benefits of reform

6.9 The removal of the S.765 rules, with the introduction of a modernised reporting requirement, would remove current material costs from multinational groups. The
Government would be receiving the right information for compliance monitoring purposes, in line with the real-time auditing approach being fostered under the Review of Links with Large Business, while companies would be able to carry out commercial transactions without the need for Treasury Consent, and at less cost.

**Other anti-abuse protection**

6.10 Some anti-abuse protection is required in respect of the interest relief rules to ensure, amongst other things, that dividend exemption does not encourage abuse. The Government hopes if at all possible that no further protection is needed beyond this, but is concerned that any new dividend exemption and CC rules, if they are to be as straightforward as intended, may offer opportunities for abuse. The Government would like to discuss these concerns with business and, in the light of this discussion, consider whether a specific anti-diversion rule or targeted anti-abuse measure might be required.
DIVIDENDS

7.1 In relation to the proposed tax treatment of foreign dividends, the Government welcomes comment in particular on:

- whether exemption of participation dividend income, coupled with the new CC regime and limited, targeted interest restriction, is more appropriate for large and medium business than the current approach of taxing dividends and giving credit for any foreign tax paid;
- what dividends from controlled companies it would be appropriate to exclude from exemption;
- whether a simplified credit system, with a CC regime applying only to specifically defined passive income is a more appropriate approach for smaller business;
- the likely behavioural consequences of the package, as context for decisions on what further anti-abuse rules, if any, may be necessary to prevent abuse of dividend exemption.

7.2 In relation to portfolio dividends, the Government welcomes comment on the three options, the likely behavioural response to these options, and whether other options are available.

CONTROLLED COMPANIES REGIME

7.3 In relation to the proposed controlled companies regime, the Government welcomes comment in particular on:

- the overall approach of the proposed regime, including whether application to UK as well as foreign subsidiaries will be useful in preventing artificial location of profits within the UK and in limiting remaining uncertainties regarding the extent of EU law in the field of anti-avoidance, or how else these uncertainties might be addressed;
- the income categories covered under the regime, including the appropriate definitions of the various passive income categories, and in particular, how the “other mobile income” category might be framed in order to ensure the rules achieve sufficient certainty, without being too wide;
- the exemptions, in particular the design of the active finance and group treasury exemptions;
- whether any underpinning is necessary to prevent avoidance of the proposed CC rules.

7.4 The Government would also appreciate practical views on the question of measurement of income. As indicated at para 4.31, a starting point might be that apportioned income should be calculated by applying UK GAAP rules to the local income, net of any expenditure laid out in earning the income (to the extent that this would be allowable for UK tax purposes). This will create a level playing field. However,
the Government would be interested in views as to whether computations by other major international standards could be allowed without introducing an unacceptable risk to the new regime.

7.5 The Government would also appreciate views on the impact and cost to business of the proposed rules, including the impact of the application of the rules for larger and smaller business to controlled UK subsidiaries.

**INTEREST AND OTHER ELEMENTS**

7.6 In relation to the paper’s proposals on interest, the Government welcomes comment in particular on:

- how best to ensure the necessary certainty in respect of the proposed rules; and
- whether the two changes proposed to the interest relief rules, combined with the controlled companies package, will be effective to deal with possible behavioural effects of a move to exemption.

7.7 For Treasury Consents, the Government welcomes views on whether the rules should be repealed and replaced with a modernised reporting regime, and if so what information companies should provide in respect of cross-border arrangements involving controlled companies.
A.1 The Government welcomes comments on the proposals in this discussion paper. Any comments, or any technical queries, should be sent to:

Dominic O’Connell  
Corporate Taxation Team  
HM Treasury  
1 Horse Guards Road  
London SW1A 2HQ  

Email: Dominic.O’Connell@hm-treasury.x.gsi.gov.uk  
Telephone (Treasury switchboard): 020 7270 5000

A.2 Comments should be received by 14 September 2007.

DISCLOSURE OF RESPONSES

A.3 Information provided in response to this discussion paper, 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).

A.4 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, amongst other things, with 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.

A.5 An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

A.6 If you have any queries concerning confidentiality or the FOI then queries should be directed in the first instance to Dominic O’Connell at the above address.

A.7 This document is available at www.hm-treasury.gov.uk/consultations.
PARTIAL IMPACT ASSESSMENT

B.1 This partial impact assessment provides a framework for exploration of the potential impacts of the proposals in this discussion paper.

What is the problem under consideration? Why is government intervention necessary?

B.2 This discussion paper considers some options for reforming the taxation of foreign profits in the UK. The proposals suggested are intended to:

- improve the competitiveness and attractiveness of the UK as a location for multinational business, whilst ensuring that any new system or structures introduced cannot be used to undermine the UK tax base; and
- provide equally fair, but different packages, tailored to the different sizes of companies, reflecting the different circumstances they face.

What are the policy objectives and the intended effects?

B.3 The proposals are a package of structural reform, intended to modernise and create a more straightforward regime for taxing foreign profits. The aim is to achieve a balanced, broadly revenue-neutral package that meets the needs of both business and the Government. The package will deliver improvements in the coherence and transparency of policy, as well as deregulatory benefits – especially through the simplification of the rules for taxing foreign dividends and repeal of the Treasury Consents legislation. The proposals on interest mean the relevant rules will, as business requested, remain largely unchanged with changes limited to anti-abuse aspects.

What policy options have been considered? Please justify any preferred option

B.4 Maintaining the status quo is not a viable option, as this would not deliver improvements to address competitiveness concerns or deal with the policy issues regarding portfolio dividends following the ECJ ruling in the FII case [3.15].

B.5 The package proposed in this paper would provide for exemption for large and medium business alongside a major reform of the CFC rules. Alternative options would be to couple exemption with the introduction of interest allocation, or apply a more limited form of exemption. However, the Government previously consulted on these alternatives and they did not find favour with business.

When will the policy be reviewed to establish the actual costs and benefits, and the achievements of the desired effects?

B.6 The introduction of any package will be dependent on the outcome of this discussion and any proposals issued for further consultation. The Government would expect to undertake a Compliance Cost Review (CCR) between one to two years following the implementation of any reform.
MINISTERIAL SIGN OFF

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Paymaster General

Policy Option: description

B.7 The package proposed in this paper offers exemption for foreign dividends, coupled with introduction of a more targeted controlled companies (CC) regime, which will apply to multinationals and larger domestic UK groups (including medium groups). For smaller groups, this combination would not be an appropriate system so the paper proposes a simpler form of credit regime, with a simpler CC regime applying only to smaller groups with profits over a certain threshold. The package will include some tightening of the UK’s interest rules to prevent avoidance, and repeal of the Treasury Consents legislation.

B.8 The package is intended to achieve a balanced, broadly revenue-neutral outcome and to provide important benefits in terms of reduced compliance costs (particularly in relation to foreign dividends). However, as much of the cost/benefit assessment depends on the detailed design of the new rules, this impact assessment does not provide a detailed assessment of costs and benefits but offers a qualitative assessment, based on the proposals set out in the paper.

B.9 The main benefits to multinational and larger business from the proposed reforms will be more straightforward rules for taxing foreign profits, which the Government anticipates will reduce the administrative costs they face in operating the rules and give them greater flexibility in managing their commercial affairs.

B.10 Small business will, broadly, remain unaffected by the package, though those with foreign profits will benefit from the proposed simplification of the credit rules, and where the CC rules apply, from the fact that the rules will only extend to specified passive income.

B.11 The Government considers that any estimate of transitional costs (which could arise for example from the requirement to introduce new systems for the proposed controlled companies rules) would be more appropriately considered at a later stage in the development of these proposals.

B.12 The proposed package constitutes a significant change in the UK’s system for taxing foreign profits and could encourage a range of behavioural responses. These will also be highly dependent on the detailed design of the proposals. One of the aims of
this discussion is to understand better the likely behavioural response to the proposals in order to ensure that they are developed in a way that minimises risks and uncertainties for Government and taxpayers.

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<th>What is the geographic coverage of the policy?</th>
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<td>Which organisation(s) will enforce the policy?</td>
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<tr>
<td>Will the proposal have a significant impact on competition?</td>
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**EVIDENCE BASE**

**B.13** The proposals in this paper have been developed on the basis of information shared with Government by business stakeholders in the course of informal dialogue in 2006. They reflect the Government’s initial understanding of the likely benefits and costs of the proposals, and the behavioural effects that could be expected on introduction of an exemption system. On this basis, the Government believes they represent a fair package, which will bring important benefits to business, without undermining the UK tax base.

**B.14** As set out in Chapter 1 (and in the summary above), the package offers:

- for multinationals and large/medium groups: simplification of the current rules for taxing foreign profits through an exemption for most dividends from subsidiaries, and stronger, more straightforward and more targeted controlled companies (CC) rules; and
- for smaller business, a simpler credit system alongside simpler (or, if below a de minimis level, no) CC rules;

plus, for all companies,
• limited, targeted tightening of the interest rules and repeal of the Treasury Consents legislation in return for modernised reporting requirements.

For non-exempt dividends, the Government proposes that the credit system should generally be retained.

**Package: costs and benefits**

**B.15** Although the proposed package is based on a high-level understanding of the benefits and costs that flow in principle from the proposed reforms, much of the actual benefits and corresponding costs cannot be known until the detailed proposals are developed. The commentary below does not therefore attempt a quantitative analysis of the administrative costs and benefits, but does provide some qualitative assessment on the basis of the design set out in the discussion paper.

**B.16** The Government would expect to publish a more detailed assessment of the compliance costs at the stage when more detailed proposals are published for consultation.

**Smaller groups**

**B.17** The Government estimates that this group includes around 1mn of the 1.2mn companies registered in the UK.

**B.18** The proposals for this sector mean that companies will not generally be subject to any additional costs. They will enjoy a more straightforward credit system in respect of foreign dividends; and most will be excluded from the CC rules since these will apply only where a group’s consolidated profits exceed a specified amount, the appropriate level for which the Government proposes to explore with business.

**Multinational and larger groups**

**B.19** This group includes multinational and larger UK groups – including medium groups.

**B.20** The package offers important benefits to these groups, in particular, for multinational groups for which the current DTR system involves the highest administrative cost. The proposed exemption system will allow these groups to reduce these administrative costs. It will also reduce the tax costs of those groups which evidence from KPMG suggests are put off by the current rules from claiming double tax relief.

**B.21** For the future, the proposed exemption system will remove some tax-based constraints on how multinational groups organise their group and funding structures, enabling them to organise their affairs in line with commercial, not tax, considerations.

**B.22** The Government expects that, for this sector, the costs of complying with the new controlled companies rules will be lower than those involved with the current exemption-based CFC regime as indicated in the KPMG survey\(^1\). In addition, the Government’s dialogue with business suggested that income-based rules, as proposed in this paper, will fit more neatly with the way larger business currently organises its internal management information systems.

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\(^1\) “Administrative Burdens- HMRC Measurement Project” by KPMG, published 20th March 2006.
UK application of controlled companies rules

B.23 As the paper notes, the application to UK as well as foreign subsidiaries will be useful in preventing artificial location of profits within the UK and in limiting remaining uncertainties regarding the extent of EU law in the field of anti-avoidance.

B.24 Within the UK, the rules will be confined to specifically defined passive income that groups already compute separately for UK tax purposes. To address domestic double taxation, the Government proposes that there should be a system of compensating adjustments similar to the system that applies in relation to transfer pricing.

B.25 The Government acknowledges that this domestic application of the rules could impose a new compliance cost on business. However, as indicated above, the vast majority of UK companies will not bear this cost since the rules will not apply to them. For larger UK groups, the Government anticipates that the income-based nature of the proposed rules means that they will require management information systems (MIS) that are very similar to the MIS groups require from their subsidiaries to comply with existing tax obligations – in particular, loan relationships, group relief and transfer pricing provisions. While there may be some marginal increase in ongoing costs, these are not expected to be material in the context of a large group’s overall compliance cost base. The Government will seek views from business to test whether and to what extent this view is correct.

Competition assessment

B.26 Application of the competition filter test shows that the new rules are not likely to have a material effect on competition.

Enforcement, sanctions and monitoring

B.27 The Government proposes that the system offered in this paper should continue to be part of the overall CT self-assessment regime. On that basis, HMRC would be expected to secure compliance through the risk-based monitoring of returns and through targeted enquiries, enhanced by the guidance developed for the legislation. The normal procedures – including the possibility of penalties – would remain for companies that fail to meet their obligations.

B.28 In providing assurance for the new regime, HMRC would take an active approach to enabling compliance in line with the standards being implemented as a result of the Review of Links with Large Business. HMRC will train and deploy appropriate staff to manage compliance with the new rules.

B.29 In line with standard practice, the Government would expect to keep the new rules under review to ensure they are meeting the overall policy objectives set for the proposed reform and provide the certainty that business and the Government want to achieve.

Specific impacts tests – Checklist

B.30 The assessment above covers Competition assessment and the Small Firms Impact Test. The Government has considered the other potential impacts and confirms that they are not relevant to the policy proposals set out in this discussion paper.
C

EU DEFINITIONS OF SEGMENTS

C.1 Commission recommendation 2003/361/EC concerns the definition of micro, small and medium-sized enterprises, irrespective of their legal form, and came into effect from 1 January 2005 (replacing 96/280/EC).

C.2 Within the SME category, a small enterprise is defined as one which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed € 10 million.

C.3 Calculating staff numbers and financial amounts depends on whether the enterprise is autonomous. Briefly, if more than 25% of the enterprise is owned or controlled by another enterprise, then special rules apply that can place the enterprise in a higher category.

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