EXPLANATORY MEMORANDUM TO

THE CONTROLLED FOREIGN COMPANIES (EXCLUDED COUNTRIES) (AMENDMENT No. 2) REGULATIONS 2005

2005 No. 186

1. This explanatory memorandum has been prepared by the Inland Revenue and is laid before the House of Commons by command of Her Majesty.

2. Description

2.1. These Regulations amend the Controlled Foreign Companies (Excluded Countries) Regulations (S.I. 1998/3081: "the Excluded Countries Regulations"), to prevent their abuse in tax avoidance arrangements.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1. Two separate instruments amending the Excluded Countries Regulations are being made. The first applies in respect of accounting periods of companies resident outside the United Kingdom beginning on or after 3rd December 2004, whilst the second (to which this memorandum relates) applies in respect of accounting periods beginning on or after the date on which it comes into force. Although it would have been possible to combine the instruments, as discussion with business had proceeded upon the basis of two separate instruments it appeared desirable to keep the provisions distinct so as to avoid confusion.

4. Legislative Background

4.1. These Regulations are being made under powers conferred by section 748(1A) of the Income and Corporation Taxes Act 1988, and are subject to annulment in pursuance of a resolution of the House of Commons.

5. Extent

5.1. This instrument applies to all companies that are subject to the Controlled Foreign Companies ("CFC") legislation.

6. European Convention on Human Rights

6.1. This instrument is subject to annulment and does not amend primary legislation. Accordingly no statement as to compatibility with the Convention rights is required.

7. Policy background

7.1. The CFC rules can be found in Chapter 4 of Part 17 of the Income and Corporation Taxes Act 1988. The rules are designed to stop UK companies avoiding tax in this country by diverting income to subsidiaries in low-tax

régimes. The rules work by requiring UK companies to pay an amount of tax equal to any tax that would otherwise be avoided.

7.2. There are six exemptions from charge including a motive test, to ensure that a charge only applies in respect of those companies which are deliberately diverting UK income to a low-tax régime. The Excluded Countries Regulations provide one of these exemptions.

7.3. The Excluded Countries Regulations provide an administratively simple exemption for foreign subsidiaries which, because of the nature of their income and the tax regime of their country of residence, can reasonably be assumed not to be involved in UK tax avoidance. More than 90% of foreign subsidiaries of UK groups obtain exemption from CFC rules on this account.

7.4. However an increasing number of schemes have been used to take advantage of the Excluded Countries Regulations exemption in cases which present a risk of UK avoidance. Several of these have been countered by the first amending regulations for 2005. However the number of schemes means that it is no longer practical or desirable to amend the Excluded Countries Regulations for each one.

7.5. These amendments prevent companies benefiting from the Excluded Countries Regulations when they are involved in a scheme or arrangement which has the reduction of UK tax as one of its main purposes. This will ensure that the Excluded Countries Regulations continue to provide exemption as originally intended.

8. Impact

8.1. The amendments seek to return the application of the Excluded Countries Regulations to their original coverage. Most foreign subsidiaries will continue to benefit, as originally intended. Only those companies involved in tax avoidance will be affected by the amendments being made. Accordingly no regulatory impact assessment is required.

9. Contact

9.1. Andrew Hoar at the Inland Revenue Tel: 020 7147 2719 or e-mail: Andrew.Hoar@ir.gsi.gov.uk can answer any queries regarding the instrument.