(1) MICHAEL, Scholar.
(2) Alan Walters.

I hope this explanation is helpful!

DW.

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24th February 1982

BY HAND - URGENT

D. Wolfson, Esq.,
10 Downing Street,
London SW1.

Dear David,

As requested, I enclose a few comments on some of the points behind the Sunday Express article about the Inland Revenue's draft legislation, entitled "International Tax Avoidance", which was published in November 1981 with the Government's authority.

What really prompted the draft has not yet been admitted publicly, but it looks as if upstream loans may be a proper anti-avoidance target in certain circumstances; exchange control was perhaps considered a bulwark against avoidance and evasion, but I suspect implementation of the draft, with all its new uncertainties, may do more harm to genuine businesses, and cost more — not to mention the need for additional staff — than it would gain. It has also been suggested that the Inland Revenue wishes to make more non-UK controlled companies UK resident so that requiring dividends from tax haven companies will produce additional advance corporation tax.

The draft may have drawn enough adverse comments for the Inland Revenue to regard them as an orchestrated campaign, but this does not surprise me as the draft is considered more extreme than the consultative document which preceded it and itself drew adverse comments from many quarters. There is, of course, a degree of overlap in the composition of many sub-committees in the City which comment on Government proposals and other matters, but many of the various bodies represented — and their constituent members — are apt to be affected in a similar way and to see the need to make representations.

There is also a suspicion that the question of upstream loans could have been covered explicitly in the consultative document and not brought forward — clause numbers included — only a few months before the Budget and with a 6th April 1982 effective date. This subject should therefore be deferred as being more suitable for consideration with the general review of corporation tax contained in the current Green Paper.

I gather several detailed submissions on the draft are emerging, the final date for receipt being the end of this week, and you might like me to get you a copy of one or two of the best ones.

Naturally, please also let me know if I can help in any other way.

Yours,

George

GRP/mc

DRAFT LEGISLATION PUBLISHED BY THE INLAND REVENUE IN NOVEMBER 1981 ON "INTERNATIONAL TAX AVOIDANCE"

Fundamental objections on general principles are that a general bludgeon is being created for use against tax avoidance without specifying targets, that fundamental changes in the UK tax system are being introduced under the guise of being anti-avoidance legislation, that the Inland Revenue is taking wide discretionary powers (without any provision for clearances to be obtained) to decide whether the grey areas are to be treated as black or white and whether or not to require (subject to appeal to the Special Commissioners as to the circumstances of the requirement) the production of documents of, for example, any foreign subsidiary and its clients and that there is a general bias against the financial sector.

Many UK resident companies have overseas subsidiaries. Some are operating subsidiaries, some are holding or finance subsidiaries. Some are intended to protect the parents from risks overseas, to satisfy overseas requirements or to provide the more efficient planning of global tax liabilities; some are needed because their customers will not deal directly with UK residents, because the Inland Revenue will no longer (following a change in its practice after the removal of exchange control regulations in 1979) consent to eurobond issues by UK resident companies or because fiscal burdens are eased and, as a result, keener competition is possible with overseas rivals who would otherwise be subject to less onerous conditions.

Most international groups have an element of co-ordination and reporting requirements that make the determination of residence by the proposed new concept of "independent control and management "of overseas subsidiaries more difficult in practice than might have been supposed. The existing concept of"central management and control" has been judicially determined, and compliance with the new concept would seem likely to require much higher overseas employment costs, resulting in reduced UK profits assuming the business remains competitive.

The concept of employing an adequate number of employees seems over-subjective as a standard for judging the genuineness of a business since it depends on selecting working practices, as well as general efficiency, for comparison.

It is also the case that some UK companies would become non-resident under the proposed concept, which could have unexpected — and sometimes unfair — results.

As regards privileged tax regimes, the UK is regarded as such by foreigners in many respects, and it is not clear why a high nominal rate of tax offset by large allowances should be more acceptable than a low nominal rate of tax or a tax holiday.

Non-UK resident clients need to have confidence that they will not unexpectedly be burdened by UK taxation, and Sir Eric Faulkner's recent correspondence with the Chancellor and Mr. Ridley seems to have been unsuccessful in obtaining reassurances that non-UK residents can have their portfolios managed by UK residents without being deemed to have agencies in the UK and that their foreign currency cash, for example, deposited with UK banks (but necessarily held by overseas banks in the country of the currency) should not on death be liable to capital transfer tax. It is therefore even more important for UK controlled overseas subsidiaries in the Channel Islands and elsewhere to continue to be able, for example, to take non-resident deposits to place in the UK and, with the assistance of periodic advice from the UK, to manage portfolios for non-UK residents. Not all Channel Islands subsidiaries are controlled from the UK, and these and other non-UK resident companies compete actively for business. It is, of course, to be expected that evaders of UK taxes reduce the risk of detection by using non-UK groups, not that harming UK groups will reduce evasion.

The question of upstream loans was only alluded to in the consultative paper, but these would be accepted as proper targets for anti-avoidance legislation if, for instance, they were made by certain cash box companies overseas. However, the draft contains penal proposals without tax refunds on repayment of the loans or proper recognition of allowances and underlying taxes, and it does not acknowledge that dividends are not always appropriate. There may be compulsory retentions overseas, and expanding businesses need retentions of profits, whether calculated on UK or overseas criteria. Furthermore, the draft gives the Inland Revenue too much scope for attacking groups of companies with genuine businesses in the financial sector.

N.B.

Implementation of the draft would give rise to years of uncertainty and confusion and, abetted by overseas competitors, frighten away existing and new clients, particularly in the field of invisible earnings. Even if this had been thought worthwhile, the Inland Revenue may not have dealt with all the practical difficulties which ought to be solved, including that it should have the staff capacity to cope at short notice with large numbers of applications for clearances.

GRP/mc
23rd February 1982.