INVERSIONS: A UK PERSPECTIVE

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Until recently the U.K., like the U.S., operated a worldwide basis of taxation. Overseas profits of operating subsidiaries were taxed upon repatriation in the form of taxed dividends, and the controlled foreign company (CFC) rules, the equivalent to Sub-part F, taxed many passive profits earned abroad on an accruals basis. The profits and losses of foreign branches were taxed (or relieved) in the same manner as U.K. profits, subject to double taxation relief.

However, the U.K. regime has changed markedly in the last few years. The result is a much more territorial tax system – and one that seems to be proving attractive to business.

Background

The U.K.’s tax regime has always had a number of attractive features for multinational groups, including the absence of a dividend withholding tax, generous relief for financing costs, and an extensive tax treaty network. Against this was the existence of the CFC regime and the historic lack of an exemption for foreign dividends. Nevertheless, the UK held its own against other major economies overall.

In the years leading up to 2007/2008, however, the balance started to shift. A gradual annual tightening of the CFC rules was followed in 2007 by a proposal from the Labour Government to implement major changes that threatened to bring almost all passive income earned abroad into the U.K. tax net unless it was taxed at rates close to the U.K. tax rate (then 30%) – like Sub-part F, but without the benefit of any deferral mechanisms.

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For many, this represented a tipping point, and a number of high profile U.K. companies took steps to move their tax domicile abroad. WPP, the giant advertising group, announced in 2008 that it had moved its tax domicile to Ireland – as did Henderson Group, United Business Media, and Shire, the pharmaceutical group. Ineos, the fourth-largest chemicals company in the world, moved to Switzerland a few years later. By late 2009 this trickle risked becoming a flood – with the Financial Times reporting that more than half of companies had considered leaving the U.K.\(^2\), including a number of FTSE heavyweights.

The U.S. response, when confronted with similar circumstances prior to 2004, was to introduce and then tighten draconian anti-inversion rules – effectively using a legislative ‘stick’ to ensure that U.S.-domiciled corporations were not tempted by the lower effective tax rates offered by overseas jurisdictions.

In contrast, the UK’s response was to start dangling the carrots.

**The UK reforms**

In truth, the Government may have been influenced in part by the fear that a blanket anti-inversion rule could not be implemented without the risk of taxpayer challenge based on the EU fundamental freedoms – a fetter to which the U.S. is not subject. In any event, whatever the reason, the official tone softened, and in July 2009 the first substantive legislative change was made with the introduction of a broad exemption for overseas dividends.

However, it was when the current Conservative-led coalition Government came to power in May 2010 that the transformation of the U.K. tax system really accelerated, with Chancellor George Osborne declaring his goal for the U.K. to have “the most competitive tax regime in the G20.” A period of consultation with business and professional bodies followed, culminating in a substantial reform of the U.K.’s CFC regime with effect from 1 January

2013. The rules are now intended to be targeted more narrowly at the kind of “wholly artificial” diversions of profits from the U.K. that the European Court described in the *Cadbury Schweppes* case (C-196/04). This complemented a corresponding (optional) exemption for profits of overseas branches of a U.K. resident company introduced in 2011. These measures, coupled with the dividend exemption, substantially completed the U.K.’s transition to a territorial basis of taxation – bringing it into line with many other European jurisdictions.

A parallel initiative was to slash the mainstream corporation tax rate. In 2010, the rate was 28% (still low by U.S. standards, of course). By 2015 it will be 20%, the joint-lowest in the G20. For profits deriving from patented products, the new “patent box” regime will bring the effective rate down to 10%. This makes the tax differential with countries like Ireland and Switzerland much narrower – which in turn makes the incentive to leave the U.K. significantly weaker.

*The reaction*

So has the “carrot” policy been a success? It is early days but the signs are positive. Some of the most high profile departures have announced their return, including WPP and Henderson. Additionally, new businesses are starting to see the attraction of a U.K. base. Aon, the global insurance broker, last year moved its headquarters from Chicago to the U.K. (its shareholders apparently taking the U.S. tax hit) and disclosed in an SEC filing that the U.K. territorial tax system would produce “significant value for shareholders” going forward. Indeed, research by FDI Markets found that 45 foreign companies recently moved their global or regional headquarters to London, up from just 25 in 2009.

Of course, UK headquarters do not themselves attract much investment or create much employment. But once a base is established, further growth may follow: Noble Corp
cited the talented local workforce as one of the reasons for its recently announced relocation to the U.K. from Switzerland. And GlaxoSmithKline has pledged to invest £500m in the U.K., and to relocate key research jobs, as a direct result of the U.K.’s patent box regime and other tax reforms.

But it’s not all plain sailing. Even while striving to make the U.K. more attractive to multinationals, the Government clearly feels forced to respond to the current wave of popular hostility against perceived “unfair” or “immoral” tax minimization techniques of large companies. The result is a mixed political message, which risks undermining the positive effect of the reforms. An Ernst & Young survey recently reported that 67% of tax professionals believe that uncertainty created by the debate on tax “fairness” is now the main deterrent to investing in the U.K.3

Overall, however, most businesses acknowledge that the U.K. has taken a big step in the right direction. Perhaps the U.S. should take note.

*The views expressed in this article are those of the author and do not necessarily reflect the views of Freshfields Bruckhaus Deringer LLP.*

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3 “Budget 2013: Keeping the UK open for business”, Ernst & Young, 20 March 2013.