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PRIME MINISTER

TAXATION OF INTERNATIONAL BUSINESS: COMPANY RESIDENCE, TAX HAVENS AND UPSTREAM LOANS

The purpose of this letter is to let you know how matters now stand with our tax proposals on company residence, tax havens and upstream loans.

2. You may recall that, shortly before the last Budget, we had some discussion of the best way to handle these issues. Our original intention was to follow up our November 1981 draft clauses (the yellow paper) with legislation in the 1982 Finance Bill. But, in view of the widespread anxiety amongst the business community those draft clauses created, we decided to defer action for the time being.

3. Accordingly I announced in my Budget Statement that there would be no legislation this year. I made it clear that the company residence issue needed to be looked at again. On tax havens and upstream loans, I said that our objective was to find the "right middle road" which, while recognising the legitimate requirements of the Exchequer, would not damage UK business generally, nor the position of London as a financial centre. In the subsequent Finance Bill debate on these issues John Wakeham intimated that revised draft clauses would be published later in 1982, so as to leave open the option of including legislation in the 1983 Finance Bill.

4. With the aims I outlined in my Budget Speech in mind, we have over the last few months been looking again at these three related issues. In this period, too, the report of a working party, set up by the Institute for Fiscal Studies specifically to examine these issues, has appeared. While making all the expected noises about need for further study, this broadly supports our November 1981 proposals on tax havens and company residence but recommends rather more limited action on upstream loans.

5. In recent weeks John Wakeham has tested the water by conducting a series of informal discussions with informed and influential individuals. Bruce Sutherland, John Chown, John Avery Jones, Keith Carmichael and William Clark have all been invited to give their views on the best way to approach these problems. In addition John has sounded out a number of the major representative bodies, including the CBI, the IoD, the Consultative Committee of Accountancy Bodies and the British Bankers' Association.

6. These discussions revealed a substantial degree of support for our revised proposals amongst those representatives of the business and financial worlds. There was agreement that, on company residence, we were right to be dealing with specific abuses, rather than proposing the upheaval of a statutory redefinition. Everyone felt that upstream loans would need a good deal more consideration before we could act. Nobody quarrelled with our view that there was a serious problem on tax havens, and all welcomed the revisions we have made to protect genuine business activity.

7. Against this background, I think we can feel that the package we have put together represents a reasonable response to the business community's criticisms of the November 1981 proposals.

8. At the same time it should go sufficiently far to forestall accusations that we have failed to protect the taxpaying public generally by not dealing with an important source of revenue loss. What I have in mind is:

on company residence, as a response to the particularly acute fears engendered by our original proposals, to drop the idea of a general redefinition of company residence. Instead we should take the much more limited action of blocking the specific avoidance devices of profit and loss importation, which are currently costing the Exchequer around £m50 a year. It would seem appropriate to do this in next year's Finance Bill;

on upstream loans, we should do precisely what the business community are asking us to do and give ourselves time to think again how best to deal with the problem. The sums of money involved are large: we have already

identified over £m400 of overseas profits which have been repatriated in (non-taxable) loans form over recent years. Even though the annual tax loss which these represent is a much lower figure, we would undoubtedly be open to criticism if we now abandoned all prospect of action. But, in the absence of any consensus on what form that action should take, we should make it clear that we do not propose to deal with the issue in the 1983 Finance Bill. In due course we would publish revised draft clauses as a basis for further consultation;

on tax havens, there is sufficient broad agreement to go ahead with publishing revised draft clauses and so initiating a further period of public consultation. These new draft clauses would differ from the original draft legislation on several important respects; in particular they would incorporate clearer and more certain protection for genuine business transactions. They would be accompanied by much fuller explanatory material which would set out the case for action, highlighting the current £m100 or so annual tax loss, much more fully than hitherto. Initially the aim would be to keep open the option of legislation in 1983 but the decision on that would be taken in the light of the representations we receive.

9. I attach an appendix which shows in summary form our current package alongside the original proposals. As this demonstrates, no one can really claim we have not listened or failed to act on the advice we have been given. I therefore propose to authorise the publication, later this month or earlier next, of a further consultative document which will set out all three elements of the package. The main purpose of this document will be to invite comments on the new draft clauses on tax havens. But at the same time it will explain that we are not proceeding with a statutory definition of company residence, outline our decision to postpone action on upstream loans and describe in detail the reasons why we feel our tax havens proposals are needed.

10. I shall, of course, keep you closely informed of any further developments in these three related issues.

(G.H.)

November 1982

Original Proposal	Criticism of Original Proposal	My Proposal
COMPANY RESIDENCE		
1. Repeal Section 482 ICTA.	Repeal of Section 482 and consequent redefinition of company residence not necessary.	Retain Section 482 (possibly with minor modifications in the 1984 or subsequent Finance Bill).
2. Replace current case law with statutory definition based on place where company's business as a whole managed.	Unnecessary, and would create widespread uncertainty (would the company be taxed as UK resident or not?), which would be damaging to UK-based enterprises generally.	Drop idea of a general redefinition of company residence, and instead introduce specific legislation to deal with the specific avoidance devices of loss and profit importation.
TAX HAVENS		
3. Introduce new tax charge on the income of certain tax haven companies under United Kingdom control.	In principle case for action on tax havens accepted, but proposals criticised as too far-reaching and hence damaging to genuine businesses.	Retain charge, but significant changes of detail to meet criticisms.
4. Tax charge may fall on any UK company with at least 10% stake in the tax haven company.	The 10% figure is too low : it would bring in many shareholders who had no control over the haven company's distribution policy.	Stick to 10% figure to prevent manipulation through fragmentation of holdings.
5. Define "privileged tax regime" by comparing tax actually borne by haven company with the tax it would have paid under the UK regime.	a. This would bring in many countries (eg Netherlands) not normally thought of as tax havens. b. Complicated calculations would be needed to ascertain whether any company was enjoying a PTR or not.	Retain basic approach but Revenue to issue a non-statutory list of non-havens to provide a greater degree of certainty.

6. Only those tax haven companies which satisfied a fairly rigid set of criteria deemed to be "genuinely trading" and therefore exempt from the tax charge.	The test is right in principle, but too restrictive in its application and many bona fide companies could not satisfy it.	Modify test to provid greater protection fc banks insurance and some holding companies.
7. A haven company which distributes a reasonable proportion of its profits to the UK should be exempt from the charge.	a. Test should be retained, but with some provision for special circumstances eg profits retained for the business requirements of the haven company. b. Wrong that, in looking at the profits available for distribution, UK measure of taxable profits can be substituted for profits per accounts.	Meet point b, but otherwise leave test unchanged - its value to groups with haven subsidiaries lies in its being a simple, mechanistic test.
8. A company will not be caught if it can show that avoidance of UK tax was not one of the "main purposes" of any of its transactions.	a. Language of test too vague. b. Wrong that a company could fail because of a single avoidance motivated transaction.	a. Language of test to be made clearer and less emotive - eg to talk in terms of a "significant reduction" of tax. b. Trivial amount of avoidance income no longer to taint whole of haven company's profits.
9. Scheme to operate at Board of Inland Revenue's direction.	Gives too much discretion to Revenue (this criticism based largely on misunderstanding of the provisions as drafted).	Retain provisions more or less as drafted, and explain just how limited are the Revenue's discretionary powers in explanatory notes.
10. Tax charge on UK shareholder should be appropriate proportion of haven company's notional UK tax bill.	Some critics argued for apportionment of income (on US lines) rather than apportionment of tax.	Retain present approach, and try to demonstrate that it is both simpler and fairer.

11. A UK company assessed to the haven charge should not be able to set off any ACT against its haven tax.	Denial of ACT set-off is unreasonable.	Allow ACT set-off.
12. In computing the haven company's notional UK tax, there should be certain restrictions on the reliefs and allowances available.	These restrictions unreasonable in the context of a tax charge which purports to focus on the UK tax a haven company would have paid had it been UK resident.	Restore full range of UK capital allowances, subject only to a specific anti-abuse provision.
13. If haven company subsequently pays a dividend, haven tax should be treated as underlying tax for the purposes of double taxation relief.	In some circumstances - eg where the overseas country levies a withholding tax on the subsequent dividend - this approach would result in some "wasted" DTR.	Retain general approach, but meet "wasted" DTR point by permitting surplus to be set against original haven charge.
14. The scheme should not incorporate a formal clearance procedure.	A clearance procedure is necessary to prevent widespread uncertainty and unreasonable compliance costs.	Offer no clearance procedure, because of the staff cost it would involve.
15. Meet problem of avoiding the haven charge by dressing up income as gains by extending Section 15 CGTA.	Probably because there was no draft clause to this effect, there was little comment on this aspect of the proposals.	On Revenue advice, leave issue in abeyance pro tem, but reserve right to return to it is evidence of abuse in future.

UPSTREAM LOANS

16. To tax as income a loan made to a UK resident out of the profits of an overseas company controlled directly or indirectly by the borrower, and to deny relief for any interest paid on the loan.

Many commentators did not accept the case in principle for legislation of this kind and there was more criticism on the detail of the proposed provisions.

Defer legislation beyond 1983 but continue consultation on a revised version of the draft clauses.

These would be modified to meet at least some of the criticism on points of detail (see Annex B to Mr Taylor-Thompson's 18 August note).

For example the "loans in the ordinary course of business" exclusion would be widened; the charge would be confined to companies; "downstream" and "cross-stream" loans would be specifically excluded.

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10 DOWNING STREET

From the Private Secretary

29 November 1982

TAXATION OF INTERNATIONAL BUSINESS:
COMPANY RESIDENCE, TAX HAVENS AND UPSTREAM LOANS

The Prime Minister was grateful for the Chancellor's minute received here on 26 November on what changes are proposed on the taxation of international business: company residence, tax havens and upstream loans.

The Prime Minister has minuted that she remains very concerned about this. She fears that the Government would, if it went ahead on this basis, be replacing one set of anomalies with another. She has further commented that some points in the minute and its attachment are unclear: for example, the proposal that the Government should take limited action, in blocking the specific avoidance devices of profit and loss importation. She has also enquired about what is meant by "significant reduction" of tax in item 8. under "Tax Havens" in the attachment to the Chancellor's minute. The Prime Minister has also noted that this minute does not deal with the other tax issue which has recently caused her concern, the proposal that dividend and interest receipts must be made through a licenced depository. Finally, as I mentioned to you on the telephone this morning, the Prime Minister will wish to think further about these proposals before reaching a conclusion.

M. C. SCHOLAR

Miss Jill Rutter,
HM Treasury

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