COMPARATIVE CONTROLLED FOREIGN CORPORATION QUESTIONS
FOR MSSRS. THOMAS, EDGE, MENGER, AND SCHOON

Submitted by Reps. Rangel, Stark, Blumenauer

And answered by Stephen Edge in bold below

[Note, in relation to these questions, that the UK situation is complicated at present by the fact that UK law has been successfully challenged in the European Courts and is also in the process of change through ongoing government consultation. These questions could thus be answered under existing UK statute law, under such UK statue law as amended by conforming interpretation as a result of the European Court of Justice judgment or by reference to the most likely outcome of the current consultation process. Rather than give three possible answers, what is set out below reflects the most likely outcome of the proposals the government has made for future CFC rules in the UK. It is hoped that this will be the most relevant and helpful information to provide in this context.]

How would the following situations be treated under your controlled foreign corporation (CFC) rules in Japan, the Netherlands, the United Kingdom, and Germany?

(a) P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.

So long as the profits made by the CFC are commensurate with its assets or attributes and activities in X, income earned by the CFC from its manufacturing activities should not be subject to CFC apportionment despite the fact that the products are being sold back to P and X has no income taxation.

(b) Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X.

If, as well as carrying on a manufacturing activity, the company receives "incidental investment income" (not more than 10% of its turnover is one proposal that has been put forward), the position will be as in (a). To the extent that additional investment income in excess of the safe harbour arises, however, that will be treated as a coming from a separate activity and could be subject to CFC apportionment.

The government proposes to introduce a finance company regime which, by incorporating maximum capitalisation requirements, effectively means that eligible finance companies will be subject to an effective UK tax charge of 5.75% on underlying interest income by the year 2014. Again, the level of taxation in X will not affect this analysis. Some consideration is also being given to the possibility of a wholly exempt offshore finance company regime (something many commentators believe to be justified by the Cadbury decision in the European Court). However, it

is not yet clear that a CFC which carries on a trade will be able to fall within the finance company regime.

(c) Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.

Same answer as (a).

(d) Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.

The answer here will depend upon the nature of the IP from which royalties are earned and how the income arises. If the IP has been generated and is maintained by expenditure and efforts wholly outside the UK, the answer in (a) will continue to apply. The position where IP is generated or maintained to a significant extent by UK activities is still under review but there may be a CFC charge if it has.

(e) Same as (a), except that the CFC earns interest derived from another CFC controlled by P.

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(f) Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.

If the CFC is not manufacturing but is still carrying on a commercial activity, the position should still be as in (a) so long as the CFC's profits are commensurate with its assets or attributes and activities. The fact pattern here would, however, require it to be clearly demonstrated that there was a genuine commercial activity being carried on in X and that the CFC was adding value.

(g) Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.

Special rules are proposed for companies carrying on genuine banking activities. If they are regulated, it is unlikely that their commercial profits would be subject to CFC apportionment.

(h) Same as (a), except that the CFC is an insurance company.

Special rules are proposed for companies carrying on regulated insurance businesses – insurance outside the regulated sector would potentially be subject to apportionment unless another exemption (such as the general purpose exemption that looks at whether or not a business is genuinely carried on in an overseas territory and whether the profits generated are commensurate with the activities) applies.

(i) Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

There are no specific rules in the UK which treat upstream loans as a dividend. However, upstream loans can, under the worldwide debt cap regime, affect the amount of overall interest deductibility for the group concerned in the UK. There is also the possibility that income from upstream loans will be specifically targeted by the new CFC regime. Even without such targeting, however, interest income from upstream loans will either have to be protected under the incidental income rules or will be potentially subject to CFC apportionment (possibly at the lower rate applicable under the finance company regime) unless the general purpose exemption applies. Apart from that, the position should be the same as in (a).

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