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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister

MCS 8/3

PRIME MINISTER

INCOME TAX THRESHOLDS

You asked me to think about the possibility of increasing the thresholds by 10 per cent.

2. In recent weeks I have, as you know, been planning a 8½ per cent increase, largely because:-

a. we need to demonstrate our determination to go on reducing borrowing, even if only at a moderate rate; this means a 1983-84 PSBR which can be shown (after some "rounding down") as no more than £8 billion;

b. which in turn means that our scope for total net tax reductions (after indexation and valorisation) is, on the latest forecast, limited - in terms of PSBR impact - to some £1.5 billion (and even that is pushing it a bit); and

c. to target more than three quarters of these reductions on individuals, rather than business and industry - and more than two thirds on the single area of income tax thresholds - would be open to sharp criticism. (Frankly, I think we would be accused of electioneering.)

3. There is no particular magic about the 8½ per cent figure: the £1 billion relief (in PSBR terms) which it represents, on top of indexation, is more important. But 8½ per cent does meet, or

/beat

beat, a number of important targets, viz:-

a. taking the Government Actuary's assumption of earnings growth of 6½ per cent between 1982-83 and 1983-84, it reduces or matches average rates of tax and NIC for 1982-83 for all people who are contracted-in;

but not tax + NIC

b. it reduces average rates of tax compared to 1978-79 for married men on at least three quarters of average earnings - ie two thirds of married men; and

c. because I have rounded up the married man's allowance, it gives all married men a tax reduction of just over £2 a week.

4. As I told you, there is a huge choice of figures on which to base alternative calculations. They are all complicated by two things: the increases in NIC which we have had to make (including this year's special addition to the contracted out rate): a total of 2.5 per cent for those contracted in, and of 2.85 per cent for those contracted out; and the very large increase in average earnings that has taken place.

5. With this in mind one can make a variety of comparisons with 1978/79, Labour's last year. A reduction in the average percentage rate of tax and NIC combined to the levels in that year would require an increase of more than 30 per cent over indexation. On average rates of tax alone, indexation plus 8½ per cent improves the position for most married men, but indexation plus 15 per cent would be needed to match 1978/79 for a majority of the single (and earning wives).

6. The figure of indexation plus 10 per cent (which I mentioned) would, as it happens, restore allowances to their 1978/79 level as

/a percentage

a percentage of earnings. But it would take no particular tricks, since that milestone is seldom mentioned. Reference is more often made to the real value of the allowances expressed (as "Rooker-Wise" requires) in terms of prices; and by that yardstick indexation plus 3 per cent is sufficient to restore the 1978/79 level. (I see that the ITN Budget Factbook, for example, suggests that to "provide complete indexation during /his/ time as Chancellor" would require me to make an overall increase this year of 12 per cent and we shall be doing better than that.) Average earnings, of course, have increased more than prices - which means that all the options, including bare indexation, show real net earnings in 1983/84 after tax and NIC as higher than in 1978/79.

7. There is one other thing which may have been obscured by the way in which we are obliged to do our initial arithmetic in terms of the first year net PSBR cost of any measure. The income tax cuts which I now propose cost, on that basis, "only" £1 billion. But the full year revenue cost of such income tax cuts, including indexation, is about £2.5 billion, and that is the figure which will hit the headlines.

8. I believe it would be unwise to go beyond that, not least because it would make the PSBR up to £8.5 billion. To announce an intention of borrowing much more, in nominal terms and as a proportion of GDP, next year than in the current year would cause considerable surprise, since it would be inconsistent with the strategy we have been following over the years. And it would reduce still further our very limited room for manoeuvre in face of a sharp fall in oil prices.

9. So I really do think that 8½ per cent makes sense, and that more would be a mistake.

GH

(G.H.)
8 March 1983

Michael

10 DOWNING STREET

From John Kerr:

1. IF threshold is uprated by 10% each of 4 blokes would be 50P better off.

2. 75% of mortgages are less than £15.000, 60% less than £10.000.

∴ examples quoted are a typical.

Peter

2335692

Michael

Econ Pol

(2)

10 DOWNING STREET

Prime Minister

Budget: Tax avoidance measures

Alan Walters thought you should see John Chown's views on the tax avoidance measures in the Budget as amended by John Wakeham.

MCS 9/3

M.T.

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Professor Alan Walters,
10 Downing Street,
LONDON, SW1.

3rd March, 1983.

JFC/PJP

Dear Alan,

For information as requested. Everything seems under control.

I shall be in your old stamping ground, Washington, most of next week catching up on their problems by way of light relief from ours.

With best wishes,

Yours sincerely,

John F Chown

Enclosure

J F Chown and Company Limited

ADVANCE COPY

1st March 1983

"TAXATION OF INTERNATIONAL BUSINESS"

JOHN CHOWN, JOHN DEWHURST, STEPHEN RUMBALL

After two years of discussion, this year's UK Finance Bill will include provisions to tax the income of certain foreign subsidiaries of UK companies. This analysis of the latest draft Clauses is for the guidance of clients of J F Chown and Company Limited.

I INTRODUCTION

A new set of draft Clauses has now been published. They provide for the current taxation of UK corporations in respect of the undistributed profits of certain 'controlled foreign companies' in 'low tax jurisdictions'. No immediate proposals are made on 'company residence' and 'upstream loans' but there are important comments (discussed in Parts IV and V) which need to be watched by the business community. It is no longer proposed to abolish Section 482 (not to be confused with the US Code section of that number).

MS

The new proposals are a great improvement on earlier versions and are now published with a preface by Mr John Wakeham, Minister of State at the Treasury. It is thanks to his personal, energetic and intelligent intervention that we may now have, at least, a firm base for detailed consultation.

Although further representations were invited there was little chance for further consultation before the 15th March Budget. The Clauses, are expected to be introduced in the 1983 Finance Bill with an effective date of possibly 6th April 1983 but more probably 6th April 1984. This paper is an analysis of the proposals mainly for the benefit of clients and correspondents. We draw attention to some technical points - readers can assume that these will be taken seriously and may be reflected in the version which emerges from the Parliamentary scrutiny of the Bill.

We indicate where the new proposals differ significantly from the original. This should bring home to new readers (rather more forcibly than the bland prose of the document itself) the full horror of the unlamented original. The business community should remember that its authors are still at large: 1983 may be an election year and a new government could well 'buy' the original package. Meanwhile, foreign financial institutions looking forward to the emasculation of UK based competition may not have all their hopes fulfilled.

There have for many years been provisions (now sections 478 - 481, Taxes Act 1970) by which UK resident individuals can be subject to tax on income arising to companies, trusts and other entities abroad for their benefit. Following the 'Vestey' case the law was changed (both to close a loophole and to limit the Revenue's overkill powers) by the Finance Act 1981.

Another consultative paper is promised on the tax treatment of non-residents operating in the UK. We do not discuss either topic here.

Part II below sets out the history and background leading up to this paper. Part III is a detailed analysis of the actual proposals, while Parts IV and V draw attention to some serious threats still contained in the comments on company residence and upstream loans.

II BACKGROUND

In our 'Finance Act 1982' memorandum last year (copies still available) we drew attention to two conflicting aspects of recent tax legislation. The 'positive thread' was represented by the elected government's determination to restore the economic conditions necessary for prosperity, stability and growth. The 'negative thread' was represented by the preoccupation of the Inland Revenue with so-called tax avoidance and with highly technical measures drafted by civil servants with a less than whole-hearted commitment to the free enterprise system.

We are delighted that policy on 'International Tax Avoidance' (to use the provocative title of the earlier papers) now appears to be under Ministerial control.

UK companies expanding abroad had until recently to contend with two sets of administrative restrictions: exchange control (now happily abolished) and Section 482 ICTA 1970. The latter prohibits a wide range of normal international transactions by UK companies without prior Treasury consent. Originally enacted as an emergency measure, it is unusual in tax legislation in imposing specific criminal penalties. The end of exchange control strengthened the case for also getting rid of this archaic provision. Although it had been fairly liberally administered in recent years, it gives an unacceptable degree of administrative discretion over the normal and proper affairs of international business.

It was generally recognised that the abolition of Section 482 might facilitate certain types of international tax avoidance and ministers authorised the Revenue to make recommendations. Both the original proposals themselves and the Revenue attitude in putting them forward were widely criticized by a remarkably broad section of the business community.

International tax is a small profession: the specialist independent advisers and the heads of tax of the major multinationals tend to know each other pretty well, and to know what is going on amongst reputable companies world wide. We were frankly puzzled by the Revenue attitude: we were genuinely not aware of the type of abuse of which they complained. Recent events, though, suggest that the Revenue may have seen (and misinterpreted) transactions with tax havens which constituted not tax avoidance (or even evasion) but simple old fashioned fraud. This conjecture certainly makes their attitude more explicable.

On 26th January 1981 the Revenue published a consultative document. The Institute for Fiscal Studies organised a seminar to discuss this on 3rd March, 1981, and various representative bodies made critical submissions. (See 'Taxes International' July and August 1981.

In November, 1981 the Inland Revenue produced draft Clauses for the 1982 Finance Bill. This document known as the "Yellow Peril" dealt with three subjects: company residence, tax-haven subsidiaries and upstream loans. It took little account of the representations submitted and there was a storm of protest. Again the Institute for Fiscal Studies played a substantial role, organising a seminar on 3rd March, 1982 a year after the previous one, and with the same three speakers: John Chown, Alun Davies and Kenneth Evans.

Following these pressures, the Chancellor announced in his 1982 Budget that the proposals would be deferred for a year. The Institute for Fiscal Studies then set up its Working Party under the chairmanship of Mr Edmund Dell. Meanwhile an Inland Revenue letter of 4th June 1982, apparently intended to be conciliatory, did little to cool tempers. It also hinted at an attempt (since withdrawn) to extend the "tax haven" concepts to capital gains as well as to income.

The Dell Report was regarded, even by those who had commissioned it, as 'wet'. The IFS held another seminar at which the 'opposition' to Dell was represented by Margaret Erskine and John Chown. (FN: See 'Taxes International' November 1982).

There are in fact substantial changes and, specifically, Ministerial influence has ensured that the new paper gives proper regard to the effect on international competitiveness and the position of London.

The new paper argues (paragraphs 19-21) against the case some of us had made, 'that it was inappropriate to seek to take action on company residence, tax havens, and upstream loans separately. Instead the issues should be considered as part of the wider debate on the corporation tax green paper or double taxation matters generally'. The Revenue arguments, sound enough in context, miss the point. There are anomalies favouring business and adversely affecting the Revenue. There are also those, involving very large sums of money, which adversely and inequitably affect international business. The same priority should be given to dealing with both: it is simply not acceptable to push forward with closing loopholes while postponing indefinitely relief for serious tax traps remaining in present legislation.

There is a practical point here. Tax traps recruit tax avoiders. Many reputable companies have refused to be a party to anything even approaching 'tax avoidance' (never mind 'evasion') and have been reluctant to take specialist international tax advice, even at an elementary 'check up' level. Having been caught in the 'foreign loan' or 'ACT prejudice' trap they tend to become enthusiastic tax planners, determined to get 'some of their own back'. The unfortunate tone of the earlier Revenue papers did nothing to deter the flow of recruits. We hope that the Revenue will now succeed in re-establishing the traditinal good relationship with corporate taxpayers.

III TAX HAVEN COMPANIES

The draft clauses cover only one of the three topics dealt with in the November 1981 draft. (There are generalised threats on 'company residence' and 'upstream loans', and we deal with these briefly in Sections IV and V.) Further representations have been sought but the real (and possible final) opportunity for scrutiny and amendment will be during the Finance Bill debates.

SUMMARY

Briefly, where an overseas company is under UK control (a 'controlled foreign company' - 'CFC') and is subject to a 'lower level of taxation' in its country of residence, the Inland Revenue may direct that 'notional UK tax' be apportioned to any UK company which, with 'persons who are connected or associated' with it has at least a 10 per cent stake in the overseas company. No direction may be made if the tax paid by the overseas company in its country of residence is at least half the amount that would have been payable in the UK had it been resident here (ie, it does not enjoy 'a lower level of taxation') or if the overseas company is engaged in 'exempt activities' or makes an 'acceptable distribution' to the UK parent of a proportion (generally half) of its profits or if it satisfies a 'motive test'.

The precise meaning of all these technical terms is, of course, vital. We discuss each of them below.

The Revenue paper (paragraph 23) draws attention to five ways in which UK companies are said to be using low tax countries to minimise tax.

- i) 'Money box' companies
- ii) 'Dividend trap' companies
- iii) Offshore captive insurance companies
- iv) Sales, distribution or service companies
- v) Patent holding companies

DEFINITIONS

The legislation only comes into play at all if there exists a UK company which has an assessable 'interest' in a 'controlled foreign corporation'.

There are no material changes in the definition. A CFC will be a company under the control of one or more UK residents. "Control" follows the broader Section 302 definition (Clause 9(3)). This gives a variety of alternative tests and includes the words 'is entitled to acquire' which can catch option or trust arrangements. The profits (but not chargeable gains - the threats in the 4th June letter have lapsed) of such a company may be computed in accordance with UK principles and apportioned to any UK resident company (or other person) having an 'interest' in the company. Apportionment will be made only to any UK person entitled (with 'associates') to at least 10% of the profits. In contrast with the US practice all shareholders however small their holding will be taken into account, with no "de minimis' provision, in determining whether UK residents have control.

'Notional UK tax' (NUT) can be apportioned not only among shareholders as such but also among those who at any time during the relevant accounting period have 'interests' (broadly defined) in the CFC (Clause 2(5)).

LET-OUTS

Even if a company is 'prima facie' a CFC, it is still possible to invoke a number of let-outs. Two are closely related. No direction is to be made if the company is not subject to a 'lower level of taxation' (previously referred to as a 'privileged tax regime') or if it pursues an 'acceptable distribution policy'. These two tests in concept could mean that a UK parent can postpone about half its potential tax charge. It can either divert profits to a zero tax jurisdiction and pay half these profits as dividend or it can set up in a jurisdiction where the effective tax burden exceeds, by as small a margin as possible, half the UK burden. In practice we have to examine the precise rules, which turn out to be less favourable.

'Lower level of taxation'

A CFC is regarded (Clause 3) as enjoying a 'lower level of taxation' if the 'local tax' paid in its jurisdiction of residence (defined in Clause 2(1) and (2)) is 'less than one half of the corresponding United Kingdom tax on those profits'.

The original version made the comparison with a wholly artificial base from which many normal UK adjustments, such as capital allowances, were specifically excluded. The comparison is now in principle to be made on a consistent basis but there are still problems. (The concept of a notional UK tax (NUT) is again relevant - see below.)

List of countries

As a practical matter the Inland Revenue says it intends to

> "publish a list of countries which would not be regarded as low tax countries ..... Some of these countries will in no circumstances trigger a charge ..... For other countries it would be necessary to distinguish those companies which benefit from particular reliefs or allowances, which would be specified on the list." (page 20)

The business community is pressing for the list to be incorporated in the statute - or at least to be published as part of the consultative process. This may prove difficult in practice. Will the Revenue put EEC partners (such as the Netherlands) on a black list, even under the proviso?

The United States does not specifically designate territories although one let-out from the provisions is granted by reference to the tax regime of the country to which the profits arise.

Canada has an exclusion for countries with which there is a double tax agreement even though the current form of the agreement may have no specific provision governing it.

Germany excludes from the provision companies in jurisdictions where there is at least a 30% tax rate. It is not clear whether this is actual or potential tax. The wording of this provision is complex: there is an attempt to prevent "mixing in" of losses and tax credits from other sources.

Japan has a list of designated tax havens. France appears to have the same concept, but it is not yet clear whether the "list noire" under Article 238(A) is the one which will apply. (Article 238(A) applies a more than usually stringent "arm's length" test to interest, royalty and managerial fee payments to suspect territories.)

'<u>Acceptable distribution</u>' (Schedule 1 Part I)

A UK shareholding company can avoid a charge if the controlled foreign company distributed by way of dividend at least 50% (if it is a trading company) or 90% (if it is not) of its profits to UK residents within a reasonable time. The percentage is of the <u>total</u> profits regardless of the proportion attributable to UK residents. This would produce perverse and unacceptable results for companies with foreign minority shareholders. (See Schedule 1 Para 2(1)(c).) This anomaly is defended (unconvincingly) on page 47 of the preamble, and will doubtless be changed.

For the purposes of the 'acceptable distribution' test, the definition of 'available profits' specifically excludes chargeable gains (see Schedule 1 Para 2(4)(b)).

The test will not be satisfied to the extent that dividends are paid out of specified profits, (Part I Clause 2(1)(b)). This prevents a UK resident company from circumventing the UK's source by source double tax relief limitation rules. This will most commonly apply to a CFC which is a holding company. It might otherwise attempt to avoid an assessment by specifying that a dividend paid on to the UK is paid out of distributions from a high tax subsidiary rather than a low tax subsidiary. It would then be possible to satisfy the 90% test by remitting dividends which would not be liable to UK tax because of double tax relief and leaving unremitted dividends from low tax subsidiaries in the CFC.

The new draft clauses still do not contain a 'de minimis' or 'consent dividend' provision to cover the situation where there is a marginal failure to satisfy the acceptable distribution test. The result will be that the <u>unwary</u> will incur an assessment on a CFC, even when a substantial part of the profits of the CFC have been remitted to the UK in the form of dividends. In addition, no account will be taken of funds retained in the CFC to meet the needs of the business. In both cases, the 'motive' test is not an acceptable substitute for the omission of specific provisions.

In deciding whether a dividend was paid within a reasonable time, regard must be had to the length of time it normally takes for the foreign company's accounts to be prepared and for payment of a dividend to be agreed. It is stated in the text, (but <u>not</u> in the draft clause, which is all the courts could look at) that where a dividend is paid within eighteen months after the end of the period to which it related, the condition would be regarded as satisfied.

Exempt activities (Schedule 1 Part II)

The most complicated of the let-outs relates to the carrying on by the CFC of 'exempt activities' (clause 1(6)(b) and Schedule 1 part II). The premises, business establishment and management provisions are predictable and straight-forward. We need to watch the provision that "any services provided by the company for persons resident outside that territory are not in fact performed in the United Kingdom". (Schedule 1 paragraph 7 (b)). This, as worded, could adversely affect contracts entered into by the CFC part of the performance of which is sub-contracted to firms or individuals in the UK at proper arm's length prices. It would be clearer if the words 'by the CFC' were inserted after the word 'performed'.

'Exempt activities' cannot include leasing, dealing in securities (otherwise than as a broker) or receipt of passive income such as dividends, interest or royalties. Nor can the phrase include dealing in goods for delivery to or from the UK (unless the goods are actually delivered to the territory where the CFC is resident) or to or from connected or associated persons. There is no 'export trade corporation' let-out as in the United States.

'Exempt activities' also do not include the activities of a CFC engaged in 'wholesale, distributive or financial business' if 50% or more of the CFC's gross trading receipts is derived directly or indirectly from connected or associated persons. 'Wholesale, distributive or financial business' means wholesale dealing in goods, shipping or air transport, banking, trust administration, dealing in securities as a broker, dealing in commodities or financial futures and long-term insurance. There are specific provisions which deem banks and insurance to fall outside this exemption in certain circumstances.

Paragraph 4(2) of Schedule I purports to allow a CFC to satisfy the 'exempt activities' test where it has no country of residence for the purposes of the legislation. However, it uses 'effective control and management' rather than 'central management and control'. This new concept will have to be defined by the courts and it adds an undesirable degree of uncertainty.

Motive

Even if a CFC fails the 'acceptable distribution policy' and 'exempt activities' tests, the parent may escape a direction if it satisfies the 'motive' test. This is really a long-stop and it is perhaps unfair to expect the test to be both satisfactory and precise.

Under Clause 1(8), supplemented by Schedule 1 Part III the test is met if it appears to the Board that, having regard to the reasons why it did fail those tests, the transactions giving rise to the CFC's profits were:

a) carried out for bona fide commercial reasons and -

b) ....it was not the main purpose or one of the main purposes of the transaction to achieve a reduction in income tax, corporation tax or capital gains tax, and,

c) in so far as the existence of the CFC resulted in a diversion of profits from the UK, the diversion was not the underlying reason, nor one of the underlying reasons for the existence of the CFC.

The 'motive test' is extremely subjective and it appears that if one transaction fails, then the whole 'motive test' is failed. The third limb of the test (c) is a new obstacle which did not appear in previous versions. Rational business decisions must be taken in after-tax terms, and it is unlikely that (c) can ever strictly be satisfied. UK companies will seldom, if ever, be able to rely on the 'motive test' alone.

There is no reference here to the distinction between UK taxes and foreign taxes and the test does not recognise that the minimisation of the tax bill by legitimate means is part of commercial operations and indeed, a duty owed to corporate shareholders. Many CFC's are established to avoid or reduce foreign taxes, to avoid foreign exchange control rules or to avoid being forced into a UK or foreign tax trap because of the need to accept a foreign joint venture partner for local political or other reasons.

Paragraph 42 of the commentary explains that '... the charge would not apply where the objects and activities of the company were not directed towards achieving a significant reduction in UK tax.' The reference needs to be made explicitly in the legislation.

POWERS OF THE BOARD

The Board is given powers to obtain certain information relating to 'controlled foreign companies'. They may require a CFC's 'controlling company' to supply specified information within a prescribed period. In addition, they may inspect the relevant books and accounts of the 'controlling company' and any company under its control.

It is objectionable that tax should be levied at the discretion of the Revenue rather than in accordance with statutory rules. The 'motive test' proposed is at the discretion of the Revenue as is the legislation in general (Clause 1(1)). Prior experience with Section 460 ICTA 1970 indicates that discretionary powers do little or nothing to narrow the scope of legislation.

'NOTIONAL UK TAX' (NUT) AND CONSEQUENCES OF APPORTIONMENT

Where a company is 'prima facie' within the mischief of the provisions NUT must be calculated both to ascertain whether or not the CFC 'enjoys' a 'lower level of taxation', and to provide a basis for assessment. In principle the new proposals (unlike the old) broadly make a fair comparison of the local tax and the tax the CFC would have paid if it had actually been resident in the UK. There are still serious anomalies.

Clause 3(1) excludes from the calculation of local tax, any taxes which are computed on some basis other than profits. This is in line with the provisions on double taxation relief. Clause 3(2)(b) also excludes third country taxes, which, <u>would</u> be taken into account in computing double taxation relief. Since the CFC is assumed to be resident in the UK for the purposes of computing NUT, such third country taxes would be taken into account under the normal double taxation relief rules in computing the corresponding UK tax with which the local tax is being compared.

There is no provision for companies which pay little or no tax in their territory of residence because of losses brought forward from accounting periods <u>prior</u> to that in which the new charge first applies. Schedule 2 paragraph 2(2) does appear to allow any losses sustained by the CFC, <u>after</u> the first direction has been made by the Revenue, to be carried forward and set against a notional UK tax charge in the future. This is so even if no directions have been made in intervening years.

There are also potential problems (see page 35) on the timing of overseas reliefs in that an overseas territory may allow reliefs, such as capital allowances, in different years from those in which they would be allowed in the UK. This anomaly is dismissed in the consultative document on the grounds that in practice cases of this kind should be excluded from the charge, because the country in question would probably fall within the list of countries excluded from the new legislation. This is unsatisfactory.

An assessment may be made on a person who held an interest at any time during the accounting period (Section 1(3)(b)). There is no explicit provision by which an apportionment would take account of the fact that the interest was not held for the whole period.

Clause 5 deals with the rules for apportioning tax. The basis is to apportion tax rather than profits. This is justified in paragraph 48 but we would still argue that the provision is an attempt by the Revenue to 'evade' (or to be charitable to 'avoid') the provision of double tax agreements.

A UK company which is assessed on its apportioned share of a CFC's notional tax liability may claim to set certain reliefs against that assessment. Since only tax, and not profit is being assessed on the UK company, to the extent that it has an excess of relevant allowances over taxable profits for the appropriate accounting period, it may claim that tax at the appropriate rate on that excess be set against its liability to notional UK tax, (Schedule 3 Para 1(1)).

The relevant allowances which may be utilised in this manner are:

1. Trading losses (incurred in the relevant accounting period or carried back from a subsequent period).

2. Charges on income.

3. Management expenses.

4. Excess capital allowances, of the type given by discharge or repayment under the Capital Allowances Act 1968 S 74.

5. Group relief.

6. Surplus Advance Corporation Tax.

The normal six year time limit applies in accordance with Section 43 of the Taxes Management Act. In the case of group relief, the limit is extended beyond the normal two years to the end of the accounting period following that in which the assessment is made, if that is later.

Relief from a double tax charge is given by Schedule 3, Para 3(1) and (2). Therefore, when the NUT has been apportioned for a particular period to a UK resident company and the CFC pays a dividend wholly or partly out of its profits for that period, the NUT is treated as underlying tax paid in respect of the dividend and eligible for foreign tax relief. This relief is not confined to shareholders to whom notional tax has been apportioned and the normal rule that a shareholder must have a minimum holding of 10% to qualify for relief for underlying tax is suspended for this purpose.

Holding companies

In contrast with the original proposals, a holding company which derives at least ninety per cent of its gross income during the relevant accounting period from companies which it controls and which are throughout the relevant period engaged in exempt activities and resident in the same territory as the holding company will be covered by the 'exempt activities' test. (Part II, Para 5(3)).

This amendment is a result of criticism of the fact that holding companies could never satisfy the 'genuine trading' (now 'exempt activities') test. It has been recognised that many overseas holding companies are set up for policy reasons or to save foreign rather than UK taxes. An illustration of this principle is where a company has two subsidiaries, A and B in another country. Because there is no common parent in the country, A and B are not a 'group' for tax purposes. If A were to make a profit and B were to make a loss, they could not generally be offset. Clearly, a holding company would be essential in such circumstances and its function would be to reduce foreign, not UK taxes.

The present draft proposals exempt certain holding companies specifically under Para 5(3) or more generally under the 'motive' test. In the preamble to the clauses, it is provided that the 'motive' test will be regarded as satisfied where the main purpose of the holding company is:

(a) receiving dividends and interest from overseas subsidiaries as a mere 'staging post' in the course of reinvestment into the trading operations of the overseas subsidiaries concerned; or

(b) the holding of funds outside the source country for the purpoe of reinvestment into that country because of exchange controls, inflation, exchange fluctuations, political instability or the risk of expropriation.

These extra-statutory guidelines should be given statutory recognition and the reinvestment should not be confined to the subsidiary which has paid the income to the holding company. If the 'motive' test is applied in this manner, a limited amount of flexibility will remain. However, the extent to which 'money-box' activities will be exempted is now minimal and the reasons for the retention of funds will be closely scrutinised.

The constraints on holding companies are still far too restrictive. It is not acceptable that to satisfy the test, a holding company must derive at least 90% of its gross income from companies resident in the same territory as the holding company. In addition, the holding company, a passive creature by nature, must have a business establishment and be effectively controlled and managed in the territory concerned.

Interaction with Section 485

One of the justifications given for the draft clauses is that they will counter sales, distribution and service companies in low-tax areas. It is stated that '... companies may make little or no real contribution towards the business of the multinational. But by enabling selling, distribution or service profits to be attributed to the entity in the low tax area, such companies serve to reduce the amount of UK tax paid by the multinational.'

The Revenue already have the means to deal with any artificial diversion of profits in this way by using Section 485, ICTA 1970, the 'transfer pricing' section. This additional weapon in their armoury is justified on the grounds that:

1. S 485 does not apply to transactions between a low tax company and an unrelated company and,

2. S 485 does not apply to transations between two non-resident companies, whether related or not.

The Revenue have given no reasons to justify extending their powers to cover transactions between non-resident companies and unrelated companies.

BANKS AND FINANCIAL INSTITUTIONS

After many representations criticised the November 1981 draft proposals, the provisions relating to banks have been substantially modified. As a result, diverse and large scale banking activities will generally be outside the scope of the prospective draft legislation. However, it is clear that 'captive banks' and possibly finance subsidiaries remain a target.

The 'exempt activities' let-out is denied by Schedule 1 Para 5(2)(b) to

> '... a company which is mainly engaged in wholesale, distributive or financial business where less than 50 per cent of its gross trading receipts from that business is derived directly or indirectly from connected or associated persons.'

An additional requirement is contained in Schedule 1 Para 10(3). A company engaged in banking activities will be presumed not to satisfy the 50% rule if at any time in the accounting period, the persons in control of the company and/or persons connected with them have an aggregate 'capital interest' in the company such that the amount by which that interest exceeds the company's fixed assets is 15% or more of the amount by which the company's outstanding capital exceeds the fixed assets.

Loan Creditors

The Board may treat a loan creditor as having an 'interest' in a controlled foreign company if they think it appropriate - Clause 2(7). Such a direction is subject to a right of appeal under Clause 6(4)(c). The problem is further compounded by Clause 5(3) which gives the Revenue power 'if it seems to them just and reasonable to do so' to treat a loan creditor as having an interest in a CFC if the CFC is not a trading company. Clause 5(3) appears to conflict with Clause 2(7).

The main purpose of this provision appears to be to prevent those persons in 'control' of a CFC circumventing an assessment by becoming substantial loan creditors. It would otherwise be possible to set up a CFC with an artificial capital structure including a high debt/equity ratio. The loan creditor would then be able to divert profits in the form of interest repayments without ever suffering an assessment on the profits of the CFC.

By virtue of Clause 9(3)(b), a banker acting in the ordinary course of his business will not be regarded as a loan creditor. The preamble states that any arm's length loan creditor of a CFC will not be deemed to have an 'interest' in that CFC where either, the creditor was acting in the ordinary course of his business, or, neither the creditor, nor persons associated with him, had an interest (direct or indirect) in the company, other than the amount of the debt together with any interest payments. A greater degree of certainty is necessary here and these informal guidelines must be given statutory authority.

Captive Insurance Companies

The draft clauses on insurance companies have also been modified. However, they are still directed against captive insurance companies and against reinsurance or pooling arrangements for conventional insurance companies.

To satisfy the 'exempt activities' test, the insurance company must show that fifty per cent of its gross trading receipts are derived from independent sources. This rule is applied as follows, (Schedule 1 Para 10(b)):

1. Only receipts relating to commissions and premiums received under insurance and reinsurance contracts are to be taken into account.

2. Any return commission or premium is not to be taken into account.

3. Where a liability under an insurance or reinsurance contract is reinsured, in whole or in part, the premium attributable to that liability shall be treated as reduced by the appropriate proportion of the reinsurance premium.

IV COMPANY RESIDENCE

The original proposals to produce a statutory definition of 'dual residence' were widely criticised on the grounds that they would produce uncertainty and that, in the absence of proper transitional provisions, could have serious and inadvertent adverse effects. These have been dropped. However, Section 482 '(which amongst other things makes company migrations unlawful without Treasury consent)' is now to remain. 'The Inland Revenue will issue a statement of practice which will clarify the application of the present test of company residence' (paragraph 7).

A statement in the paper contains a lightly veiled threat for the future:-

> 'Section 482 does not apply where companies move to or are set up in the UK. There is evidence that UK multinationals are increasingly taking advantage of this to 'import' the losses or lowly-taxed profits of overseas subsidiaries. Thus a company making losses overseas may arrange to be treated as UK resident although its business activities are elsewhere. Under the group relief provisions the losses are now available to be shifted amongst other members of the group and so reduce the group tax bill as a whole. Similarly a company resident overseas which has accumulated profits and which may previously have transferred its business to a non-resident foreign subsidiary may transfer its residence to the UK and then, provided there is a group election in force, these accumulated profits can be distributed to the UK group members without any tax becoming payable' (paragraph 8).

Legislation is threatened to deal with these 'abuses'. The paper does <u>not</u> include any draft clauses dealing with these points. There is thus a generalised threat on which the process of consultation cannot properly be said to have begun. It would be quite unacceptable for the government to legislate on this without initiating such a consultative process.

We have already suggested a more appropriate approach to this problem. There should be no change in the definition of company residence and Section 482(1)(a) <u>should</u> be abolished. What is needed is legislation to modify the fiscal consequences of a change of company residence. We can draft detailed proposals.

In general the new provisions should ensure that a change of residence should neither give a once and for all tax advantage nor should it force a company which (maybe inadvertently or by the consequences of law) changes its residence into a tax trap.

Dell, in our view, missed the point on this one. See our comments in 'Taxes International' November 1982.

Section 482 requires administrative consent for far more than the change of residence of a UK company: prohibitions include the setting up of a new company overseas, the transfer of shares in and the issue of shares by such company and the transfer of a trade or business overseas. Since these provisions were designed to prevent what the proposed legislation on tax haven companies may now deal with in a more appropriate way, these other provisions (Section 482(1)(b), (c) and (d)) must also go.

V UPSTREAM LOANS

The upstream loans provisions of the previous draft would have seriously affected the ability of companies to manage their foreign exchange exposure rationally and would have inhibited their efforts to deal effectively with tax and exchange control problems in other countries. In our view they should have been dropped completely. Instead, we are told that the government have decided:

> 'to give further consideration to this problem bearing in mind the need to protect loans made in the ordinary course of business. In due course the government will consult further but it is not their intention to bring forward proposals for the 1983 Finance Bill'.

The matter is not, therefore, dead and it is therefore vital that those affected should keep up the pressure to ensure there is no back door introduction of technical 'negative thread' legislation while Ministers have their attention distracted elsewhere.

The Inland Revenue paper of the 4th June 1982 referred to '50 cases involving loans worth a total of £300 million'. A reader might have assumed, and was probably intended to assume, that the figure referred to the amount of tax at stake. In the latest paper the figure has been increased to £400 million but it is now admitted that:

> 'the annual tax loss involved is of course' (their words - now)
> 'much less than the £400 million of the loans themselves'.

In our contribution to the critique of Dell we pointed out that business enterprises exist to maximise profits and a rational business will seek to maximise after tax profits. Any decision taken by a business must be affected, and can be distorted, by tax factors. We cannot accept a subjective definition of "tax avoidance" as being any circumstance where the tax actually paid is less than the Inland Revenue feel they would like to be able to collect.

An old story is worth repeating in this context. It involves what many practitioners believe to have constituted a serious miscarriage of fiscal justice.

The 1960 Finance Bill introduced legislation (now ss 460-468 ICTA 1970) directed at a family of hard core tax avoidance devices, including 'dividend stripping' and 'bond washing'. It was absolutely right to legislate and the broadly drafted provisions were, for the purpose, appropriate.

The trouble began with some additional provisions (s 461 D and E) tabled at Report Stage which dealt with matters outside the original problem. (This, as so often, produces highly unsatisfactory results. Parliamentary procedure should be amended to require that clauses with substantial new material adverse to the citizen are recommitted for further detailed examination in Standing Committee.) It has been argued that Parliament was misled as to the nature and intention of these additional provisions.

The outline facts in an early case under these provisions (Cleary v IRC) are as follows:-

Two individuals owned two companies, company A and company B. Company A had over the years earned profits on which tax had been paid but which had not been distributed. During those past periods the Revenue had power, by imposing a 'surtax direction' to treat those profits as distributed to shareholders. They had not in fact used those powers but had given clearances. There is an analogy with an overseas subsidiary of a UK company which has earned profits not been subject to a direction under the 'tax haven company' rules.

Company A had cash surplus to its trading requirement and which could be more fruitfully employed in the pockets of its shareholders. It was accepted that the company could have been sold to a third party for a (then) tax free capital gain with the benefit of its accumulated assets. There were also several ways in which the company could have been reconstructed and slimmed down to extract the cash without falling foul of the provisions on which it was to become a test case. The course in fact adopted was the simple, obvious and (it was thought) innocuous method of selling the share capital of company B to company A at a proper arm's length value for the greater part of Company A's surplus cash.

This was held to be 'a transaction in securities' giving rise to 'a tax advantage' which the Revenue were entitled to 'counteract'. Given the available alternatives, it might be thought that the advantage was minimal. Not so: the company was taxed as if it had adopted the very worst of the options open to it - ie that it had distributed the whole of its accumulated profits to high bracket tax payers in a single year! The effect was confiscatory.

Pursuing our analogy, the making of an <u>upstream loan</u> might result in a company being deemed to have fallen over a trip-wire which immediately gives the Revenue the right to recompute the company's tax affairs as if its affairs had been conducted in such a way as to maximise the take of the Revenue and to have paid a dividend in circumstances where this was overwhelmingly the least attractive alternative.

A Conservative government was (unwittingly) responsible for this legislation although the case was decided after they had lost office. Their more fiscally sophisticated successors must not let history repeat itself.