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Every lawyer has been there. You spend ages drafting a document to cover all conceivable eventualities and then the thing that happens is the one thing nobody predicted. A lot of undignified scrambling results as you try to squeeze the facts of what has happened into the description of all the other things that you thought might happen (but haven’t) in order to give your client a remedy.

HMRC’s brave attempt to do that with the CFC rules, drafted at a time when we were trying to pretend that we were not in Europe, foundered on the rock of the Vodafone case when an extremely thorough and convincing High Court judgment was issued. The Judge said that he simply could not see how the drafting in the legislation (whether it was the motive test or the exempt activities rules) could be “interpreted” so as to cover the principles established in the Cadbury case.

As the Courts made clear in Condé Nast, it is not their job to re-write the law to make it comply with EU freedoms. If they can interpret it so as to conform to them they will, but at some point the scope for interpretation or cosmetic surgery ends and redrafting or major surgery is required. At that stage, the legislation simply falls away as non-compliant.

So that is the rather sad prospect facing HMRC at present. They may, of course, appeal – but I rather hope that they do not spend a lot of our money on that particular bet.

Although not relevant or material to the decision, the Judge said that he had considerable doubts about whether or not the Section 751A rules were EU compliant. The notion that more profit could be treated as “good profit” for CFC purposes where someone had old and very inefficient machinery offshore (of the Heath Robinson variety) that needed to be operated by 500 people than would be the case for someone who spent a large amount of capital buying a modern machine that only needed 3 operatives dressed in smart white coats has always seemed to defy logic.

So we now have considerable doubts as to whether or not any of our CFC rules are EU compliant. That uncertainty will continue until the Courts either overturn or overrule Vodafone (which must be very unlikely) or until the UK introduces something that does pass muster.

The difficulty facing legislators in trying to decide what to do is compounded by the fact that the Cadbury hearing (postponed earlier this year) looms. In that case, HMRC will no doubt seek to raise the threshold of what constitutes adequate substance to buy your passport to an EU fundamental freedom. Particularly after comments made in the Vodafone decision, it is likely that HMRC will suffer another rebuff here – but again (if nothing is done to reach a sensible compromise) the likelihood is that uncertainty will continue as appeals wend their way through the Courts.

At this stage, one must have some sympathy for HMRC – hemmed in as they are by EU uncertainties and pressurised by the queue of UK corporates at the airport with tickets for potentially cheap flights to Ireland. The furore caused by the foreign profits consultation – and the initial misguided notion of describing that as “revenue neutral” – has abated for now but the Government is clearly on probation as people await the next move.

So, what should we do?

The starting point should be that an exemption system is a done deal. There is no other credible alternative.
Whether it will come with some form of EU compliant interest allocation or restriction rule remains to be seen – other jurisdictions in Europe (notably Germany) are certainly heading in that direction. That might be an acceptable price to pay for a friendly CFC regime and perhaps also a corporate tax rate reduction.

Germany is also one of the jurisdictions within Europe that responded to Cadbury by introducing a rule that exempted EU income from CFC apportionment provided there was adequate substance and an absence of tax avoidance. The second condition here is, of course, the tricky one because the ECJ has said that exercising your right of freedom of establishment in order to pay tax at a lower rate in another EU jurisdiction is okay. So, some forms of tax avoidance are acceptable but others are not. One suspects that Cadbury will resolve this by saying that you need to have enough substance in the jurisdiction concerned to be able to carry on the business that you are purporting to carry on (the degree of that will obviously vary from case to case once the nature of the business is defined) and that, once you have got over that hurdle, motive becomes irrelevant.

Facing all these difficulties, should we simply pretend that the foreign profits review was a terrible dream and wallow around until the situation becomes clearer? Should we put general language into our legislation the precise import of which will only be known once all the litigation has settled? Or, should we be a bit bolder and try to do something that Government and industry have faith in?

As litigation has been brewing on a number of fronts in the CFC area, it has been interesting to look back at the consultations and debates that preceded the introduction of CFC rules in 1984. At that time, the emphasis (with Conservatives at the helm and Labour in opposition but trying to defend our multinational community) was very much on stopping the export of capital from the UK to create offshore money boxes whilst allowing business generally to carry on pretty much unaffected. That contrasts sharply with the current policy which seems to be to bring back to the UK all passive income even:

(i) where it arises on intellectual property that has been generated outside the UK or generated here but transferred out at full value; and

(ii) if it is interest or other financing income which has been extracted from another jurisdiction as part of an attempt to reduce the global effective tax rate but at no detriment to the UK because the funds concerned are still being reinvested offshore.

At the heart of this debate, therefore, is the question of what constitutes avoidance and what action is appropriate to counteract it.

A number of policy decisions need to be taken before we can proceed with any certainty:

(a) Is it accepted that the CFC rules are not going to be used to broaden the UK tax base of the multinational community?

(b) Is it agreed that avoiding non-UK tax when funds are being reinvested abroad is acceptable?

(c) Are we prepared to try to agree some common ground on what constitutes adequate substance or are we going to submit to further delay and uncertainty while the Courts work it out for us?

Once those questions have been answered, then we can start to think about what sort of CFC regime we should have.

It ought to be possible to find some middle ground on the substance question once that is separated from motive.

Sorting out the sheep from the goats in terms of foreign passive income is more difficult.

We can make life easier for ourselves, however, by taking IP off the table here. It may be that our exit charge provisions need looking at a bit more closely but there should surely be no difference between income generated by IP or income generated by people for these purposes. If overseas IP is still being supported from the UK, then transfer pricing should be the way in which profits are allocated back to the UK. Otherwise, the UK should allow profits to accrue abroad
and be content to look after its own patch by a properly functioning transfer pricing regime only. Anything other than that will surely make the UK less competitive.

That leaves the treasury area. There are various ways in which goats could be identified and labelled there. For example, passive treasury income could be treated as good income provided that it is being received on loans made to active companies producing good income in CFC terms. This could then be supplemented by rules designed to work out whether or not a group has the correct balance between debt and equity in its onshore and offshore activities – thin capitalisation technology could come in useful there. This should pick up where any surplus cash assets are.

Putting a general motive test in on its own will simply confuse things for longer. No business does anything without considering taxes as one of the aspects. The CFC motive test has been a disaster zone for years. If the ECJ says it is okay to move to benefit from a low Irish tax rate, just where would you draw the line with a non-scientific test based on motives?

We should come to some simple conclusions on this – and have a regime that would work both in the EU and for the rest of the world. The UK has been unusual but should be commended for the fact that responses to EU measures have generally gone global in order to encourage investment in and from other non-EU trading partners.

If we do not do that, then we will face another conundrum – which is to what extent can the EU be a refuge or safe haven in ADP terms? If a UK business has established an investment holding company in another EU jurisdiction and that subsidiary has non-compliant investments outside the EU, can UK CFC rules simply leapfrog the EU (probably okay if the same limitations would apply to a direct investment from the UK)? Can they also tax in the UK dividends that have been taken out of those entities and reached a safe sanctuary in the EU (much more debatable if the investment holding company is otherwise good in substance and motive terms)?

What industry and the Government should now be doing is focusing on how we can have a fair and stable UK regime that gets those corporates, who rightly have doubts about the UK and have no desire either to see the foreign profits regime as proposed come in or to see us go back to the uncertainties and challenges inherent in the existing regime, cash in their cheap flight tickets and decide to stay here with enthusiasm.

We have an opportunity to produce something that is better and we should take it.