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Prime Minister (1)

You asked John Sparrow to have a look at this (for discussion at your meeting tomorrow ?).

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Qa 06238

To: PRIME MINISTER

From: JOHN SPARROW

31 January 1983

para 8
If you agree with X I must tell the Chancellor and John Wakeham.

Yes please
MCS 31/1

Taxation of International Business

1. We have examined the Inland Revenue's latest consultative memorandum on this subject, together with the proposals put forward at the end of 1981 about which you expressed concern.

2. The present proposals are significantly less drastic than their predecessors and would lead to action in this year's Finance Bill on tax havens only. Further work is proposed on company residence (the importation of profits and losses) and on upstream loans, with a view to legislation at a later date. Despite the concessions that have been made, problems remain.

Company residence

3. The Chancellor has now recommended against a major redefinition of company residence, but instead intends to introduce (at a later date) specific measures to prevent the importation of losses and profits. I agree that there is no need to amend the present definition of company residence - the law is clear and any change would involve upheaval and uncertainty. The problem lies in inconsistent application of existing case law by the Inland Revenue and this should be alleviated by the proposal that the Revenue should issue a Statement of Practice. However, any legislation to prevent importation of overseas profits/losses should only be drafted after careful consideration of the likely economic and commercial effects, against your own broader objectives. When losses are incurred, some measure of relief from UK tax may be crucial if the financial viability of a UK based group is not to be prejudiced. As for the importation of profits without a liability to UK tax, to prevent this would of course deplete corporate funds. And some tax would become payable if and when those profits are subsequently distributed to UK shareholders.

Upstream loans

4. Here again, the Chancellor intends to think further, bearing in mind the need to protect loans from overseas companies made to UK parent companies in the ordinary course of business. This is clearly necessary. The proportion of assets held overseas by UK based multinationals has increased, and can be expected to continue to increase. There are risks that misplaced enthusiasm might have adverse financial consequences for the companies concerned, and might even lead some of them to consider moving their head offices away from the UK. These matters also require careful study before legislation is drafted.

Tax havens

5. The Chancellor is proposing new legislation on tax havens. Although the previous proposals have again been watered down, legislation will inevitably be complex if abuses are to be dealt with effectively. It is suggested that the annual tax saving will be £100 million; this may well be overstated, but even if it is not, one has to ask if the game is worth the candle. Some of the abuses are capable of being dealt with under existing legislation. One of the problems which has been identified ('dividend trap' companies) is caused primarily by an anomaly in existing double tax relief arrangements. Another identified abuse (managed 'money box' companies) will not in fact be remedied by what is proposed.

6. The business community will not welcome these proposals. Despite the comprehensive exceptions, legislation will affect many international companies based in the UK. Apart from the additional administrative effort and cost involved, there will be genuine worries since -

(a) tax haven legislation is only part of the Revenue's plans for taxing international profits; the other proposals on upstream loans and importation of profits and losses and the Statement of Practice on company residence will not be produced until later; and

(b) no list of specified tax havens has yet been published.

7. Despite these objections, the present proposals probably provide adequate protection for genuine business transactions, and UK business should not be damaged unduly, despite the administrative inconvenience and additional cost. However, if legislation now is judged necessary, then it should only be introduced on the basis that the present deficiencies in double tax relief arrangements are dealt with at the same time. In particular 'averaging' or 'pooling' of dividends from overseas should be permitted so that there is some relief for overseas tax on dividends where one of the overseas rates exceeds the UK rate of tax.

8. That said, there seems to me to be a case for legislation to be deferred until comprehensive proposals can be brought forward to deal with all of the problems in the light of wider Government policies for the health of industry as a whole and for stimulating (or preventing) investment overseas; and after reconsideration of two fundamental questions -

(a) should the overseas earnings of UK based companies be subject to UK tax, regardless of whether they are remitted to the UK? (Germany has tax haven legislation but does not tax overseas income where a double tax treaty is in force.)

(b) should companies be subject to the same fiscal regimes as individuals, bearing in mind the fact that distributions of income by companies to individuals and capital gains made by individuals on corporate investments are already subject to personal taxation?

9. I attach a copy of a background note prepared here, which you might find helpful in considering the Inland Revenue proposals.

JB.

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31 JAN 1983

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26 January 1983

Taxation of International Business

Background Note

Inland Revenue Objectives

1. In November 1981, the Inland Revenue published a consultative memorandum, referred to as the yellow paper, setting out proposals for limiting opportunities for tax avoidance by UK controlled international companies.

2. The Revenue was concerned about the increasing use of loopholes in existing legislation to minimise the incidence of UK tax. In particular companies had, in the Revenue's view, been artificially transferring the tax residence of their subsidiaries to and from the UK, to obtain relief for overseas losses and to avoid UK tax on overseas profits remitted to the UK. Loans were being made instead of dividends from overseas subsidiaries to the UK, in order to avoid tax. Tax havens were being used to shelter income from UK tax.

3. Other countries have in recent years introduced fiscal legislation to stem losses to their Exchequers. The Inland Revenue saw the proposals as catching up the others, reducing avoidance, and also preventing abuses from growing.

Consultation with industry and commerce

4. Prior to publication of the yellow paper, the Inland Revenue did not discuss the proposals with industry, commerce or their professional advisers. The draft clauses were so wide-ranging that they caused great anxiety on the part of the business community. There is little doubt that UK industry would have suffered commercially as a result of these proposals.

5. The Treasury claim to have learnt two lessons from this affair: first, it is advisable to be clearer within Whitehall as to the objectives and effects of any proposals, so that they can be considered alongside other policies for industry and commerce; second, there is a need to consult the representatives of commercial organisations informally before a consultative document is published to test likely reaction and to be clearer about likely effects.

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The present proposals

6. The present proposals were published in December 1982 under the title "Taxation of International Business". These are considered briefly below.

7. Despite reaction to the previous yellow paper, the preparatory work to the present document may be criticised in two respects:-

(a) The effects of the draft tax haven clauses on Exchequer revenues and on international companies are largely unknown. The economic considerations have not been weighed against the revenue benefits. The Institute for Fiscal Studies criticised the earlier yellow paper for not examining the impact of proposed legislation on organisations and on taxable capacity, and for relying on anecdotal evidence. Similar criticisms can be levelled against the present proposals. In addition the draft clauses have not been considered in the light of more general Government policy for the industrial and commercial sectors as a whole;

(b) prior consultation with business representatives has been of a cursory nature and limited to very general principles.

8. Although comments on the yellow paper have been taken into account in the new proposals, they will not be welcomed by business, who will see them as a further burden on international companies. If legislation is introduced, a major difficulty created by deficiencies in the present legislative arrangements for double tax relief should also be removed.

Company residence

9. The yellow paper proposed a redefinition of company residence for tax purposes on the grounds that the present situation was unclear and there was a need to determine residence by reference to the place where effective management took place.

10. The business community argued that the legal position was clear but the Inland Revenue had created uncertainty by not applying the rules in a consistent manner. They further agreed that a change at this stage would result in great upheaval, particularly to businesses who had structured their organisations based on existing legislation, and the new rules would not necessarily result in greater clarity.

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11. The present consultative document states that a new definition will not be proceeded with at this stage but that the Inland Revenue will issue a Statement of Practice which will clarify the application of the present test of company residence. This should help, if only to clarify the Inland Revenue's approach to present law.

12. The document also states that the Government intends to bring forward specific measures to deal with the loss of tax, estimated at around £50 million a year, created by "importing" profits and losses.

13. The Revenue does not like the practice of "importing" losses, whereby an overseas subsidiary company which is making losses may be treated as UK resident (although its business activities are elsewhere), so that these losses can be relieved against the taxable profits of the UK group. In order to be treated as UK resident, the overseas company must be seen to have transferred its management and control to the UK. While recognising the immediate loss to the Exchequer arising out of this practice, it is nonetheless a reasonable activity to permit since:-

(a) it is typically in start-up situations where losses are incurred. In these situations the UK parent company will wish, in most instances, to control the overseas business from the UK;

(b) where overseas losses arise, UK management will typically wish to control the overseas business themselves until it is restore to health;

(c) a group is most vulnerable financially when one part is making losses. If losses incurred overseas cannot be offset for tax purposes against profits arising elsewhere, then the group's future may be prejudiced. To deny the possibility of relieving overseas losses in the UK may not enhance the commercial viability of UK based international companies;

(d) once an overseas company becomes profitable again its profits will be taxed in the UK or overseas, depending upon where it is then resident.

As a result the across-the-board banning of importation of losses will adversely affect the commercial prospects of UK companies. It should also be pointed out that the importation of losses is restricted to those arising after the company becomes tax resident in the UK. The potentiality for relief, and also for abuse, is therefore already restricted.

14. The Revenue also dislikes the practice of "importing" profits, whereby profits accumulated abroad by an overseas subsidiary can become available to a UK parent company, without payment of tax, if the overseas company becomes resident for tax purposes in the UK. This is undoubtedly a method of escaping UK tax on profits transferred to the UK; however such profits cannot be distributed to shareholders without tax becoming payable; also to tax these accumulated funds will weaken the financial position of the group and leave it with less funds in the UK for future investment.

Upstream Loans

15. In recent years UK based international companies have invested more overseas and the proportion of assets held overseas has increased. This trend has increased following the suspension of Exchange Control regulations and is understandable in view of the higher rates of return that may be earned overseas. As a result, profits have been accumulating overseas, which because of lower rates of return in the UK have been required to fund working capital and investment programmes in UK companies in the same group.

16. Despite the need for these funds, UK companies have refrained from obtaining dividends from overseas subsidiary companies, either

(a) because UK tax has become payable where overseas taxes (including withholding tax) have been less than 52%; or

(b) because of an anomaly in UK double tax relief arrangements, whereby overseas taxes (including withholding tax) in excess of 52% cannot be relieved in any way.

Thus loans have been made by overseas companies to the UK parent.

17. The Inland Revenue has identified £400 million worth of such loans, mostly in the years since 1979. Proposals have been put forward in the yellow paper to seek to tax these. However the reaction from the business community was such that the Inland Revenue has now agreed to consider the whole issue further, bearing in mind the need to distinguish clearly between loans made in the ordinary course of business and loans which are effectively disguised dividends.

18. It is likely that because of higher rates of return overseas, multinational companies will invest more overseas, and have available funds in overseas companies for investment in the group as a whole (including the UK). To seek to tax funds lent to UK companies for bona fide purposes would not assist the financial viability of UK multinationals or encourage reinvestment in the UK. Indeed to do so may encourage multinationals to move their head offices from the UK. It is probable that the loans made as disguised dividends represent a very small part of the £400 million figure. To this extent, use of this figure in the context of the Inland Revenue's current proposals is misleading.

Tax Havens

19. The use of tax havens has increased in recent years. A number of other countries, notably the US, Germany and Canada, have introduced legislation to attempt to reverse this trend. In all cases, tax haven legislation has tended to be complex in order to be effective. It has resulted in significant additional administrative effort and cost on the part of companies, including those engaged in bona fide activities; it tends to be over-general and therefore affects all.

20. It should be noted also that in countries such as the USA and Germany which have tax haven legislation the regimes are much less severe than those now proposed by the Inland Revenue. In the US "pooling" of overseas dividends is permitted (see 22(b) below). In Germany overseas earnings are not taxed even when remitted, providing there is a double taxation treaty with the overseas country.

21. In its present consultative document, the Inland Revenue has put forward proposals which represent a watering down, following representations made, of those included in the yellow paper. As a result, the figure of £100 million referred to as the annual loss of tax to the Exchequer may be a misleading figure in terms of what might be saved in the future. It is questionable whether the benefit will be greater than the costs which will be incurred by British industry, even if all the alleged benefits materialise.

22. The Inland Revenue has identified five main abuses which it is intended should be removed by tax haven legislation. These are commented upon briefly below:-

(a) "Money box" companies. These are used by UK companies to invest surplus funds overseas tax free or at low rates of tax. The Inland Revenue proposals will prevent companies from using their own money box companies to reduce tax. However they will still be able to benefit from investments in money box companies managed by some of the City institutions;

(b) "Dividend trap" companies. These are intermediate holding companies established overseas by UK holding companies to trap dividends from overseas subsidiaries so that only income distributed to the UK is taxed and the tax borne in different companies is averaged for UK DTR purposes. In practice, most dividend trap companies are established for commercial reasons to deal with the anomaly in the UK DTR arrangements referred to in paragraph 16 above. A preferred method of dealing with this problem might be to amend DTR legislation to introduce "averaging" or "pooling"; this would cure the disease rather than remove one of the present remedies;

(c) Offshore captive insurance companies. UK companies establish their own offshore captive insurance companies for two main reasons:

(i) to reduce the cost of insurance by administering the companies themselves and because investment income may bear a lower tax charge;

(ii) to circumvent UK insurance regulations which are designed to protect consumers generally.

The Inland Revenue is seeking to tax the offshore income of these captives. This would result in increased insurance costs to UK companies;

(d) Sales, distribution or service companies. The Inland Revenue would like to tax profits which are artificially transferred from UK companies to sales, distribution or service companies in tax havens. However the Revenue has such powers already under section 485 of the Taxes Act 1970;

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(e) Patent holding companies. The Inland Revenue would like to tax royalty income earned by patent companies established in low tax countries where such income is derived from the UK. However in practice, it would not be possible to transfer patent rights to low tax areas other than at fair value and the Revenue has powers under the 1970 Act to deal with abuses.

23. It will be apparent from the above that either the draft clauses will not remedy the problems which have been identified, or alternatively that the problems should be dealt with (or capable of being dealt with) in some other way.

24. To introduce such proposals would have an adverse effect on the financial position of some UK companies. Unless the DTR anomaly is removed, the draft clauses would adversely affect the competitiveness of UK multinationals.

25. Instead of introducing tax haven legislation in the form suggested, consideration might be given instead to exempting overseas income from tax altogether (as in Germany), providing such income has been taxed overseas and there is a double taxation treaty in being. This will require a study of the effects of tax on international companies' investment patterns and should be considered in the light of wider Government objectives for investment overseas by UK businesses.

Licenced depositories - rents and dividends from overseas

26. There is no mention in the consultative document of licenced depositories, which are no longer required following the suspension of Exchange Control regulations. The Inland Revenue has stated that the increasing tax evasion (where income from overseas is not declared) will only be prevented by the re-introduction of licenced depositories. However no proposals have been put forward. We support this since it is Government policy that licenced depositories should not be re-introduced. We are also dubious about the extent to which licenced depositories would contribute to a reduction in tax evasion.

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