

PROPOSALS FOR CFC REFORM: which principles and how many?

Michael P. Devereux



OXFORD UNIVERSITY
**CENTRE FOR
BUSINESS TAXATION**

Focus on two related issues

1. General principles

- Territoriality v ownership

2. Taxing finance companies

- What is the problem, and what should we aim to tax?

Why tax corporate profit?

- As a proxy for personal income tax?
 - then need tax on worldwide income, based on domestic *ownership* of assets located anywhere
- As a way of taxing economic activity taking place in the UK?
 - then need a territorial tax, basing tax in income generated from *real economic activity* taking place in UK

UK government's view

“A move towards a more territorial approach, whilst retaining ownership as an underlying principle appears to be the optimal solution”

HM Treasury, Principles Document, July
2009

Two principles

1. *“to protect the UK tax base from artificial diversion of profits from the UK”*
“not tax profits genuinely earned in overseas subsidiaries”
2. *“UK ownership and control are the most suitable basis for bringing artificially diverted profits within the scope of the UK tax base”*

Note, in passing

- UK now exempts dividends received from non-UK subsidiaries
 - Territorial basis
- But taxes interest received from non-UK subsidiaries
 - Ownership basis
- Raises question of what is “profit”
 - Arguably, both territorial if “profit” includes interest receipts and excludes interest payments

Why tax monetary assets in CFCs?

“A risk of artificial diversion of UK profits exists where finance companies are funded through UK capital on which the UK does not earn a return. The clearest example is where the finance company is funded through equity and either (i) that equity is paid for out of UK borrowings by the parent company (the corresponding interest costs being claimed as a UK tax deduction) or (ii) the group’s accumulated UK funds ... are used to pay for the equity in the finance company so that they are unavailable for use elsewhere” (para 3.7)

Why finance companies?

“A risk of artificial diversion of UK profits exists where finance companies are funded through UK capital on which the UK does not earn a return.”

- But this is at heart of territorial system
 - No UK tax is paid on the profits of equity-funded CFCs undertaking active investment
 - Why should finance companies be different?

Negative UK tax

“The clearest example is where the finance company is funded through equity and that equity is paid for out of UK borrowings by the parent company (the corresponding interest costs being claimed as a UK tax deduction)”

- ie. negative UK tax; agree this is a problem, effectively subsidising outbound investment

Default presumption?

“(ii) the group’s accumulated UK funds ... are used to pay for the equity in the finance company so that they are unavailable for use elsewhere”

- Funds “could have been” used in the UK – but weren’t ...
- *“new rules move away from current default presumption that all activities that could have been undertaken in the UK would have been carried on here had it not been for the tax advantages of the overseas location” (p.4)*

Example 1

- UK parent company uses retained earnings to equity finance US subsidiary
- US subsidiary makes profit in US, pays US tax, and distributes profit to UK parent

No tax in UK

Example 2

- UK parent company uses retained earnings to equity finance Jersey finance company subsidiary
- Jersey subsidiary lends to US subsidiary
- US subsidiary makes profit in US, pays interest to Jersey
- Jersey subsidiary pays dividends to UK parent

Should UK tax interest earned in Jersey?

Examples 3 and 4

- Instead of examples 1 and 2, in both cases the UK parent company now finances the outbound investment through borrowing in UK
- Interest payment reduces existing UK tax liability

Should UK tax interest earned in Jersey?

Or restrict relief in UK?

Fat cap approach

Tax interest received by CFC if it has sufficiently high equity finance

- Does this identify the problem?
 - Would tax interest received from US in example 2
 - Unrelated to the problem of negative tax in UK, since doesn't depend on UK borrowing

Interest relief: a tentative proposal

Suppose UK parent

- raises equity of 100 in UK,
- borrows 100 in UK, with interest cost of 10
- purchases shares in foreign affiliate of 120
- Capital remaining in UK is 80
- Net equity used in UK is *minus 20*

Relief for interest payment should be restricted to minimum of borrowing and capital remaining in UK – here relief restricted to 8, not 10

Caveats

1. Revenue costs (or gains) are unknown
 - Probably gainers and losers amongst companies
 - But is current level of CT revenue “optimal”?
2. Would not tax the profits of a UK subsidiary financed by borrowing
3. Would probably need to apply this to equity investment in UK subs as well

Conclusions

1. Rationale for taxing finance CFCs is unclear:
 - because return is in the form of interest, and is more mobile?
2. Problem appears to depend on UK company claiming interest relief for outbound investment not subject to UK tax
 - applies equally to any CFC, not just finance companies