EXPLANATORY MEMORANDUM TO

THE CONTROLLED FOREIGN COMPANIES (EXCLUDED COUNTRIES) (AMENDMENT) REGULATIONS 2005

2005 No. 185

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**

These Regulations amend the Excluded Countries Regulations (S.I. 1998/3081), to prevent their abuse in tax avoidance arrangements.

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

None.

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 by resolution of the House of Commons.

4.2 The powers under which these Regulations are made permit the making of provision having effect for accounting periods ending up to one year before the date on which they are made.

4.3 These regulations have been made on 2nd February 2005 and take effect for accounting periods ending on or after 2nd December 2004.

5. **Extent**

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

6. **European Convention on Human Rights**

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 at 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 regimes. 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 low-tax régimes. The excluded countries regulations (ECR) provide one of these exemptions.

7.3 The ECR provide an administratively simple exemption for foreign subsidiaries which, because of the nature of their income and the tax régime of their country of residence, can be reasonably 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, a number of schemes have been used to take advantage of the ECR exemption in cases which present a risk of UK avoidance. The amendments made by these Regulations prevent companies benefiting from the ECR in those circumstances, and ensure that the ECR continues to provide exemption as intended.

8. Impact

8.1 The amendments seek to return the application of the ECR to its original coverage. Most foreign subsidiaries will continue to benefit, as originally intended. 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.