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PRIME MINISTER

TAXATION OF INTERNATIONAL BUSINESS

I understand that you would like some additional background information on the proposal mentioned in my minute of 20 September. I apologise for the length of this minute: as you know, the issue is a highly complex one.

2. As you will recall, the proposed legislation enables a charge to corporation tax to be imposed on certain UK resident companies in respect of the income of their tax haven subsidiaries. In this way it seeks to recover the revenue loss - estimated to be running at £m 100 a year - as a result of companies using tax havens deliberately to avoid their UK tax liabilities.

3. The charge would be confined to certain quite narrowly-defined circumstances (eg where the tax haven subsidiary is under overall UK control). Even where all the relevant conditions were present, a company might well escape the charge under one of the three major tests for exclusion incorporated in the legislation. An ability to satisfy any one of these three tests - which focus in turn on the nature of the haven company's activities, its distribution policy and the motives for operating through a haven - would ensure exemption from the proposed tax charge. A more detailed description of how the legislation would work is given in the Annex to the Inland Revenue's 30 March press release (attached).

4. As it appeared in the December 1982 consultative document, the proposed legislation took on board many of the business community's criticisms of the original (ie November 1981) draft. This was universally seen as a great improvement on the original proposals. A few bodies still questioned whether it was right for the charge to extend to profits earned abroad which are then parked in a tax haven rather than being remitted to the UK. But it is clear from the response generally that the business community accepts the case in principle for a UK tax charge on the revised lines we are now proposing.



5. The detail of the December 1982 draft was however criticised in a number of respects. In particular the business community wanted more certainty as to the circumstances in which the charge would apply. We were able to go a long way to meet this - quite understandable - criticism when on Budget Day the Inland Revenue published a provisional list of countries which would not be regarded as tax havens for the purpose of the legislation. This effectively provides a cast-iron guarantee of exemption for every overseas subsidiary resident and carrying on a business in any one of the countries given a clean bill of health. There were 85 such countries on the provisional list. (The issue of this list also provided us with an opportunity to consult the Foreign Office about the possible implications for those territories which would be regarded as tax havens for this purpose. In his 14 March response to John Wakeham, John Belstead expressed himself content with what we propose.)

6. Otherwise the legislation on controlled foreign companies incorporated in the original 1983 Finance Bill was in the same form as it had appeared in the December 1982 document. But in an announcement on the day the Bill was published, John Wakeham made clear that the Government intended to introduce a number of important modifications to reflect the business community's criticisms of the consultative document proposals. (These modifications are detailed in the attached 30 March press release.) In the event Parliament was dissolved before the necessary amendments could be tabled.

7. The 30 March modifications have been incorporated in the draft clauses which we would propose to issue shortly. A draft revised in this way should meet all the business community's criticisms of the structure of the legislation - though not of course any objections of principle which still remain. There are two specific points about these modifications to which I should perhaps draw your attention. The first is the various amendments to the "exempt activities" text (subparagraph d of 30 March Press Release). Taken together these provide a valuable element of added protection for those many UK companies whose operations in low tax areas are commercially based and thus of benefit to the UK economy as a whole, rather than simply an artificial contrivance designed to avoid their UK tax bills.

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8. Second is the clarification of the "motive" test promised at subparagraph (e). This is a sensitive area, where feelings run particularly high. Accordingly we thought it right to solicit the views, on a personal and confidential basis, of two individuals who are informed and influential in the international tax field - Bruce Sutherland and John Avery-Jones. Both said they were satisfied that the projected Committee Stage amendments succeeded in meeting the criticisms of the previous version of the test. These amendments have now been incorporated in the revised draft.

9. Against this background, I feel we can go ahead and publish the revised draft legislation on controlled foreign companies with some confidence. It would be naive to think we shall escape criticism altogether. But I think our revised proposals will be generally regarded as a fair and moderate way of dealing with what is widely acknowledged to be a real - and increasingly costly - problem for us.

10. If we are to leave enough time for representations on the proposals before legislating next year, we ought to publish soon, preferably by about the end of this month. Otherwise we shall risk running into a repetition of last years complaints that the business community had been given inadequate advance opportunity to comment before the introduction of legislation.

A handwritten signature in blue ink, appearing to be 'N.L.' with a flourish.

(N.L.)

19 October 1983