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Prime Minister

MR. SCHOLAR

Relevant to tomorrow's

meeting with the Chancellor

MUS 6/12

MEASURES AGAINST TAX AVOIDANCE

Item 1 first of all is the Yellow Paper on Company Residence, Tax Havens and Upstream Loans. The Chancellor's memorandum of 26 November is a great step back from the proposals which we saw before the Budget of 1982. Now the suggestions are somewhere near the range of tolerable.

The major difficulty is, however, that it still leaves a great deal of room for interpretation in the hands of the Inland Revenue. Although the suggestion that decisions should be moved to head office, instead of leaving it to individual inspectors, may remove some of the persecution which some companies genuinely feel, there will still be considerable power in the hands of the officials of the Revenue.

On the specific measures referred to in paragraph 8:

a. On company residence

I think it is entirely right to drop the idea (for ever?) of a general redefinition of company residence. We have a working definition which is valuable and understood by everyone. But we must ensure that the "limited action against specific avoidance" which the Chancellor refers to, is appropriately limited and not an open season for the Revenue.

b. On upstream loans

It is quite impossible to differentiate between genuine upstream loans and those which are designed to avoid dividend taxation. The vast majority of upstream loans are genuine loans and are advantageous both to the lending subsidiary and the borrowing parent, irrespective of tax arrangements. Since after a great deal of diligent work, we cannot find a formula which would identify those which are carried out for tax avoidance purposes, I would suggest that we simply cease our search at this stage. Instead of promising to publish more daft clauses as a basis for further consultation, we should say now that we are not going to introduce any such distinction. And we cease consultation and consideration of any measures against upstream loans immediately.

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/c. On tax havens

c. On Tax Havens

On tax havens, the best procedure is to test any proposed legislation to see whether it puts the onus of proof of the use of tax havens on the Revenue rather than the company. Underkill would be much better than overkill. The measures being suggested by the Chancellor move in the right direction, but I am afraid they give the Inland Revenue considerable power in determining the motives for having a foreign subsidiary. Similarly, they do not take into account the fact that in many cases a company will set up subsidiaries, in Malaysia for example, and pay virtually zero tax. But the company is not really avoiding tax by setting up in Malaysia, since the Malaysian Government is anxious to promote industry by these tax remissions. It is part of normal commercial activity.

I am very much an amateur in this area of corporate tax avoidance. It would be a good idea for the Prime Minister to get some independent advice, possibly from Peter Rees, or John Chown. In the case of John Chown, this would have to be done on a very confidential and closed basis, since he has lots of interests outside.

Rents and Dividends from Overseas - Licensed Depositories

The Treasury, in the shape of John Wakeham, was just as alarmed by the tone of the Inland Revenue letter of July 1982 as we were. The Treasury propose to do nothing yet. But John Wakeham argued that the elimination of exchange control had, as the Inland Revenue suggested, created opportunities for evasions which had not hitherto existed. He agreed, however, that the basis for some of their figures was slim or non-existent.

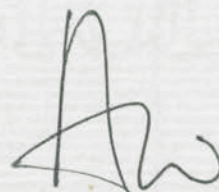
I suggested that one way of dealing with this would be to make the penalties for evasions of property income received from overseas much higher than for any other tax evasion. This is the way these matters are dealt with in the United States where, as you know, there is no restriction on interest and dividends received from overseas. But the penalties, if such dividends and interests are not reported, are enormous. This seems to do the trick, since the Internal Revenue in the United States does not complain of any significant tax loss from this source.

It would create a very bad impression if we set up a system of licensed depositories. It would certainly be interpreted as the first stage, at least, in a return to controls on exchange rates.

Conclusion

The Treasury have made very big strides in changing their perception of and proposals for tax avoidance legislation. I still think there is room for modification. But as a general proposal, they are on the right lines.

29 November 1982



ALAN WALTERS