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Controlled Foreign Companies (CFC)
February 2012

On 31 January 2012 HM Treasury released a further update as part of the ongoing overhaul of the tax rules on controlled foreign companies (CFC) and foreign branch profits.

The new rules seek to make the UK's tax system competitive with other EU jurisdictions, but, in typical UK tax drafting fashion, also attempt to protect against the diversion of profits from the UK to low tax jurisdictions and comply with EU law. The result is an unnecessarily complex piece of legislation that isn't likely to enhance the UK's competitiveness. The update does, however, give us a better idea how the new rules will work.

In comparison with the current rules where the chargeable profits of a CFC will include essentially all of its profits, the proposed rules aim to include only certain categories of profits within the CFC regime (the so-called "Gateway approach"). Chargeable gains remain excluded.

Where a taxpayer meets some of the initial criteria (in particular a nexus of people / functions with the UK) the new rules potentially apply. Taxpayers then have a degree of choice in how they might apply it. The more straight forward approach is the entity exemption. Where none of these exemptions apply, you then have to apply the income exemption (i.e. the Gateway) which, in practice, may introduce a significant compliance burden.

The Gateway approach excludes certain profits from the scope of the UK CFC legislation, leaving only those business profits that are attributable to activities in the UK, certain finance profits and some insurance profits.

According to the Gateway test, CFC profits will be left outside the CFC rules where the chargeable profits fall within Chapters 8-12 and are not also excluded by Chapter 13.

Chapters 8-12 (i.e. Chargeable profits included within the CFC rules) include the following:

Chapter 8 ("Profits attributable to UK SPFs")

The first category of in-scope profits are those attributable to any "significant people functions" or "key entrepreneurial risk taking functions" ("SPF") in the UK.

The analysis requires us to pretend that the CFC is in fact a permanent establishment ("PE"), and to attribute profits based on a functional and factual analysis in accordance with the OECD Report on the attribution of profits to a PE (the "OECD Report"). Broadly speaking, the profit which would be attributable to the UK is within the scope unless specifically excluded by further rules (e.g. where the UK SPF is minimal).

Confused yet? No, OK, let's look at Chapter 9…

Chapter 9 ("Non-trading finance profits")

The second category of in-scope profits covers "non-trading finance profits" (e.g. interest income). Profits from "trading finance profits" (i.e. profits of banks or other financial institutions) are dealt with separately in Chapter 10.

Non-trading finance profits are included in chargeable profits if the related SPFs are carried on in the UK, or they arise from funds that are directly or indirectly derived from the UK (e.g. through a capital contribution), or they relate to loans to UK residents or branches where it is reasonable to suppose that the main reasons for such loan include a tax-related reason.

It is worth noting that where a CFC with financing income is largely autonomous from UK SPFs – e.g. where the group's treasury function is based offshore – and where the CFC's capital does not derive from the UK, then profits arising from lending to non-UK persons could be fully outside of the scope of the CFC charge.

Where finance profits are within scope, they may benefit from the finance company partial exemption (see further below).

Chapters 10 to 12

Chapters 10 to 12 contain rules relevant to specific companies (e.g. banks or insurance companies). In the absence of discussing these rules in detail, it is probably sufficient to say that these Chapters apply a different set of criteria to banks or insurers and are the subject of further refinement.

Chapter 13

Chapter 13 states that certain amounts are excluded from chargeable profits (e.g. certain incidental non-trading profits).

So far it seems clear that applying the Gateway will be a complex, cumbersome and costly exercise for many companies, particularly in relation to determining the profits attributable to UK SPFs. In practice, we would anticipate that in some cases, taxpayers may choose to skip over the gateway and see whether they first qualify under the entity level exemptions.

Entity level exemptions

Where a CFC satisfies an entity-level exemption (described below) no CFC charge will be imposed in relation to any of its profits (whether or not they would be in-scope of chargeable profits described above).

Low profits exemption – for CFCs whose accounting profits do not exceed £50,000 for an accounting period and for CFCs whose accounting profits do not exceed £500,000 and whose profits from non-trading income do not exceed £50,000.

Low profit margin exemption – This exemption will be available where a CFC's accounting profits do not exceed 10% of its relevant operating expenditure.

Excluded territories exemption – CFCs resident in specified territories (broadly intended to be those with a headline tax rate of more than 75 per cent of the UK main corporation tax rate) will be exempt provided that their total income within certain categories (generally income that is exempt or subject to a reduced rate of tax) does not exceed 10% of the company's pre-tax profits for the accounting period (or £50,000 if greater). Note that the exemption will not be available where significant IP has been transferred to the CFC from the UK in the prior 6 years.

Tax exemption – A CFC will be exempt if the local tax amount payable in relation to the CFC's profits in its territory of residence for an accounting period is at least 75% of the corresponding UK tax that would be payable. This is similar to the lower level of tax test used to define a CFC under the current rules.

Temporary period exemption – A 12 month exemption period is available on buying a new subsidiary provided that the subsidiary is restructured within 12 months so that no CFC charge would arise for future periods.

Finance Company Exemptions

Profits of "non-trading finance companies" will be within the scope of the CFC rules and chargeable to tax in the UK if they are not excluded under the Gateway test and none of the entity level exemptions applies. However, they may still be partially excluded from the rules where the finance company partial exemption ("FCPE") applies.

The FCPE operates by providing an overriding exclusion from a CFC's chargeable profits of three-quarters of its "qualifying loan relationship profits". This will apply only where a claim is made by the company on whom the CFC charge would otherwise be made. The requirement to make a claim may be an attempt to preclude taxpayers seeking to avoid any CFC pickup on financing activity under the Gateway or entity level exemptions and using the partial exemption as a mere back-up position.

"Qualifying loan relationships" will be those loans where the debtor is a company connected with the CFC which does obtain a UK tax deduction. It will also be necessary for the CFC to have appropriate business premises in its territory of residence.

The provisions also include a "full exemption" although the terms of the full exemption are narrowly drawn (in general, where the profits derived from loans funded from "qualifying resources" and the CFC charge exceed a company's UK financing expense) and we expect this to have limited application.

The possibility of a reduced charge to UK tax under the FCPE (or indeed the potential for full exemption) may allow UK-based multinationals to structure group financing functions in low tax jurisdictions. This will put the UK on a par with countries like Luxembourg and Switzerland and, prima facie, allows the UK to compete with all of the other major EU countries as a domicile for multinationals.

However, to fall within the financing exemptions it will be necessary for the financing function to be carried on in the overseas jurisdiction. This is a curious feature since it potentially encourages finance jobs to leave the UK.

General Comment

In general the new rules are to be applauded in seeking to put the UK on a level playing field with other EU jurisdictions as a place to locate the holding company of an international business. The UK also has an added advantage as a base for multinationals since they will be able to rely on the UK's much extended tax treaty network.

However, the issue that most multinationals will be concerned with is the fact the UK's legislation is far more complicated than most other jurisdictions. In addition, in countries such as Luxembourg or Switzerland, we can be fairly certain that, regardless of future changes in government, tax regulation and policy will remain relatively static. That is rarely the case in the UK. This can have a significant bearing on whether taxpayers choose to locate themselves here.

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