



Pre-Budget Report '06

Controlled Foreign Companies: The Government's retaliation or yet another reason why UK Float Co. is a good idea?

In the Pre-Budget Report, the Chancellor stated that: "The Government will continue to defend the tax system robustly against legal challenges from EU law." This is not surprising given the "body blows" that the European Court of Justice (ECJ) has recently delivered to the UK tax system. One important plank in the UK anti-avoidance armoury has been the controlled foreign company (CFC) regime where, in essence, the UK taxable company is assessed to tax on the profits of its subsidiary company where that company pays tax at a lower level and none of the existing exemptions apply.

The ECJ ruled in the case of Cadbury Schweppes Plc -v- Revenue and Customs Commissioners (Case C-196/04) that EC law (which, inter alia prohibits restrictions on the freedom of movement of individuals and companies) precludes the inclusion in the UK company's tax base of profits made by the CFC in another member state (where those profits are subject in that other state to a lower level of taxation than that applicable in the UK) unless such inclusion relates only to wholly artificial arrangements intended to escape the tax which would otherwise have been payable in the UK.

In the case of Cadbury Schweppes, the claimant companies were challenging the application of the CFC regime to subsidiaries which had been set up in Ireland to take advantage of Ireland's more favourable corporation tax regime.

Halliwells

Future Strategies

From 6 December 2006, a group of companies in a similar situation will be able to apply to HMRC for permission to exclude the CFC's profits from charge to tax in the UK. The applicant will need to show, inter alia, that:

- (a) the CFC has a real presence in the European Economic Area (EEA) country, i.e. a business establishment (such as an office, shop, factory which the CFC will occupy and use for a reasonable length of time), together with either employees and/or consultants; and
- (b) the level of profits realised by the CFC represents a reasonable economic return on the activities undertaken by the CFC and members of the same group of companies (if it is a member of a group), through the CFC's employees/consultants from its business establishment in the EEA territory.

Whilst some commentators are remarking on how narrowly drawn this new legislation is, we consider that many UK groups, who have bona fide trading activities in an EEA territory, will be able to reduce their effective UK tax burden.

Going forwards, such groups will no longer need to comply with the distribution exemption and will instead be able to roll-up profits in the CFC (thus maximising potential sale proceeds) and achieve a tax free sale by virtue of the substantial shareholding exemption. This is perhaps yet another advantage to UK Float Co.

A further change to the CFC rules sees the abolition of the "public quotation exemption" in response to alleged artificial transactions relying largely on the ease of getting a stock exchange quotation in the relevant CFC jurisdiction.

If you have any queries or wish to take any action on the basis of the Pre-Budget Report '06, please contact:

Tony Hennessy

Head of Tax

Direct Tel: +44 (0)870 365 8838

Direct Fax: +44 (0)870365 8839

tony.hennessy@halliwells.com

Elizabeth Small

Tax Partner

Direct Tel: +44 (0)870 365 8584

Direct Fax: +44 (0)870 365 8585

elizabeth.small@halliwells.com

Halliwells LLP is a limited liability partnership registered in England and Wales under registered number OC307980 whose registered office is at St James's Court, Brown Street, Manchester M2 2JF.

A list of members is available for inspection at the registered office. Any reference to a partner in relation to Halliwells LLP means a member of Halliwells LLP. Regulated by the Law Society.

Halliwells LLP Tel: +44 (0)870 365 8000

St James's Court Brown Street Manchester M2 2JF

Fax: +44 (0)870 365 8001 **DX** 14317 Manchester 1

1 Threadneedle Street London EC2R 8AY

Fax: +44 (0)870 365 8002 **DX** 98933 Cheapside 2

The Plaza 100 Old Hall Street Liverpool L3 9TD

Fax: +44 (0)870 365 8004 **DX** 14126 Liverpool 1

City Plaza Pinfold Street Sheffield S1 2GU

Fax: +44 (0)870 365 8003 **DX** 10525 Sheffield

info@halliwells.com www.halliwells.com

Halliwells