# NATIONAL FOREIGN TRADE COUNCIL, INC.

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September 11, 2007

The Right Honorable Alistair Darling, MP
Chancellor of the Exchequer
HM Treasury
1 Horseguards Road
London, SW1A 2HQ

Dear Chancellor:

The National Foreign Trade Council, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and our members have for many years been significant investors in the United Kingdom, where our members have created significant jobs and wealth.

We are writing in response to the paper issued by your Department in June 2007: *Taxation of Foreign Profits of Companies: A Discussion Document*, and your request for comments. There are some good proposals in the document. Moving to a dividend exemption system, without interest allocation, is a thoughtful approach to a basis for a modern tax system. Also, moving towards an income-based Controlled Foreign Corporation regime is not an unreasonable corollary to an exemption regime. However, we are very concerned that some of the details of the proposal that are now emerging might have an adverse impact on inward investors. The NFTC, and especially those members that have made significant investments in the UK economy, would be very glad to work with you and your officials on the resolution of the issues set out below.

***NFTC Member Concerns***

Our concerns fall into two broad categories. First, those that would have a direct, adverse effect on US businesses operating in the UK, especially those which have selected the UK as a hub for their European (or wider non-US business) operations. The second, more general, concern relates to the effect that implementation of a number of those provisions might have on the formation of tax policy in other countries where US (and UK) corporations do business.

***I. Direct Effects on US Businesses***

In the first category are issues concerning intellectual property, non-UK intra-group payments, intra-group treasury operations and post-acquisition restructuring.

Regarding intellectual property (IP), we understand that your officials are currently proposing to tax income from the exploitation of IP owned directly or indirectly by a UK-headed group (or sub-group), without reference to whether the income is "actively" or "passively" earned; without regard to where the IP was developed and who paid for that development; and without regard to whether income arising from the IP relates to a direct license or to an embedded intangible. This new approach is a serious departure from customary international practice. If the rule were to be implemented in this form, no US corporation would ever hold or develop IP in or below a UK holding corporation. Without a major change to the thrust of this proposal, inward investment into the UK "knowledge economy" would quickly, and significantly, diminish.

Another issue directly affecting inbound investors is the possibility that seems to be emerging, based on public presentations by members of your Department, that there will not be a strong rule which would exempt from taxation payments of dividends, interest, rents and royalties outside the UK between related companies which have been made out of active business profits. In many cases, US multinationals will have several affiliates performing different functions in the business operations which will naturally require them to make payments between each other. It seems completely unnecessary to subject such payments to tax, particularly because they do not affect the UK tax base. As such payments are not taxed under current US rules, nor, in the case of payments between parties in the same country, under most local consolidation regimes, there would be a considerable new tax burden on US multinationals, which they might not be able to offset against US tax. This would be particularly troublesome for those U.S. companies whose business practice it is to reinvest foreign earnings in foreign markets. This additional tax cost of holding property through the UK would, again, strongly discourage investment in the UK, especially where such investment is in a European holding company.

Another issue directly related to this last point concerns intra-group treasury operations. Multinational businesses establish intra-group funding arrangements for a variety of business reasons including centralization of the group's cash and currency management, as well as controllership and risk management. We are pleased that an exception is contemplated for interest paid to these companies. We are strongly concerned, however, about the apparent restrictions to be imposed. Most particularly, we are troubled by the reference to a treasury company's equity capitalization. The level of equity funding is simply not germane to the point that businesses have real operational needs for intra-group funding arrangements. Further, based on our experience, a requirement to determine appropriate capitalization in a world of varied business circumstances will be inordinately complex. Your Department's proposal would apparently tax interest paid to a group treasury company that is deemed to have too much equity despite the fact that the underlying income was earned in an active foreign business. As in the case of other income described above, imposition of UK but not US or foreign tax on such income, would be a strong disincentive to invest through the UK. Nor do we believe that such a policy is appropriate given that there is no effect on the UK tax base in such circumstances.

We note that the proposals would only apply to foreign earnings of foreign companies and not to foreign branches of UK companies. We believe this distinction will further discourage non-UK companies from using UK companies through which to make investments. The distinction both adds further complexity and could also be contrary to the freedom of establishment rules within the EU. The ability to chose between branches and subsidiaries without a significant tax distinction helps businesses adapt to conditions and circumstances in different markets. If a major tax distinction exists between the two structures, businesses will know in advance that their flexibility will be limited in adapting to changes in conditions and circumstances, and their ability to respond in an efficient manner will generate significant differences in UK taxation. To have completely different tax regimes for branches and subsidiaries will, thus, impede business flexibility and thereby discourage the very investment the government seeks to encourage.

A final direct cost relates to what we understand may be the rules on the taxation of capital gains under the Controlled Company regime. Oftentimes, a US business acquisition of a UK group with foreign subsidiaries is not an uncommon transaction. To harmonize the business structure of the acquired group and the acquiring group, certain restructurings are often required. These transactions may include moving former UK-owned foreign subsidiaries to other places in the group. The current UK rules (including the substantial shareholdings exemption) have facilitated this legitimate restructuring. However, if such movements, although not subject to US tax, were to become subject to UK tax, investing in UK businesses could become very unattractive to a U.S. business.

***II. International Tax Policy Concerns***

We are also concerned that the elements of extra-territorial taxation in the package will only encourage other countries to reject OECD standards. Novel proposals to tax IP, and the apparent abandonment of the arm's length method are examples of questionable ideas from smaller "source country" economies that have been discussed recently. NFTC members believe that the application of and adherence to arms-length transfer pricing standards that follow the OECD principles permit tax authorities to collect the appropriate amount of corporate income tax for operations conducted in their jurisdictions. However, if a major economy like the UK, with a traditional leadership role in tax policy, were to move away from international norms, the potential for retaliatory actions that could adversely affect both UK and US businesses would be a real, current danger.

With respect to the proposed extra-territorial taxation of intra-group payments, in cases where there is no reduction to the UK tax base, on a policy level we do not understand the UK concern regarding cross-border flows, if the country from which the payment is made is not itself concerned. You note that Capital Export Neutrality can no longer be achieved, so, if such payments are made in accordance with the laws of the countries involved, are also made from income generated by active business operations, and truly do not affect the UK tax base, we do not understand why the UK would seek to tax such payments. We strongly urge you to reconsider this position.

We completely understand your need to respond to the European Court of Justice cases, and understand the reasons for a stronger Controlled Foreign Corporation regime - although hopefully, much less complex than in the US. However, the emerging details of the proposals, as they stand, could be far more harsh than the US rules. That could only have the effect of discouraging the inward investment from the US which historically has been so important to the UK economy.

These initial comments are offered at this stage based on our current understanding of the consultation. As the consultation period continues and as other matter arise, we will be pleased to offer further comment. We look forward to working with you and your officials on these important and thoughtful proposals.

Sincerely,

William A. Reinsch
President

cc: The Right Honorable Jane Kennedy, MP
Financial Secretary to the Treasury