UK Controlled Foreign Company Reform

Draft Legislation on Permanent Changes to the CFC Rules

SUMMARY

The UK government has now published draft legislation for a reformed controlled foreign company ("CFC") code. The legislation sets out the framework for a new regime in detail, although the government has yet to provide drafting in some areas and is still consulting on several issues. The new code would be more sophisticated than the old, but at a cost in complication. The government is looking to bring in the new rules from mid- to late- 2012.

What's new?

- The new rules are significantly more complex than either the current regime or the regime proposed in the consultation document of June 2011
- Targeted anti-avoidance rules have proliferated
- The definition of “control” has been extended
- Most limitations are now partial, rather than covering all the CFC’s income
- Only specified income streams will be included in "chargeable profits", depending on whether one of seven grounds for inclusion is met and whether a relevant exclusion applies
- Property rental is fully excluded
- The government has decided how the finance company partial exemption should work – though it is still considering whether it should be more generous in some cases
BACKGROUND

Why CFC rules?
Like many other jurisdictions, the UK does not like to see corporate taxpayers moving capital into mobile assets in offshore subsidiaries so that the income from those assets rolls up outside the UK tax net. The UK introduced its CFC rules in the 1980s, following the abolition of exchange controls. Their aim is to tax this “artificial diversion of business profits from the UK”.

The story so far …
Some years ago, the UK government decided to revisit the CFC rules as part of the wider project to reform the treatment of foreign profits so that they would be taxed on a more “territorial” basis. The government published a discussion document in July 2007 proposing a new dividend exemption, changes to the rules on relief for interest payments and replacement of the old Treasury consent rules with reporting requirements. At the same time, the government proposed moving from the existing all-or-nothing entity-based CFC rules to an income-based “controlled companies” regime. This was intended in part as a revenue-raising measure to counterbalance the dividend exemption. Moreover, the CFC rules were under attack on the basis that they were not compliant with EU law. The government proposed to deal with this by extending the rules to UK subsidiaries. The CFC element of the foreign profits proposals met with fierce resistance from business. One of the aims of the package was to encourage multinationals to remain in, or come to, the UK. But one of the key factors cited by groups redomiciling out of the UK as a reason for their decision was the burden of the UK’s existing CFC regime.

In response to these concerns, the government made only minor changes to the CFC rules as part of the foreign profits package enacted in 2009. A key feature of that package was the dividend exemption. Fundamental CFC reform was tackled separately. By spring 2010, it had become clear that this would take longer than the government had expected. CFC reform was again divided into two: limited interim improvements to the existing regime, since enacted in the Finance Act 2011; and root-and-branch reform, to form part of the Finance Act 2012.

In June 2011, after many discussion papers and working group meetings, the government published a consultation document with its proposals for the new regime. This was considerably more detailed and

Changes to the CFC regime:
Finance Act 2007: qualifying work exemption; removal of public quotation exemption
Finance Act 2008: changes to “control”
Finance Act 2009: foreign profits changes
Finance Act 2011: interim improvements
Finance Act 2012: new regime?

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1 Taxation of International Business: Consultation paper, Inland Revenue, December 1982.
2 The consultation document and related materials are available on the HM Treasury website at www.hm-treasury.gov.uk/consult_controlled_foreign_companies_reform.htm. See our client
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comprehensive than anything the government had published up to that point. But the government’s thinking was still fluid: the document contained 80 questions. The plan was to publish draft legislation in the autumn.

Draft legislation
On 6 December the government published draft clauses for Finance Bill 2012, including a new CFC code (of over a hundred sections). At the same time it issued a response to the consultation. The response highlights areas not yet addressed in the draft legislation. In short, the reforms remain a work in progress.

Reasons for change
The proposed changes are intended:

- to make the UK’s tax system more competitive;
- to ensure that the new rules comply with EU law; and
- to close loopholes in the existing regime.

On the competitiveness front, the UK has already moved towards a territorial system of corporate income taxation with the dividend exemption introduced in 2009 and the elective exemption for non-UK branches brought in by this year’s Finance Act. The government is also conscious that a CFC regime carries a significant compliance burden. On the other hand, the increased sophistication of the UK’s transfer pricing rules has reduced the pressure on the CFC regime.

Meanwhile, the European Court of Justice and the UK courts have seen challenges to the UK’s CFC rules as infringing the EU law right to freedom of establishment. The Court of Appeal sought to resolve this by “reading in” a new exemption to the UK legislation reflecting the rulings of the European Court of Justice. The full implications of this remain to be explored because that case subsequently settled. While the cases were going through the courts the government made its own attempt to EU-proof the UK regime, by allowing companies to apply to reduce the charge where staff of the CFC carry out “qualifying work” in a member state of the European Economic Area. (The European Commission has now sent the UK government a “reasoned opinion” that this provision does not go far enough.) The cases did, however,

4 Available at www.hm-treasury.gov.uk/d/controlled_foreign_companies.pdf.
5 Available at www.hm-treasury.gov.uk/d/condoc_responses_controlled_foreign_company_reform.pdf.
6 It is possible to opt out of the dividend exemption; taxpayers must opt in to the branch exemption.
7 In Vodafone 2 v. Revenue and Customs Commissioners (No 2) [2009] EWCA Civ 446.
make it clear that taxpayers entering into “wholly artificial arrangements” may not be able to invoke EU law to protect themselves against national provisions.

The desire to compete with other jurisdictions and the need to comply with EU law are both reflected in the government’s focus on taxing only profits “artificially diverted” from the UK and defining more tightly what sorts of profits are “artificially diverted”. However, the government’s various aims may also conflict with each other:

Next steps
The government is still sticking to its plan to enact the new regime in the Finance Act 2012. It proposes to publish draft sections to fill in some of the gaps in the legislation in the course of January. It also plans to hold an open event on its proposals on 11 January. The deadline for responses on the drafting published so far is 10 February. The government still considers that the earliest the new rules could become effective is for accounting periods beginning on or after the date when Finance Bill 2012 receives Royal Assent (sometime in July). The timetable could yet slip again.

OVERVIEW

Introduction
Structure. The draft legislation rewrites the CFC code in its entirety. The structure of the regime remains broadly the same:

Step 1: Identify CFCs
Step 2: Exempt some CFCs
Step 3: Make elections for alternative basis of calculation of UK-equivalent profits
Step 4: Calculate “chargeable profits” and “creditable tax”
Step 5: Apply for reduction of chargeable profits (and creditable tax)
Step 6: Apportion chargeable profits (and creditable tax)
Step 7: Claim reliefs to offset CFC charge
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**Step 8:** Pay CFC charge (as if corporation tax).

(The consultation document puts Steps 3 to 7 together as a single Step 3: Calculate the CFC charge.)

This hides substantial changes to Steps 1, 2, 4 and 5. (The government proposes mostly minor changes to the other steps.)

**Focus on mobile assets.** The government has thought hard about what is “artificial diversion” of UK profits and has cut back the scope of the regime to focus on mobile assets. Most obviously, rental income from real property is now excluded. On the other hand, the government remains suspicious of transactions which move intellectual property offshore.

**Move to partial limitations.** The old regime deliberately took a purely entity-based, all-or-nothing approach: if the CFC fell within an exemption, there was no charge. 2007 saw the introduction of the first partial limitation on the scope of the regime: the reduction in chargeable profits to reflect qualifying work carried out in an EEA state. The Finance Act 2011 “interim improvements” also included partial limitations.

The proposals for the permanent regime have continued this trend. In part this is due to the focus on profits “artificially diverted” from the UK. As a result, a wider range of CFCs will benefit from some form of limitation. But another reason for the move is the crackdown on “swamping”: a CFC carries on trading activity and thereby benefits from exemption, which allows it to shelter finance income (or other investment income, such as royalty income) from a CFC charge. The size of the CFC’s other activities is sufficient to “swamp” the finance income, so the exemption is not lost. In future, whether investment income is excluded from the CFC charge may depend on whether it is “incidental” to an excluded trading or property rental business.

**Anti-avoidance measures.** The government is also looking to curb other forms of avoidance: the definition of “control” is wider and there are more targeted anti-avoidance rules (“TAARs”).

**Identifying CFCs (Step 1)**

As before, the regime will target companies

- **resident outside the UK** and
- **controlled** by UK residents.

However, a CFC need no longer be subject to a lower effective rate of tax than it would be in the UK (the “lower level of tax test”). This will become an exemption. In other words, a company not subject to a lower effective rate of tax could now be a “CFC”, but there would usually be no CFC charge.

The draft sections include new default provisions for allocating residence where the existing provisions do not assign residence. We discuss the changes to the definition of “control” below.

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The definitive rules bringing exempt non-UK branches into the ambit of the CFC regime have not yet been drafted. But we do have a rule – trailed in the June consultation document – treating the cells of a protected cell company or incorporated cell company as if it were a company in its own right. The Treasury is also given a regulation-making power to treat other entities which are not companies as if they were companies.

Limitations (Steps 2, 4 and 5)
As before, a CFC (or rather, the UK companies to which its profits would be apportioned) may benefit from several limitations on the scope of the CFC rules. However, the government proposes extensive changes.

- As noted above, the old lower effective rate of tax test is to become an exemption.
- The new regime would rely less on full exemptions and more on partial limitations.
- Some limitations are new; some of the old limitations will be retained, but with changes of detail.
- The way taxpayers benefit from most partial limitations will change.

Full exemptions (Step 2). There will be four full exemptions. These will be – relatively – simple to apply. They are intended to deal with specific situations where avoiding UK tax on profits is unlikely to have been a factor in choosing the CFC’s jurisdiction of residence:

- where it pays tax of at least three-quarters of the amount it would have paid in the UK – formerly the "lower level of tax test", now the "tax exemption"; or
- where the CFC’s profits are low – the "low profits exemption";
- where it is resident in a jurisdiction where it is unlikely to pay less tax than in the UK – the "excluded territories exemption"; or
- where its margin of operating profit is low – the "low profit margin exemption".

Exemptions of the first three types are already in place (the first in the form of a condition to CFC status), but the draft legislation makes changes to them. The fourth is new.
The diagram below sketches the development of the limitations from the old regime to the new.

Pre-FA-2011 regime

- Lower level of tax test
- De minimis
- Excluded countries

Interim improvements

- Small profits
- Limited UK connection

Draft legislation

- Tax exemption
- Low profits (tax)
- Low profits (a/c)
- Excluded territories
- Low profit margin

Exempt activities

- Special rules for banks
- Special rules for insurers

Qualifying work in EEA state

Motive test

Period of grace clearances

Temporary

Temporary period

Finance company

Finance company

Key

- No changes announced
- Similar approach, some changes
- Different approach, similar effect

Drafted

Proposed

Under consideration

Condition to CFC status

Enacted

Full exemption

Partial exemption

Chargeable profits

a/c: accounts-based measure of profits
Calculation of chargeable profits (Step 4). The way most partial limitations take effect will be different. Essentially, taxpayers must claim the partial limitations in the current regime from HMRC (at Step 5). Most of the partial limitations on the new regime, however, will come automatically through the calculation of “chargeable profits” (Step 4). These will no longer simply be the CFC’s profits from all sources except chargeable gains\(^8\), computed under UK tax rules.\(^9\) Instead, some of those profits, as well as chargeable gains, will be excluded.

There are also a few changes to the assumptions on which those profits are calculated. Some of these are to ensure that anti-avoidance measures are capable of operating.

Foreign and any actual UK tax already suffered on those profits is then computed, giving “creditable tax”.

Claims to reduce chargeable profits brought into account (Step 5). Taxpayers will have to claim:

- the new “finance company partial exemption”; and
- (probably) the “temporary period exemption”.

Solo consolidation and CFCs of UK banks. If the CFC is a subsidiary undertaking of a UK-resident company and is the subject of a solo consolidation waiver under section BIPRU 2.1 of the FSA Handbook\(^10\), none of the full exemptions will apply. The full exemptions will also be disappplied if one of the shareholders controlling the CFC is a UK resident bank, a fall in the value of the shares would be disregarded for UK regulatory capital purposes and the UK bank holds the shares for tax reasons. These carve-outs from the exemptions are new.

Elections for alternative basis of calculation of UK-equivalent profits (Step 3)
As now, the calculation of a CFC’s profits on a UK tax basis assumes that the CFC has made whatever claims and elections it needs (with a few exceptions) in order to reduce those profits to the minimum possible. The UK-resident companies to whom most of a CFC’s income is apportioned may make a joint election to disapply any election which would otherwise be made. They may also make one of the excepted elections.

Apportionment (Step 6)
The profits (and creditable tax) will continue to be apportioned to the substantial “participators” in the CFC, who may be direct or indirect shareholders. The threshold for being a substantial “participation” will

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\(^8\) Chargeable gains are gains which are capital in nature and treated as such for UK tax purposes. Chargeable gains made by non-UK-resident companies with direct or indirect investors in the UK are subject to a separate, narrower anti-avoidance rule. That is not being amended, although its compatibility with European Union law has been challenged by the European Commission.

\(^9\) Income from trusts of which the CFC is a settlor or beneficiary is also added.

\(^10\) A financial firm is normally not allowed to incorporate the capital and requirements of a subsidiary when it calculates its capital resources and capital resources requirement. A solo consolidation waiver allows it to do so.
continue to be a 25% interest, including the interests of any affiliates. Profits are apportioned to and chargeable on the UK-resident corporate participator(s) closest to the CFC in the chain of ownership. These are referred to as “chargeable companies”. The chargeable companies are then liable to a tax charge equivalent to corporation tax. Any creditable tax will provide relief from the CFC charge.

Reliefs offsetting CFC charge (Step 7)
The chargeable company may still set various reliefs off against the CFC charge, such as the losses from a trade it carries on or surrendered to it from elsewhere in the UK tax group.

According to the June consultation document, it was intended that the new legislation would continue to eliminate any economic double taxation following an apportionment where:

- the UK participator disposes of shares (presumably, where the shares carry the ownership of the CFC, whether directly or indirectly); or
- the UK participator has received dividends from the CFC and elected to have them taxed, rather than claiming the benefit of the UK exemption for dividends and other corporate distributions.

The draft sections do not include these provisions.

Payment (Step 8)
The chargeable companies must pay any resulting CFC charge as if it were corporation tax.

CONTROL

The June consultation document put the definition of “control” into play. The current definition is a broad but mechanical one which looks at direct or indirect voting control and (since 2008) direct economic rights\(^\text{11}\). It also treats certain large shareholdings in joint ventures as equivalent to “control”.

The government has gone for a blunderbuss approach. Control may now come from:

- direct or indirect voting control; or
- direct or indirect economic rights; or
- accounting treatment as a parent undertaking\(^\text{12}\),

and there is a new TAAR to capture taxpayers trying to escape the rules.

The draft retains the rules bringing in the rights and powers of a person’s UK-resident affiliates or those which it will be entitled to in the future. The rules on joint ventures also remain.

\(^{11}\) Entitlement to profits on a distribution or to the proceeds of a disposal of the CFC’s shares or to the assets of the CFC on a winding-up.

\(^{12}\) Under UK GAAP (Financial Reporting Standard 2).
There is some good news for taxpayers. A concern had been raised that the breadth of the existing definition could mean that banks have “control” as a result of simply lending money with or without security (such as a pledge of shares in the CFC). The draft legislation provides an exclusion for rights held by banks regulated in their state of residence and lending money to a CFC “in the ordinary course” of their business. This exclusion does not extend to any other lenders (for example non-bank bondholders), although a “loan creditor” does not have an “interest” in a CFC for apportionment purposes simply by virtue of the lending relationship.

**TAX EXEMPTION**

**Background**
This is the current “lower level of tax” test in the guise of an exemption. Like the other exemptions, it is intended to exclude situations where the CFC is unlikely to pay significantly less tax than it would in the UK.

**Proposal**
As before, the legislation asks whether the tax paid on the CFC’s profits (ignoring capital gains) is less than 75% of the tax it would have paid if it were resident in the UK. This involves computing the CFC’s chargeable profits as if it were UK-resident. Some jurisdictions have allowed companies to set the amount of tax they pay. If the CFC benefits from such “designer rate” tax provisions (and they are specified by HMRC in regulations), it is treated as if it were subject to a lower rate of tax. Income taxed in the foreign jurisdiction but not the UK is stripped out of the comparison. In a further attempt to target mismatches in the tax base, the draft section would also strip out any expenditure brought into account in the UK but not the foreign jurisdiction.

**LOW PROFITS EXEMPTION**

**Background**
CFCs with low profits pose little risk to the UK tax base. There has therefore long been a “de minimis” exemption for CFCs with chargeable profits of £50,000 or less. The Finance Act 2011 introduced a further “small profits” exemption for CFCs with profits of up to £200,000 calculated on an accounts basis, subject to anti-avoidance rules.

**Proposal**
**Accounting profits.** The consultation document proposed three ways in which the government might build on the new accounting exemption. The option it has chosen is to increase the limit to £500,000, but add a separate ceiling of £50,000 for investment income.

The measure of profits will be the accounting profit with the same adjustments as under the small profits exemption introduced in the Finance Act 2011. However, the revised exemption allows the use of local
GAAP, rather than just UK GAAP or IFRS. As at present, there is a TAAR to prevent exploitation of the exemption, for example by fragmentation of profits. This will be extended to deny the exemption to UK-resident contractors providing personal services in the UK through offshore companies.

The government has also decided to retain the *de minimis* exemption for taxable profits up to a certain level. The same £500,000/£50,000 limits and the same TAAR as for the accounts-based exemption will now apply.

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**LOW PROFIT MARGIN EXEMPTION**

**Background**
CFCs with low profit margins also pose relatively little risk to the UK tax base. The June consultation document proposed an exemption for CFCs with a low profit rate as the first of three territorial business exemptions.

**Proposal**
In the draft legislation this has become a stand-alone exemption. As trailed in the consultation document, the CFC would be allowed maximum profit (before interest costs) of 10% of operating expenses. The cost of goods acquired for resale (unless imported into the CFC’s territory of residence) and related party business expenditure would be excluded from operating expenses. Dividends that would be exempt from UK tax would be excluded from profits. The consultation document suggested that a CFC would need some local management to come within the exemption: there is no such requirement in the draft section.

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**EXCLUDED TERRITORIES EXEMPTION**

**Background**
The government recognises that carrying out a chargeable profits computation is not straightforward. The current CFC legislation provides an excluded countries exemption as a proxy for the “lower level of tax” test. CFCs in certain jurisdictions (the “excluded countries”) are or may be exempted from the CFC rules. For many companies this removes the need to carry out a computation.

**Proposal**
The new regime will have a similar exemption. This will consist of general rules on the circumstances in which the exemption may apply, and a power for HMRC to issue regulations listing the “excluded territories”. The Finance Bill package also includes draft regulations. The government has concluded that a territory must still have a main rate of corporate tax no less than 75% of the UK rate as a threshold condition for “excluded territory” status. The list of territories covered in the draft regulations reflects changes in rates since the current regulations were last amended. Cyprus and Singapore, for example, will no longer be excluded territories.
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But a similar main rate is not enough on its own: the tax base may be defined differently. There may also be specific low tax regimes for particular types of company or income. This has led the UK to exclude CFCs falling with certain regimes from the current Excluded Countries Regulations. The government has decided no longer to specify such regimes in regulation, but to capture them in a general condition. The draft sections retain the anti-avoidance rules in the existing regulations, and layer further general conditions on top of them. One of these is aimed at preventing the transfer of valuable intellectual property from the UK into CFCs. Others target CFCs which benefit in one way or another from tax-preferred regimes in their local jurisdictions.

In the consultation document the government noted that tax-transparent entities, like US limited liability companies, might be used for genuine commercial reasons in the US, but could not benefit from the excluded countries exemption as it stands. It proposed to change this. The draft legislation does so, up to a point. A US LLC (for example) can benefit from the excluded territories exemption, as long as its members are taxable on its income in the US.

The consultation document said that the exemption would need adapting for banking and insurance businesses. This has not been done in the draft legislation and regulations, although they do deny Luxembourg-based insurance companies the benefit of the exclusion.

CHARGEABLE PROFITS

Background
The rules for calculating a CFC’s chargeable profits will be very different. These will no longer simply be the CFC’s profits from all sources except capital gains, computed under UK tax rules. Instead, only some categories of profit will be chargeable. These are the types of profits the government now considers may be “artificially diverted” from the UK.

The proposals contain elements of the rules in the current regime exempting profits thought of as genuinely overseas profits: in particular, the exempt activities and motive test exemptions and the new limited UK connection exemptions. They also develop ideas from the June consultation document.

The draft legislation, however, is much more complicated than either.

Structure
The starting point for calculating chargeable profits continues to be the CFC’s profits from all sources except chargeable gains, computed under UK tax rules: these are now referred to as the “assumed total taxable profits”. However, income is then only included as “chargeable profits” if it meets at least one of

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13 As noted above, chargeable gains of non-UK resident companies are subject to a separate anti-avoidance rule, but it is narrower in application (and being challenged by the European Commission). The effect of excluding chargeable gains has been eroded over time. If a corporate investor makes a gain by selling a loan, it is now taxed on an income basis under the loan relationship rules. If it sells
seven grounds for inclusion and if it does not fall within one of nine exclusions. These limitations on what counts as chargeable profits are referred to in the consultation response document as the “Gateway”. Which grounds for inclusion apply depends on the type of income. Which exclusions may be available depends on the ground for inclusion and the type of income. The table in the Appendix summarises which grounds of inclusion apply and which exclusions are available for different types of income.

Grounds for inclusion. These are of two types: general and specific.

The general grounds apply to all types of income. They are:

- that the profits are attributable to significant people functions in the UK ("UK SPFs"); or
- that the CFC is the subject of a solo consolidation waiver.

The specific grounds apply only to finance income. "Finance income" for these purposes includes income from equity instruments\(^\text{14}\) as well as debt instruments, derivatives and the like. Three apply to trading finance income, two to non-trading finance income. We discuss those further below.

Exclusions. There are nine\(^\text{15}\) of these:

- four specific to the UK SPFs ground of inclusion;
- three specific to the trading finance income grounds of inclusion;
- one for property rental income;
- one for incidental non-trading finance income.

UK SPFs

Background. This leans heavily on OECD principles.\(^\text{16}\)

Rule. Establishing whether the UK SPFs ground of inclusion applies is a five-step process:

Step 1: Identify the assets and risks from which the CFC’s profits arise.

Step 2: Determine whether any of the relevant significant people functions\(^\text{17}\) are carried out in the UK by an affiliate of the CFC (or the CFC itself, if acting otherwise than through a UK permanent establishment).

\[^\text{14}\] Unless the UK exemption for some types of company distribution would apply.

\[^\text{15}\] Ten if you count the exclusion of chargeable gains from the definition of assumed total taxable profits.

\[^\text{16}\] That is, the principles set out in the OECD’s 2010 Report on the Attribution of Profits to Permanent Establishments.

\[^\text{17}\] That is, the significant functions relevant to the economic ownership of assets or to the assumption or (if they are transferred) the management of risks. This will need to be considered whenever approval is required from someone in the organisational hierarchy who is based in the UK.
Step 3: Attribute those UK SPFs to a notional UK permanent establishment of the CFC and attribute the CFC’s assets and risks to that PE if appropriate.

Step 4: Determine the profits from the assets and risks attributed to that notional UK PE.

Step 5: Apply the UK-SPF-specific exclusions and the exclusions for property rental income and incidental non-trading finance income as appropriate.

The profits left are chargeable.

Exclusions. The four UK-SPF-specific exclusions are for:

- **majority non-UK SPFs** – although an asset or risk is attributed to the notional UK PE in Step 3, most of the relevant SPFs by value are non-UK SPFs;
- **substantial non-tax value** – a substantial proportion of the value created by holding the asset or risk offshore comes from something other than reducing UK tax;18
- **arm’s-length arrangements** – if the UK SPFs weren’t carried out by UK affiliates of the CFC, they would be carried out by third parties on identical terms;
- **trading income**, subject to six conditions:
  - the **business premises** condition – the CFC carries on its business from reasonably permanent business premises in its jurisdiction of residence; and
  - the **income** condition – no more than 20% of its income (10% for banking income) is derived from UK-corporation-tax-payers or UK-resident individuals; and
  - one of two conditions relating to management expenditure is met:
    - the **management expenditure** condition – not more than 20% of the CFC’s total related management expenditure (payment of the CFC’s staff or other persons carrying out significant people functions for the CFC) is spent on persons carrying out functions in the UK; or
    - the **50%** condition – in relation to an individual asset or risk, not more than 50% of the relevant related management expenditure is spent on persons carrying out functions in the UK; and
  - the **IP** condition – if any of the CFC’s profits arise from exploiting intellectual property, any part of that IP which was transferred from connected persons in the UK (including UK PEs of non-UK persons) in the last six years is not significant; and
  - the **export of goods** condition – not more than 20% of its income derives from goods exported from the UK; and
  - the **anti-avoidance** condition – the CFC has not organised its business in a particular way with a main purpose of benefiting from the exclusion.

The trading income exclusion applies only to trading income, not non-trading income. **None of these exclusions applies to non-trading finance income.** Most of the finance income earned by a multinational group outside the financial services sector is likely to be non-trading finance income. As

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18 Any value from reducing foreign tax is ignored. Imagine that holding an asset offshore brought a commercial benefit of 10, a UK tax reduction of 15 and a US tax reduction of 20. The question would be whether 10 (the commercial benefit) is a substantial proportion of 25 (the commercial benefit plus the UK tax benefit). “Substantial” is not defined in the draft legislation. No doubt HMRC will give its view in guidance.
noted above, however, property rental income is, and incidental non-trading finance income may be, excluded:

- **property rental income** – income from a UK or non-UK property rental business;
- **incidental non-trading finance income** – non-trading finance income:
  - which is incidental to a property rental business or a trade whose profits are fully excluded from the chargeable profits calculation, subject to conditions;\(^{19}\) or
  - (by way of safe harbour) which amounts to no more than 5% of the profits of a property rental business or a trade to the extent that the profits of the trade are excluded from the chargeable profits calculation.

If incidental non-trading finance income is not excluded, the finance company partial exemption may be available at Step 5 in the calculation of the CFC charge. This is discussed below and is likely to be important for non-financial groups.

**Trading or investment.** The focus on the distinction between trading and non-trading income – particularly for finance income – is new. Taxpayers will now have to consider whether a CFC is carrying on a trade or making investments – potentially a tricky line to draw, especially in the intra-group context.

**Solo consolidation**

We noted earlier that where a CFC is a subsidiary undertaking of a UK resident company and is the subject of a solo consolidation waiver under section BIPRU 2.1 of the FSA Handbook, none of the full exemptions apply. Solo consolidation is also a ground for including the CFC’s income in chargeable profits. The only exclusions available are for income from property rental or non-trading finance income incidental to a property rental business. Even these are unlikely to be relevant in practice.

**Trading finance income**

The specific grounds for inclusion applying only to trading finance income are that:

- the CFC’s income arises from the investment of *excess free capital*;
- if it carries on insurance business, the income arises from the investment of *excess free assets*; or
- if its main business is insurance business, the income is from *captive insurance business*.

**Excess free capital.** This is the excess of equity capital over what the CFC would have if it were not controlled by any person, so far as that excess is due directly or indirectly to capital contributions from UK resident persons.

**Excess free assets.** The CFC’s free assets are the difference between the value of its assets and the total of its loan capital and technical provisions. Its excess free assets are the excess of its free assets

\(^{19}\) There is a special rule for holding companies.
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over what it would have if it were not controlled by any person, so far as that excess is due directly or indirectly to capital contributions from UK resident persons.

Excess free capital and excess free assets: exclusions. HMRC will be given the power to make regulations excluding income arising from banking business or insurance business. No draft regulations have yet been published. It has been suggested that the regulations will simply provide a safe harbour capitalisation test.

Captive insurance. This ground for inclusion applies to the extent that:

- the CFC’s income arises from insurance contracts entered into with:
  - connected UK-corporation-tax-paying companies; or
  - UK residents, where the insurance relates to goods bought by or from those residents; and
- the insured has no significant reason for entering into the contract other than UK tax.

Non-trading finance income
The specific grounds for inclusion applying only to non-trading finance income are that:

- the funds invested to generate the income derive from capital investment from the UK; or
- the income is from loans made to an affiliate in the UK ("UK loans").

Capital investment from the UK includes amounts forming part of the CFC’s chargeable profits in any earlier period.

UK loans are only covered if it is reasonable to suppose that tax – which may be foreign as well as UK tax – is a main reason for making an “upstream” loan rather than a distribution (most obviously, paying the amount up as a dividend).

Exclusions. The exclusion for incidental non-trading finance income may be available. In addition, the finance company partial exemption may apply later on: see below.

FINANCE COMPANY PARTIAL EXEMPTION

Background
As first announced in the November 2010 consultation document, the government intends to introduce a finance company partial exemption ("FCPE") for income from lending by a CFC to non-UK group companies. When first mooted, this was to be a rule against “fat capitalisation”. The group would be treated broadly as if the CFC were capitalised by a minimum 1:3 mix of intra-group debt from the UK and equity. If a CFC were wholly equity-funded, 25% of its profits would be apportioned to its UK parent. This would give an effective UK corporation tax rate of 5.75% when the main rate comes down to 23%, from 1 April 2014. This partial exemption is a compromise. It reflects the lack of UK streaming or interest
allocation rules where a UK parent borrows to equity-fund a non-UK affiliate conducting group financing activity.20

Scope
As a general matter, the FCPE would apply only to a CFC’s income from lending to non-UK group companies, not upstream lending or deposits with third parties. The government had floated the idea of allowing the exemption to cover upstream loans in particular commercial situations, for example, where:

- there are temporary obstacles to payment of a dividend;
- the loan forms part of group treasury management policies; or
- the funds need to be loaned to comply with bank restrictions imposed by legal or regulatory requirements.

This appears to have been dropped. The draft includes an anti-avoidance rule aimed at arrangements to lend indirectly to third parties.

Insurance and banking. The government is concerned that it is difficult to separate monetary assets which support the trading operations of finance companies from those that support the capital structure of their business. It has now accepted that insurance and banking groups may benefit from the FCPE, with two reservations: those group members actually carrying on insurance and banking trades should not benefit from the FCPE; nor should loans to such companies. The government is considering further anti-avoidance rules.

Mixed finance and trading. As a general matter, the FCPE will apply to CFCs carrying out non-trading finance activities as part of a mix with trading activities. This includes treasury companies.

Local substance
To qualify for the FCPE, the CFC must have a business establishment in its territory of residence. As for the business premises condition for the trading exclusion, these must be occupied and used with a reasonable degree of permanence and be the place from which the CFC’s business is mainly carried on. In short, “brass plate” companies are ineligible.

Extent of reduction
The government recognises that businesses would like the FCPE to be easy to operate but also that multinational businesses tend to be complex. The consultation document outlined four design options. The government has gone for Option C: 25% of the chargeable non-trading finance profits of the CFC are to be apportioned. This takes the FCPE away from the original fat capitalisation concept: even if the CFC is funded 50:50 by equity and interest-bearing debt from the UK, there will be a 25% apportionment. (Of course, the interest payable on the debt will normally reduce the profits to be apportioned.)

20 The UK government decided not to introduce such a restriction with the dividend exemption. Instead, it brought in the UK’s worldwide debt cap rules, whose overall impact is more limited.
The government has been exploring whether there is a case for providing a full exemption for overseas finance income in certain situations and in what circumstances it might apply. It is now considering putting a further limit on the non-trading finance profits which are chargeable after applying the FCPE. These might be limited on a group-wide basis to the aggregate net borrowing costs of the UK members of the group.

TEMPORARY PERIOD EXEMPTION

Background
CFCs often come under the control of UK residents after a takeover or group reorganisation. In those circumstances the CFC is unlikely to have been used to divert profits from the UK. If it continues to operate in the same way after the change of control, it should still not be diverting profits from the UK.

Under the old regime, HMRC would sometimes give “period of grace” clearances in these circumstances on the basis of the motive test exemption. The interim improvements of Finance Act 2011 introduced a separate “temporary exemption” lasting up to three years. Anti-avoidance rules targeting changes in the CFC’s situation have the effect of making this a partial exemption.

Proposal
According to the June consultation document, the “temporary period exemption” would be similar in scope and structure to the Finance Act 2011 temporary exemption. Any “period of grace” clearances already given would continue to run for the time envisaged, as would any temporary exemptions under the Finance Act 2011.

The temporary period exemption has not yet been drafted. The government still intends to have it, but it is considering how the other changes it plans to make to the regime might alter its scope.

APPLICATION TO FOREIGN BRANCHES OF UK COMPANIES

Background
As well as interim improvements to the CFC regime, the Finance Act 2011 introduced an optional exemption for the profits of foreign branches of UK-resident companies. This included an “anti-diversion” rule – a mini-CFC regime with a small profits exemption and motive test exemption.

Proposal
The government intends to align the tax treatment of exempt foreign branches with that of foreign subsidiaries “as far as possible”. The draft legislation does not cover this. Whether branches will be dealt with through regulations or under the primary legislation to be released in January is not yet clear.

21 Technically, permanent establishments.
According to the June consultation document there would be some differences between the treatment of a branch and company. Changes to the proposals since then would affect the position, but it is worth recalling three of the points made then:

- the government envisaged that the low profits exemption would apply by reference to the profits of the branch, which would be calculated on a UK tax, rather than an accounting, basis;
- some tests, however, might be applied to the company as a whole; and
- the government was inclined not to extend the finance company partial exemption to branches.

Application of rules on connected UK companies
Several of the provisions in the draft code look at whether transactions involve UK residents connected with the CFC. These generally include the UK PEs of foreign-resident companies. Some exclude the foreign PEs of UK companies which have elected for the branch exemption, but some (in particular the conditions relating to supposedly UK-generated intellectual property) do not. It is not clear why.

CONCLUSIONS

Process

Detail. Although the draft legislation runs to over 100 sections, there is still detail to come. Outstanding points include:

- how the rules will apply to funds;
- drafting for branches;
- the capitalisation test safe harbours for banks and insurers;
- drafting for the temporary period exemption;
- whether the finance company partial exemption will be subject to more anti-avoidance rules;
- whether the finance company partial exemption will be extended;
- drafting to eliminate any economic double taxation following an apportionment where the UK participator receives taxable dividends from the CFC or disposes of the shares.

Timing. There remains a lot to do if the government is to keep to its timetable and enact the new regime in Finance Act 2012.

Pluses

Sophistication. The question of when profits are “artificially diverted” from the UK has bedevilled the consultation process. The draft legislation is another step towards a more nuanced approach. The exclusion of property rental business and potential for exclusions to apply to leasing will be helpful for taxpayers.

Pragmatism. The finance company partial exemption has been on the table for some time now, but it remains a pragmatic way of dealing with an asset as mobile as money where a UK-headed group
UK Controlled Foreign Company Reform

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conducts genuine offshore treasury and long-term financing operations. The government's willingness to consider extending the exemption is also encouraging.

**Flexibility.** The current system of full but narrow exemptions can impose an excessive penalty on some structures. Wider partial limitations offer UK-headed groups more scope to organise their businesses as they see fit.

**Certainty.** The current system of full exemptions creates a cliff-edge effect: getting the analysis wrong and losing an exemption has disproportionate consequences. The move to partial limitations where the effect is proportionate to the cause will reduce the consequences of uncertainty. The offer of safe harbours for “incidental” non-trading finance income and the capitalisation tests for banks and insurers removes a source of potential disputes.

**Minuses**

**Complexity.** The cost of all the good things has been complexity. The draft legislation is substantially more complex than the current regime and requires a number of quite subjective judgments. Where the government has felt the current regime is too friendly to taxpayers, it has fine-tuned the rules to redress the balance, adding complexity. Where it has wanted to be more generous, it has included detailed carve-outs so as not to give too much away, adding complexity. Targeted anti-avoidance rules have proliferated. The chargeable profits definition will mean that groups find themselves working through multiple exclusions for multiple income streams from a single CFC, sometimes even on an asset-by-asset basis.

**Uncertainty.** Transfer pricing is one of the least certain areas of tax law. The UK SPFs ground of inclusion in chargeable profits applies transfer pricing techniques, so it will be a recipe for uncertainty. (At least in the transfer pricing context it may not always matter whether a given asset is attributed to a PE or not, as long as the profits are split fairly. That is not true of the UK SPFs test.) The profusion of targeted anti-avoidance rules asking what are the CFC’s main purposes will also make it harder for taxpayers to be sure of their position. Finally, the distinction between trading and investment can blur at the margin.

**Real-time engagement with HMRC.** Taxpayers should be able to manage the uncertainties of the new regime by engaging with HMRC in real time. This carries its own issues.

**Compliance burden.** Complexity gives rise to compliance costs. So does applying transfer pricing techniques. This may be a particular issue for consumer goods businesses and other users of IP. To date, those formerly UK-headed groups which redomiciled out of the UK to escape the existing CFC rules have shown little sign of wanting to come back.

**Other points**

**EU compliance.** There was justified scepticism as to whether the new regime as proposed in the consultation document would comply with EU law. The draft legislation actually seems harder to
It is not clear what the government’s thinking is here: unlike the consultation document, the response document does not discuss the EU law position.

The consultation process. The process may be slow and tortuous, but one cannot fault the willingness of HM Treasury and HMRC to engage with business to get to a workable regime.

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22 Say that a UK company invests £100 million in an Irish subsidiary. The subsidiary is to invest in Irish debt securities. It has its own office and employs a full-time investment manager. All its activities are carried on in Ireland. How would the proposed CFC regime treat it? We will assume its profits are over the small profits thresholds, so those exemptions will not be available. None of the other exemptions will apply. Its profits are non-trading finance profits. It is capitalised from the UK. The exclusion for incidental non-trading finance profits will not be available. Nor will the finance company partial exemption. So an apportionment will need to be made. But what does EU law say? Following the Cadbury Schweppes judgment, this appears to be a clear breach of the right to freedom of establishment.

Preventing exempt overseas branches from using the finance company partial exemption may also be a restriction on freedom of establishment.
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### APPENDIX

**CHARGEABLE PROFITS: GROUNDS FOR INCLUSION & EXCLUSIONS BY INCOME TYPE; FINANCE COMPANY PARTIAL EXEMPTION**

<table>
<thead>
<tr>
<th><strong>Income Type</strong></th>
<th><strong>Grounds for Inclusion</strong></th>
<th><strong>Exclusions</strong></th>
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<tbody>
<tr>
<td><strong>Trading income</strong></td>
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<td></td>
</tr>
<tr>
<td>Banking income</td>
<td>Excess free capital</td>
<td>UK SPFs</td>
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<tr>
<td></td>
<td>Exclusion: banking business (not yet drafted)</td>
<td></td>
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<tr>
<td>Insurance income</td>
<td>Excess free capital or Excess free assets</td>
<td></td>
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<tr>
<td></td>
<td>Exclusion: insurance business (not yet drafted)</td>
<td></td>
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<tr>
<td></td>
<td>Captive insurance</td>
<td></td>
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<tr>
<td></td>
<td>Exclusion: non-UK-tax reason</td>
<td></td>
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<tr>
<td>Other finance income</td>
<td>Excess free capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>No exclusions available</td>
<td></td>
</tr>
<tr>
<td>Non-finance income</td>
<td>No additional ground for inclusion</td>
<td></td>
</tr>
<tr>
<td><strong>Non-trading income</strong></td>
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<td></td>
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<tr>
<td>Property income</td>
<td>Always excluded</td>
<td>Always excluded</td>
</tr>
<tr>
<td>Finance income (debt or taxable equity income)</td>
<td>Capital investment from UK</td>
<td>UK SPFs</td>
</tr>
<tr>
<td></td>
<td>Exclusion: incidental non-trading finance profits</td>
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<tr>
<td></td>
<td>(if related to property / fully exempt trade)</td>
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<td></td>
<td>Partial limitation: FCPE claim</td>
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<tr>
<td></td>
<td>Loans to UK affiliates</td>
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<tr>
<td></td>
<td>Exclusion: incidental non-trading finance profits</td>
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<tr>
<td></td>
<td>(if related to property / fully exempt trade)</td>
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<tr>
<td>Other non-trading income</td>
<td>No additional ground for inclusion</td>
<td>UK SPFs</td>
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<tr>
<td></td>
<td></td>
<td>Exclusions:</td>
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<tr>
<td></td>
<td></td>
<td>majority non-UK SPFs</td>
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<tr>
<td></td>
<td></td>
<td>substantial non-tax value</td>
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<td></td>
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<td>arm’s-length arrangements</td>
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</tbody>
</table>

Key: **Grounds for inclusion:** exclusions / finance company partial exemption; **type of income**

Note: the solo consolidation ground of inclusion and the exclusions applying to it are not shown.