

Controlled Foreign Company reform

Introduction

The British Property Federation is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses, comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry, including law firms, surveyors and consultants.

Background

We are grateful for the opportunity to respond to the Government's proposals for reform of the UK Controlled Foreign Company (CFC) rules. We are very pleased with the consultative approach which the Government has taken to CFC reform and welcome the opportunity for some of our members to take part in a working group to help formulate the new CFC rules.

Executive summary

The proposals set out in the CFC reform consultation paper represent a significant improvement on the existing rules from a real estate perspective. They show a much better understanding of the nature of property investment than the current rules and correctly recognise that property investment is a genuine economic activity along similar lines to overseas trading operations.

More specifically:

- We welcome the inclusion of property investment in the territorial business exemptions (TBEs), and the more general equalisation of treatment between property rental income and trading income in the CFC proposals.
- Property investment businesses should be able to satisfy the local management condition by simply holding a property in a country which taxes the rental income deriving from it, where the capital risk on disposal of the property can be shown to lie in the foreign company that owns the property.
- The CFC rules should not punish property companies with surplus cash arising from a disposal which is either awaiting reinvestment or is 'trapped' in the company due to legal requirements of the company's country of residence. We believe that finance income arising in these situations should be exempt from the CFC rules for up to two years.
- The compliance burden of the CFC rules could be further reduced by broadening the excluded countries and low profits exemptions as these reduce the number of CFC calculations a business has to carry out.
- Treating activities in relation to rental to owner occupiers as 'investment activities' should not give rise to significant practical issues for property investment businesses but might be problematic for certain trading businesses with commercial operations overseas. We are not sure this restriction is justified in policy terms.

Detailed comments on CFC reform proposals

Real estate as a 'non-investment' activity

We are pleased that the Government has recognised that due to the immobile nature of land and buildings, companies involved in overseas property investment are not likely to give rise to a significant risk of artificial profits diversion from the UK.

We agree with the proposal in paragraph A2 that activities relating to the carrying on of a property investment business should not be treated as 'investment activities' for CFC purposes. Accordingly, property owning CFCs should (subject to satisfying the local management condition) be exempt from the new CFC rules under the territorial business exemption (TBE).

Whilst we broadly agree with the proposed definition of a property investment business as the long term rental of property, we feel the words 'long term' should not be tested against the length of leases held by a business. It is not unusual for property businesses to offer short term leases to occupiers, for instance if a building is approaching a refurbishment, and standard lease terms in many countries around the world are significantly shorter than in the UK. Instead, 'long term' should refer to the broader objectives of the business.

Proposal that property should be in the same territory as the company that owns it

Although it is very common for a property owning company to be tax resident in the country where the property is located, it is not unusual for the property owning company to be resident in a different country. For instance, companies owning property in Germany are often Luxembourg resident because they will not then be subject to German trade taxes; Hong Kong properties are frequently owned by non-Hong Kong companies to minimise the amount of transfer taxes payable.

Accordingly, we believe that it would be unhelpful to introduce, as suggested in paragraph A5, a condition which requires the property to be located in the country of residence of the company that owns it in order to benefit from treatment as a non investment activity. We do not believe there is a policy rationale for such a condition.

Local management condition

It is not easy to define what 'local management' should mean in a property investment context. It is impractical to base the test on the presence of employees in the territory in which the property is located, as the day to day management of the property is often outsourced by the directors of the property owning company to either specialist local agents or managers, or to another group company who may manage properties on a regional basis. Indeed, the consultation paper correctly recognises that property investment does not require the presence of employees in the same country as the property.

Neither is it feasible to base the test on the role of the directors of a property owning company, as this varies across the industry. It would therefore be difficult to devise a sensible 'threshold' of activity by the directors which could be said to satisfy the local management condition.

The local management condition should ideally be satisfied where it can be shown that the commercial risks and rewards of property ownership exist in the foreign company. We would

propose that a property investment business should satisfy the local management condition by having a property situated in a jurisdiction which taxes the rental income which derives from that property. The property itself represents the economic substance of a property business's investment, and the local management condition should be satisfied by virtue of the fact that genuine commercial risk exists where the foreign company bears the capital risk on the disposal of the property.

We understand that there may be concerns that such a 'people free' interpretation of local management might somehow be exploited for the artificial diversion of profits from the UK. However, due to the immobile nature of property, we believe that it would be extremely difficult for a business to gain a tax advantage while still demonstrating that the commercial risk relating to a property has not been artificially stripped out of the foreign company

Property management companies

In property investment structures there will often be a company whose function is to provide property management or advisory services to other group companies. The nature of these services is wholly commercial and is often provided by a third party property manager but depending on the scale of a property portfolio it may be cheaper and more efficient for a property investment group to carry out these services in house.

In response to question A3, we believe that the provision of such services to group companies should be excluded from the CFC regime under Exemption 3 of the TBEs as the activities involved in their provision are commercial, being intrinsically connected with the management of overseas property assets for the group, and pose a low risk of artificial diversion of profits from the UK.

Holding companies

We agree with the proposal in paragraph A9 that companies whose principal function is to hold shares in property owning companies should generally be exempt from the CFC rules. To the extent that the holding company receives a mixture of income streams (e.g. dividends, management services income, finance income), these should be considered separately for CFC purposes. A foreign company should be subject to UK tax only on income which is not specifically exempted by the CFC rules (such as non-incidentally finance income).

Inadvertent breach of finance income condition and upstream loans

We are pleased that the consultation paper recognises that a property investment company may at times hold significant amounts of cash (such as after a property disposal) and that there is no tax avoidance motive linked to this. Property companies might also hold significant amounts of cash because they are forced to do so by the law of their country of residence. For instance, China prohibits companies from distributing capital by way of dividends until certain conditions have been met.

In situations like these we agree with the proposal in paragraph A8 of the consultation document that any excess finance income over the incidental amount should be exempt from the CFC rules for a specified period. This period should take into account the potentially long lead times between property disposal and reinvestment, and we would suggest a period of two years.

However, it will often be commercially efficient for a property company with excess cash to make an upstream loan until such time as a new property has been identified for purchase or the legal restriction on dividend distributions has passed. We believe that finance income arising in the lending company in connection with upstream loans should not be subject to a full apportionment. We therefore agree with the proposal in paragraph 6.30 that the finance company partial exemption (FCPE) should apply to that finance income where there is no tax avoidance motive attached to the loan.

Paragraph 6.30 also indicates that the FCPE should apply only to short term upstream loans to the UK, however in the context of property investment 'short term' is probably much longer than in many other industries (i.e. up to two years – or longer). Accordingly, and in response to question 6F, the worldwide debt cap approach to short term lending (where short term is defined as less than 12 months) is unlikely to appropriately exclude genuinely commercial upstream loans made by overseas property companies from the CFC rules.

CFC compliance burden

In response to question A2; while the proposed CFC rules impose a far more proportionate compliance burden on property investment businesses than the existing rules, it is hard to tell at this stage to what extent the burden will be reduced. The extent of the reduction will depend on the design of the exemptions and on what is to be considered 'non incidental' finance income in a property investment context (as calculating this figure for a number of group companies will take time).

In response to question 4D, in order to minimise the amount of profit calculation work required by property investment companies our preferred option would be Option C. However, we believe the list of excluded countries falling into Category 1 of paragraph 4.13 should be as long as possible. In addition, the general conditions set out in paragraph 4.14 for Category 2 countries should be simple to assess so that testing the conditions does not become a time consuming activity.

In response to question 4A, we believe that Option A of the low profits exemption would most reduce the CFC compliance burden of companies by making the exemption straightforward to apply. We also support the change from a tax-based approach to an accounts based approach to calculating the low profits exemption. However, we note that this exemption will only benefit property investment businesses if rental income is not treated as investment income. While the consultation paper indicates that a property investment business will not constitute 'investment activities' for the purposes of the TBE, we would welcome clarification that this treatment extends to other CFC exemptions. In addition, at £500,000 the *de minimis* limit may be too low to make a significant difference to large multinational property investment groups.

Owner occupiers

Owner occupation is not likely to be a significant part of a property investment business, and in response to question A1, excluding such activity from the property investment exemption is unlikely to pose any significant practical issues for such businesses.

However, it may be that restricting the exemption for property investment income as proposed would discriminate against certain businesses which are property rich but fundamentally operating

businesses (such as retailers, hoteliers and leisure centre operators). It is not uncommon for such businesses to split their property assets from their operating activities as this can increase cost efficiencies and make it easier to raise finance. We would like to understand why the Government would want to impose a condition on such businesses which could increase their CFC compliance burden, but understand that these businesses remain entitled to the general purpose exemption.

Conclusion

The consultative approach that HMT and HMRC have taken to CFC reform means that the CFC treatment of property investment businesses under the proposals is far more realistic and proportionate than under the existing rules. There remain some areas (e.g. local management condition, inadvertent breach of finance income condition) where further thought is required to refine and clarify how the exemptions will work in practice. Indeed, any conditions should be flexible enough to allow a property investment company to be exempt regardless of how the business is actually structured. It is very encouraging that HMT has indicated to the CFC/property working group that it will continue to consult over the coming months to ensure that the final CFC rules do not place an undue compliance burden on property businesses.

We hope that this approach to consultation will be replicated in other areas involving substantial changes to the tax system and, indeed, by other Government departments.

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