



HM TREASURY



HM Revenue  
& Customs

# Consultation on Controlled Foreign Companies (CFC) reform

June 2011





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<b>Subject of this consultation</b>	The reform of the Controlled Foreign Companies (CFC) rules. This is a key reform needed to improve the UK's tax competitiveness whilst ensuring that the UK tax base is adequately protected.
<b>Scope of this consultation</b>	This consultation includes detailed proposals for how the new CFC regime will operate, including a Tax Impact Assessment.
<b>Who should read this</b>	Primarily large UK based multinational businesses, but any UK corporate with overseas subsidiaries or exempt foreign branches.
<b>Duration</b>	The consultation period for this document will run from 30 June 2011 to 22 September 2011.
<b>Enquiries</b>	For general enquiries regarding this consultation please contact Robert Edwards at HM Treasury on 020 7270 5276, or <a href="mailto:robert.edwards@hmtreasury.gsi.gov.uk">robert.edwards@hmtreasury.gsi.gov.uk</a> .
<b>How to respond</b>	<p>Responses to this consultation should be sent either by email to:</p> <p><a href="mailto:robert.edwards@hmtreasury.gsi.gov.uk">robert.edwards@hmtreasury.gsi.gov.uk</a></p> <p>or by post to:</p> <p>Jennifer Payne or Robert Edwards  Corporate Tax Team  HM Treasury  1 Horse Guards Road  London  SW1A 2HQ</p>
<b>Additional ways to be involved</b>	Please contact Robert Edwards (contact details above) if you would like to discuss your response.
<b>After the consultation</b>	Considering the responses to this consultation, the Government will develop the proposals further and publish draft legislation in Autumn 2011, ahead of introducing legislation in Finance Bill 2012.
<b>Getting to this stage</b>	This consultation document reflects joint work carried out by HM Treasury and HM Revenue & Customs.
<b>Previous engagement</b>	Formal consultation on the CFC reform was held on proposals published in November 2010 as part of the wider consultation on Corporate Tax Reform (please see Annex J for a summary of responses). These proposals have been developed to reflect the outcome of the extensive consultation with businesses and other interested parties.



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# Foreword

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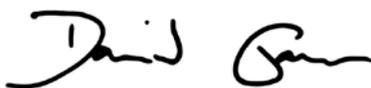
The Government's Plan for Growth<sup>1</sup> emphasises the importance of creating the right conditions for businesses to succeed, removing barriers that are preventing them from performing to their full potential. As part of this, the Government wants to create the most competitive tax system in the G20, in order to drive private sector growth.

This Government is taking action to ensure that the corporate tax regime is once again an asset for the UK. We want to attract business investment from all over the world to the UK and reverse the recent trend of businesses leaving the UK amid concerns over tax competitiveness.

In June 2010 and Budget 2011, the Government announced a series of reductions in the main rate of corporation tax, bringing it down to just 23 per cent by the end of this Parliament, as well as a substantial programme of reforms as set out in the Corporate Tax Road Map<sup>2</sup>. These reforms include significant changes to the UK's Controlled Foreign Companies (CFC) regime, to better reflect the way that businesses now operate in a globalised economy. CFC reform is a priority for our multinational businesses and a key step in the Government's plans to rebuild competitiveness.

The proposals in this document deliver on the promises made in the recent Budget and the Corporate Tax Road Map. We are committed to delivering a new CFC regime in Finance Bill 2012 that is both competitive for business and protects the UK tax base.

This document is more detailed than many comparable consultations as this is a very challenging area and we want to work with interested parties to get this reform right. The Government values these contributions and I urge interested parties to engage with these proposals so that we can work together to achieve the best result.



David Gauke

Exchequer Secretary to the Treasury

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<sup>1</sup> *The Plan for Growth*, HM Treasury and BIS, March 2011 ([http://cdn.hm-treasury.gov.uk/2011budget\\_growth.pdf](http://cdn.hm-treasury.gov.uk/2011budget_growth.pdf))

<sup>2</sup> *Corporate Tax Reform: Delivering a more competitive tax system*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_complete\\_document.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf))



# 1

## Introduction

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**1.1** At the Budget the Government published the Plan for Growth<sup>1</sup> and committed to creating the right conditions to encourage private sector investment and growth. A key ambition to help achieve this is to create the most competitive tax system in the G20. As well as lowering corporation tax rates, the Government wants to make the UK the best location for corporate headquarters in Europe.

**1.2** The Government has already taken significant steps towards achieving this. Firstly by announcing that the main rate of corporation tax will be reduced to 23 per cent by 2014 making it the lowest rate in the G7. And secondly by publishing a comprehensive Corporate Tax Road Map<sup>2</sup> that sets out the Government's plans and approach to reforming the corporate tax system over the coming years.

**1.3** Reform of the UK's Controlled Foreign Companies (CFC) rules is frequently identified by UK multinational businesses as a key priority needed to improve the UK's tax competitiveness. In common with other similar countries, the UK needs CFC rules to maintain sustainable corporate tax revenues by protecting against artificial diversion of profits to low tax jurisdictions, but there is scope for significant modernisation. In November the Government published proposals for new CFC rules to be introduced in Finance Bill 2012, and took the first step towards reforming the rules by introducing interim improvements in Finance Bill 2011.

**1.4** This document includes detailed proposals for how the new CFC regime will operate. It builds on the proposals included in the November consultation<sup>3</sup> and the interim improvements, to bring together the various changes into a modernised CFC regime. These proposals reflect outcomes from extensive consultation with business and other interested parties, including several working groups.

**1.5** All parties agree that it is challenging to design CFC rules that strike the right balance between delivering a more competitive tax system and protecting the UK tax base, and to ensure that the rules are suitable for all sectors and businesses. Consistent with its commitment to improve tax policy making, the Government has decided to publish as much detail as possible now to allow sufficient time to consult and ensure that these proposals will operate as intended ahead of publishing draft legislation in Autumn 2011.

### A more territorial tax system

**1.6** Globalisation has meant that the world's markets have become more open. As a result companies increasingly operate across national borders and UK businesses have become more internationally diverse. Against this background, to improve the competitiveness of the corporate tax system the UK tax base will focus more on taxing profits economically derived from UK activity, rather than from worldwide business. By making this change the Government

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<sup>1</sup> *The Plan for Growth*, HM Treasury and BIS, March 2011 ([http://cdn.hm-treasury.gov.uk/2011budget\\_growth.pdf](http://cdn.hm-treasury.gov.uk/2011budget_growth.pdf))

<sup>2</sup> *Corporate Tax Reform: Delivering a more competitive tax system*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_complete\\_document.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf))

<sup>3</sup> *Part 2A: Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

wants to encourage more businesses to be based in the UK and to ensure that UK businesses can compete more effectively with those located abroad.

**1.7** The Government wants to introduce a modernised CFC regime that fits with a move towards a more territorial corporate tax system and better reflects the way that businesses operate in a globalised economy. The current CFC rules were introduced in 1984 to support a corporate tax regime that operated on a worldwide basis; therefore significant change is needed.

## Why does the UK need a CFC regime?

**1.8** The UK needs rules to protect against artificial diversion of profits from the UK to low tax jurisdictions, in particular in the areas of monetary assets and intellectual property (IP) where the scope for such diversion is greatest.

**1.9** In the November consultation<sup>4</sup> the Government made clear that:

- protection of the UK tax base against risks concerning monetary assets must be provided through the CFC rules. This follows the Government's decision not to make fundamental changes to the UK's rules on interest deductibility, which was widely welcomed by business;<sup>5</sup> and
- CFC rules are needed to protect the UK tax base against risks associated with IP. Although transfer pricing rules and exit taxes help combat tax avoidance in this area, they cannot cover all aspects of artificial diversion of profits and would come under excessive pressure in the absence of CFC protection.<sup>6</sup>

**1.10** To address the majority of risks concerning monetary assets, and to give businesses greater freedom to manage overseas financing operations, Budget 2011 announced that a finance company partial exemption would be included in the new CFC regime. In most situations this will result in an effective UK corporation tax rate of 5.75 per cent on profits from intra-group financing by 2014. The Government is also considering whether there are limited circumstances where a full exemption may be appropriate for finance companies.

**1.11** Alongside the UK's dividend exemption, the introduction of a finance company partial exemption will form part of an internationally competitive corporate tax system in which businesses based here will have the flexibility to invest capital to meet commercial needs anywhere in the world, and future profits earned on that capital can generally be repatriated without a UK tax charge.

## Aims of new CFC regime

**1.12** The new CFC regime will:

- target and impose a CFC charge on artificially diverted UK profits, so that UK activity and profits are fairly taxed;
- exempt foreign profits where there is no artificial diversion of UK profits; and
- not tax profits arising from genuine economic activities undertaken offshore.

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<sup>4</sup> Part 2A: *Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

<sup>5</sup> Para 2.9, *Part 2A: Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

<sup>6</sup> Para 3.6, *Part 2A: Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

**1.13** The Government needs to ensure that a new CFC regime is introduced within the cost parameters set out at Budget 2011.<sup>7</sup> When considering representations made in response to this consultation, the overall impact on the cost of the reform as a whole will need to be considered.

**1.14** The new CFC rules must be compliant with EU law. In the interests of developing a stable regime and to inform the consultation process, Annex I includes a summary of the Government's understanding of the relevant ECJ case law in this area. To deliver a simpler CFC regime the Government proposes that the rules apply equally to entities resident in EU and non-EU jurisdictions. On 19 May 2011 the Government received a reasoned opinion from the European Commission in respect of the current CFC rules.<sup>8</sup>

## Contents of this document

**1.15** This document includes detailed proposals for how the new CFC regime will operate and covers:

- Chapter 2: An overview of the new CFC regime, including the underlying principles, approach and a summary of how the new rules will operate;
- Chapter 3: How a CFC will be defined;
- Chapters 4 to 7: The various exemptions proposed for the new regime;
- Chapter 8: How IP will be treated under the new rules;
- Chapter 9: How the protection provided by the new rules will apply to exempt foreign branches;
- Chapter 10: Next steps and engagement; and
- Annexes that include further details on a number of areas. Notably Annexes B and C include proposals on exemptions for the genuine overseas operations of insurance and banking businesses respectively.

## Consulting with business and other interested parties

**1.16** The consultation is being conducted in line with the principles outlined in the "Tax policy making: Consultation Framework" document.<sup>9</sup> This document sets out five stages for policy development and implementation:

- Stage 1 - Setting out objectives and identifying options;
- Stage 2 - Determining the best option and developing a framework for implementation including detailed policy design;
- Stage 3 - Drafting legislation to effect the proposed change;
- Stage 4 - Implementing and monitoring the change; and
- Stage 5 - Reviewing and evaluating the change.

**1.17** This consultation is taking place during Stage 2 of the process. The purpose of the consultation is to seek views on the policy options proposed and the likely impacts of implementing these proposals, to inform more detailed policy design and draft legislation.

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<sup>7</sup> *Budget 2011 Policy Costings*, HM Treasury, DWP and HMRC ([http://www.hm-treasury.gov.uk/2011budget\\_policycostings.htm](http://www.hm-treasury.gov.uk/2011budget_policycostings.htm))

<sup>8</sup> Press release from European Commission (<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/606&type=HTML>)

<sup>9</sup> *Tax policy making: Consultation Framework* ([http://www.hm-treasury.gov.uk/tax\\_policy\\_making\\_new\\_approach.htm](http://www.hm-treasury.gov.uk/tax_policy_making_new_approach.htm))

**1.18** It is important to gain a thorough understanding of the effects that these proposals could have. Behavioural responses are inherently difficult to assess in this area. The costing exercise to date has included testing assumptions about behavioural responses on business and other interested parties. As part of the ongoing consultation the cost of this reform will be further tested to ensure that the analysis is as robust as possible. The cost and impact are explored throughout the document and addressed directly in the tax impact assessment (Annex H).

**1.19** Annex J includes a summary of consultation responses to the CFC proposals published in November 2010.

## **Next steps**

**1.20** The Government invites responses to this consultation by 22 September 2011, and encourages earlier or staged responses where this is possible. Given the breadth of these proposals, the Government recognises that some businesses may wish to concentrate their responses on the areas or issues that are particularly relevant to them. This consultation will be focused on testing the proposals and options put forward, so that draft legislation can be prepared for publication in Autumn 2011 and legislated in Finance Bill 2012. Chapter 10 includes further details on the consultation approach in line with the overarching engagement strategy for corporate tax reform included in the Corporate Tax Road Map.<sup>10</sup>

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<sup>10</sup> Page 19, *Corporate Tax Reform: Delivering a more competitive tax system*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_complete\\_document.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf))

# 2

## Overview of Regime

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### Key points from Chapter 2

- The Government wants to introduce a modernised CFC regime that strikes the right balance between making the corporate tax system more competitive and providing adequate protection of the UK tax base.
- The new regime will be targeted at situations that pose the highest risk of artificial diversion of UK profits. The scope of the rules will be reduced where possible to reflect this and ensure that genuine foreign profits are exempt.
- The new rules will apply to individual entities and will adopt a proportionate approach. Where a CFC charge arises it will only apply to the proportion of profits that have been artificially diverted from the UK.
- The Government recognises that the majority of CFCs are held for genuine commercial reasons that do not pose a risk to the UK tax base. A number of exemptions are proposed to remove these CFCs from the regime.
- A new general purpose exemption is proposed as a flexible exemption for CFCs that can demonstrate that profits have not been artificially diverted from the UK. This effectively performs the same function as the motive test in the current rules, but there will be no default assumption that profits would have arisen in the UK.
- Incidental finance income that arises from the working capital of a business will be exempt and a finance company partial exemption will be introduced. It will no longer be possible to shelter large amounts of finance income from a CFC charge by the trading activity carried on by the CFC, a practice known as “swamping”.

**2.1** This chapter provides an overview of the Government’s proposals for the new CFC regime.

### Principles

**2.2** In pursuing CFC reform the Government has developed proposals that strike an appropriate balance between the principles set out in the Corporate Tax Road Map<sup>1</sup>:

- Maintaining a sustainable tax base. The primary aim of any CFC regime is to protect domestic corporate tax receipts. Under a more territorial approach, the UK’s new CFC rules will be targeted at artificial diversion of profits from the UK.
- Being aligned with modern business practice. The new regime needs to fit with current business models, recognising the need for different rules for certain sectors, and should minimise the impacts on commercial decisions. To achieve this, the rules need to be

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<sup>1</sup>Page 11, *Corporate Tax Reform: Delivering a more competitive tax system*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_complete\\_document.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_complete_document.pdf))

flexible and recognise that businesses can arrange their affairs in different ways. For example the new rules will recognise the significant increase in the centralisation of functions globally and regionally, and thus in intra-group transactions.

- Maintaining stability. The Government wants to design a stable CFC regime and avoid where possible the need to change the rules on an ongoing basis to address new avoidance risks. Discussions with businesses, in particular when designing the interim improvements, showed that targeted anti-avoidance rules (TAARs) can be helpful in both protecting the Exchequer and allowing specific rules to be more widely drawn than would otherwise be possible.
- Avoiding complexity. The aim is to make the rules as straightforward as possible to apply and to reduce compliance burdens where possible. To account for the diversity and complexity of modern business operations, and given the inherent complexities of the risks that a CFC regime is designed to protect against, there are limitations on how simple the new regime can be. In certain areas rather than targeting the regime precisely at artificially diverted UK profits, simple sets of tests or conditions have been proposed to make the rules easier to apply.
- Maintaining a level playing field for taxpayers. The Government wants the new CFC rules to maintain a level playing field across different businesses and sectors as far as possible. Without CFC rules there would be an unacceptable reduction in corporate tax revenues and groups that enter into tax motivated arrangements would gain an unfair advantage over other groups who are less inclined to test the boundaries of tax legislation.

## Approach

**2.3** The new rules will apply to individual entities and will adopt a proportionate approach.<sup>2</sup> A CFC charge will only arise on the proportion of overseas profits that have been artificially diverted from the UK. In consultation, businesses preferred this approach as it is relatively straightforward to apply and suitably targeted.

**2.4** This compares to (a) a purely income stream based approach that would have been complex and, having been previously consulted on in 2007, was not favoured by business; or (b) a purely entity based regime that, given the focus on taxing UK activity and UK profit, would not be appropriately targeted.

**2.5** The new CFC regime will operate in a similar way to the current regime by identifying lowly taxed foreign companies controlled from the UK and then providing a number of exemptions to remove CFCs from the regime that do not give rise to the artificial diversion of UK profits. This approach provides certainty to businesses that the majority of overseas operations will be outside the scope of the regime. The exemptions are being significantly modernised to reflect current business practice and to be refocused on the key areas of risk.

**2.6** Using an overall framework that works in a similar way to the current rules has a number of benefits welcomed during consultation: it minimises transitional costs; allows the current systems and processes to be used with minimal change; and allows businesses to adapt relatively quickly to how the new regime will operate.

## Application to foreign branches

**2.7** An opt-in exemption for foreign branches of UK companies will be introduced following Royal Assent of Finance Bill 2011. This will provide a more territorial approach to the taxation of

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<sup>2</sup> Box 1.A, Part 2A: *Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

branches and more closely aligns their tax treatment with that of foreign subsidiaries. It is proposed that an equivalent level of CFC protection will be provided for foreign subsidiaries and exempt foreign branches (further details in Chapter 9).

## Target

**2.8** The new regime will focus on CFCs that pose a high risk of being used to artificially divert UK profits. The high risk areas and the proposed approach for dealing with these are:

- Monetary Assets. Consultation to date has identified key risks that involve the artificial diversion of profits from the UK using monetary assets or financing arrangements. Given the move to a dividend exemption system and the decision to retain interest deductibility rules, which generally give tax relief irrespective of where the proceeds of the loan are put to use, there is a clear need to protect the UK tax base with CFC rules for certain overseas finance income.

Because money is generally fungible within a group, there may be an incentive to locate equity in low-tax jurisdictions in greater amounts than genuine commercial activities in that jurisdiction might otherwise justify. However, recognising the move towards a more territorial tax system, a finance company partial exemption will be introduced that will usually tax a quarter of overseas intra-group finance income (Chapter 6). In the case of interest arising on cash held on deposit with third parties that exceeds the working capital requirements of that business (situations sometimes referred to as “money boxes”), a full CFC charge is likely to arise.

- Intellectual property (IP). IP is a highly mobile asset class that can be relocated without a change in the underlying economic activity. CFC rules must ensure that profits derived from activity undertaken in the UK are taxed in the UK, while exempting profits that are attributable to foreign operations and foreign IP.

In consultation to date it has become clear that each situation concerning IP is different. The new CFC regime will be targeted at high risk situations where IP that has been developed in the UK is transferred to a low tax jurisdiction, and where IP is located in a low tax jurisdiction but significant amounts of activity to maintain and/or generate the value of that IP are undertaken in the UK. The proposals aim to exempt lower risk CFCs that hold IP. For higher risk situations a flexible exemption will need to be considered to determine whether the CFC profits have been artificially diverted from the UK.

The Government wants innovative activities to take place in the UK and is introducing a Patent Box to encourage companies to locate the high-value jobs and activity associated with the development, manufacture and exploitation of patents in the UK. The CFC proposals should not discourage genuine activity from being undertaken in the UK, such as sub-contracting of discrete functions. In line with this approach, the CFC proposals should not encourage or facilitate the export of IP from the UK where that results in the artificial diversion of UK profits.

- Other situations where profits and risks are not commensurate with economic activities. In a group, risk and associated profits can be artificially separated from the operations that give rise to them. As a result the profits of a CFC may not be commensurate with its activities.

For example, although captive insurance by non-insurance groups has the potential to offer some commercial benefits to the group, it can also be used to artificially divert UK profits. It should be noted that for captive insurance, as in other areas, the Government will not impose a CFC charge on foreign to foreign transactions where there is no artificial diversion of UK profits.

## Summary of how the new regime will operate

**2.9** The new regime will operate by applying the three-step approach described below.

**2.10** Step 1: Identifying CFCs. A CFC is a company that (a) is under UK control; (b) is resident outside the UK; and (c) has profits taxed at a lower effective rate than if it were resident in the UK (i.e. the lower level of tax test). Chapter 3 provides more details on these conditions.

**2.11** Step 2: Exempting CFCs that pose a low risk to the UK tax base. The majority of CFCs undertake genuine commercial activities that do not artificially divert profits from the UK and a number of exemptions have been designed to recognise these situations. A CFC can meet whichever exemption is most appropriate and there is no requirement to apply the exemptions in a specific order. A CFC may well qualify for more than one of the exemptions. In practice it is expected that the majority of CFCs will apply one of the more straightforward exemptions. This should minimise compliance burdens and deliver the most certain outcome. The proposed exemptions are:

- The Low Profits Exemption: designed to remove CFCs that make a low level of profits (Chapter 4);
- The Excluded Countries Exemption: designed to provide a proxy for the lower level of tax test to exempt CFCs that meet certain conditions and are located in jurisdictions with tax regimes that have broadly similar rates and bases to the UK (Chapter 4);
- A Temporary Period Exemption: this allows an exemption from the CFC rules for a period of up to three years where an overseas subsidiary comes within the scope of the CFC regime as a consequence of a reorganisation or change to UK ownership. A similar exemption was introduced as part of the interim improvements (Chapter 4);
- Territorial Business Exemptions (TBEs): designed to remove genuine overseas trading operations and foreign profits from the regime. A safe-harbour test is proposed to offer a simple route to remove overseas entities from the regime that have a relatively modest operating margin. It is proposed that amounts of incidental finance income that arise from the working capital needs of that business will also be exempt under the TBEs. As indicated at earlier stages of consultation,<sup>3</sup> it will no longer be possible for large amounts of finance income to be sheltered from a CFC charge by the trading activity carried on by the CFC, a practice known as “swamping” (Chapter 5). The TBE will also be available to CFCs that have income from property investment business and high value operating leases (Annex A);
- Finance company rules: this includes a finance company partial exemption (FCPE) that will apply to overseas financing. In most situations this will result in an effective UK corporation tax rate of 5.75 per cent on profits from overseas intra-group finance income by the year 2014. The Government is also considering whether there are limited circumstances where a full exemption may be appropriate (Chapter 6);
- A General Purpose Exemption: this is a flexible test that can be applied to a CFC that may not fit within one of the other exemptions, although any CFC can apply this exemption. The exemption will consider the facts and circumstances of that CFC to assess whether profits have been artificially diverted from the UK. Unlike the motive test in the current CFC regime there will be no default assumption that profits would have arisen in the UK

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<sup>3</sup> Para 2.15, *Part 2A: Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

(Chapter 7). This is the exemption that will need to be considered where CFCs have high-risk IP (Chapter 8); and

- Sector specific rules: for insurers and banks, where monetary assets are an intrinsic part of their trade, specific exemptions will be needed to remove their genuine overseas operations from the new rules (Annex B – Insurance exemption; Annex C – Banking exemption).

**2.12** Step 3: Calculating a CFC charge where profits have been artificially diverted from the UK. Where a CFC charge arises it will be proportional to the UK profits that have been artificially diverted. Genuine foreign profits are outside the scope of this regime, in line with a more territorial approach. The mechanics of the new CFC regime and the self assessment requirements will largely remain unchanged from the existing rules (Annex G).

## Other issues

**2.13** The Government considers the earliest date from which the new rules could become effective is for accounting periods beginning on or after the date when Finance Bill 2012 receives Royal Assent and would like to consult on the appropriate commencement date.

**2.14** Capital gains will remain outside the scope of the regime and subject to existing anti-avoidance provisions.

**2.15** As part of HMRC's administrative approach, as with the current rules, it is proposed that clearances can be provided on relevant aspects of the regime. A non-statutory clearance procedure would offer a more flexible approach and is the preferred Government option. The new CFC rules should also provide early certainty for business on most CFC issues given HMRC's increasing emphasis on real-time working, together with the non-statutory clearance procedures.

**Question 2A: Do the proposals overall strike the right balance to deliver a more competitive corporate tax system while providing adequate protection of the UK tax base?**

**Question 2B: Do you have any views on how the rules should be administered, and in particular how the clearance process could be improved?**



# 3

## Defining a Controlled Foreign Company

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### Key points from Chapter 3

- A CFC will be defined in a similar way as under the current regime.
- The Government wants to consider whether a principles-based approach could be used to define control to produce simpler rules that are effective and certain in their operation.
- The lower level of tax test threshold will remain at 75 per cent of the UK corporation tax that would have been suffered if the overseas company was resident in the UK. The reduction in the main UK corporate tax rate to 23 per cent by 2014 will in itself result in fewer companies falling within the regime.

**3.1** This chapter provides proposals for the three basic conditions that will apply to define a CFC: “controlled”, “foreign” and a lower level of tax test.

### Policy objective

**3.2** The objective of the basic conditions, as under the current rules, is to identify a foreign company that is directly or indirectly controlled by a UK person and, as a consequence of its residence outside the UK, pays less tax on its profits than it would if it was subject to UK tax. There is a need to define what is meant by “controlled” and “foreign” in this context. A third condition must also be considered to determine whether the company pays less tax than it would if it were resident in the UK, i.e. the lower level of tax test.

### Defining “controlled”

**3.3** The aim is to introduce a definition of control that is appropriately targeted and will prove resilient, providing certainty of scope for the new regime. The definition should determine that a foreign company is treated as controlled by the person or persons that control the economic rights over the assets or income of the company, whether through the ability to direct the affairs of the company or otherwise.

**3.4** The Government wants to consider whether alternative approaches to that taken by the existing CFC rules could produce simpler but effective rules which are sufficiently clear and certain in their operation. The Government will also consider whether a different approach could address some of the boundary issues from the use of partnerships, protected cell companies or similar structures, trusts and other entities.

### Design options

**3.5** Set out below are three alternative options to define control for the new CFC rules.

**3.6** Option A. Principles-based approach. The definition of control could be based on the principle that a person controls a company either directly or indirectly. If in substance, the person has economic rights or actual control over the assets or income of the company, whether through the power to control the affairs of the company or otherwise. A principles-based definition of this sort could provide a more effective and flexible solution to defining control, provided that its operation was sufficiently certain.

**3.7** Option B. Accounting standards approach. It would be possible to rely on the rules for group consolidation used for accounting purposes as they focus on the entitlement to economic benefits from the company and take a substance over form approach. A general rule might be if the financial results of an overseas company or entity are consolidated in the group accounts, then the control condition in relation to companies for the CFC regime is met. An approach like this is already used in the group mismatch rules. It should be noted that accounting standards change from time to time and therefore if this option was adopted careful consideration would have to be given to the need to recognise such changes.

**3.8** Option C. A more mechanical approach. Alternatively a test similar to the current CFC control definition could be retained by testing for control in terms of the ability to ensure, either directly or indirectly, that an overseas company's affairs are conducted in accordance with the wishes of a UK person. This would normally be through the holding of shares or the possession of voting powers or through rights or entitlement to rights over the majority of a CFC's income or assets.

**3.9** In all of these approaches it may be necessary to supplement the general rule with rules dealing with other entities, such as protected cell companies and joint venture companies. The principle based approaches (options A and B) may reduce the need for anti-avoidance protection of the sort likely to be required by the more mechanical approach (option C) and could therefore provide a more stable definition.

**3.10** It has also been highlighted in consultation to date that the operation of the existing control rules can result in a compliance issue for banks and financial institutions. The terms of loans provided need to be reviewed to determine whether they inadvertently result in the borrower being controlled for CFC purposes. This issue will be addressed as part of the new CFC rules.

**Question 3A: Which of the options for defining control would be preferable and why? Or would a combination be preferable?**

## Defining "foreign"

**3.11** Under the current rules, to be a foreign company for CFC purposes the company must be resident outside the UK. This will be determined by applying the generally established residence principles. The Government is not proposing to change this approach.

## Lower level of tax test

**3.12** The CFC regime should only apply where less tax is paid on a foreign company's profits than if those profits were subject to UK tax. The lower level of tax test will be retained to identify such situations. This can remove a significant number of overseas companies from the scope of the CFC rules.

**3.13** The lower level of tax test needs to be based on actual tax paid in the territory of residence, as headline rates often do not give an accurate guide to the effective rates of tax paid. To determine this it is necessary to identify the company's territory of residence for these purposes.

In general, a company is regarded as resident in a territory if it is liable to tax there by reason of domicile, residence or place of management. Additional rules are needed for companies that, for example, are not liable to tax or are dual resident. In general though it is thought that these definitions work well so the Government does not intend to make substantial changes to them.

**3.14** The Government intends to maintain the lower level of tax threshold at 75 per cent of the UK corporation tax that would have been suffered if the overseas company were resident in the UK. The reduction in the main UK corporate tax rate to 23 per cent by 2014 should automatically result in fewer companies falling within the regime, so that if foreign tax paid is greater than 17.25 per cent the CFC rules will not apply.

**3.15** Some businesses have suggested lowering the threshold to 50 per cent. This would be a significant relaxation in the protection provided by the CFC regime and would not be affordable.

### **Basis of test**

**3.16** During consultation, some have suggested that the lower level of tax test should apply by reference to accounting profits rather than a computation of UK taxable profits. Whilst an accounts based test may seem attractive from a compliance perspective, the adjustments needed to the accounting figure to ensure it is appropriate, and to protect against manipulation, would add significant complexity to the regime. As such the Government is not attracted to such an approach and would prefer to rely on the computation of UK taxable profits. However, the Government welcomes representations on how the computational rules could be simplified to reduce the compliance burden in applying this test.

**Question 3B: Are there other options for the calculation of the lower level of tax which would ensure that the UK measure of tax would broadly reflect the figure calculated under the existing rules? Can the chargeable profits approach be simplified?**

**3.17** The Government acknowledges that from a compliance perspective, it may be easier for a CFC to apply one of the other exemptions than to carry out the lower level of tax test. For example, the new excluded countries exemption (Chapter 4) is specifically designed to provide a simpler route to exempt CFCs that are not subject to a lower level of tax. As explained in Chapter 2, a CFC can apply whichever exemption it prefers and there will be no requirement to carry out the lower level of tax test first.

### **Other issues**

**3.18** Under the current CFC rules transparent entities, such as US Limited Liability Companies, that are used for genuine commercial reasons are unable to qualify for the exempt activities test or the excluded country regulations as they do not have a territory of residence for these purposes. It is proposed that under the new regime such entities can qualify for the new excluded countries exemption (Chapter 4) and the territorial business exemptions (Chapter 5).

**3.19** The Government is considering the treatment of treaty non-resident companies and the application of the new regime to a CFC which is potentially subject to a CFC charge in two territories due to dual residence.



# 4

## Low Profits, Excluded Countries and Temporary Period Exemptions

### Key points from Chapter 4

- The Government proposes different options for how the low profits exemption could operate to increase the number of CFCs that can qualify for this exemption.
- The Government recognises that an excluded countries exemption is an important part of the regime to remove CFCs that pose a low risk to the UK tax base and proposes different options for how this could operate.
- A temporary period exemption, similar to that introduced as part of the interim improvements, will form part of the new regime. This will offer a period of exemption of up to three years for foreign subsidiaries that come within the scope of the CFC rules as a result of third party acquisitions or group reorganisations.

**4.1** This chapter sets out proposals for three different exemptions: the low profits exemption; excluded countries exemption; and temporary period exemption.

### Low profits exemption

#### Policy objective

**4.2** In general CFCs with low levels of profit represent a low risk to the UK tax base. It is therefore proposed that a low profits exemption will apply to such entities.

**4.3** In Finance Bill 2011 the Government introduced an exemption to remove CFCs with profits of up to £200,000, using an accounts based measure. The Government wants to build on these changes and consider options that could increase the number of CFCs that can qualify for this exemption.

#### Design options

**4.4** The Government is considering three possible options for a new low profits exemption.

**4.5** Option A: Under this option the profits threshold would be the same for each CFC, irrespective of the size of the group. The Government is considering a threshold of £500,000 with a limit on investment income. For example, capping investment income at £50,000 or 10 per cent of total income.

**4.6** Option B: Under this option the threshold would increase in line with a measure of the group's size. This would allow larger groups to benefit from a higher threshold that is more proportionate to their circumstances and potential risks. For example, the threshold for each CFC in a group could be based on a percentage of total group turnover. Given the turnover of the largest groups, a very low percentage would be required, together with a lower limit of £200,000 that would be available to all CFCs and an upper limit of £1 million to limit the Exchequer cost. In considering this option, the Government will take into account the varied impact this would have across a range of businesses.

**4.7 Option C:** Retaining the £200,000 limit without any additional conditions would be the simplest option. However, representations from businesses have said that larger groups consider this limit to be too restrictive.

### Other issues

**4.8** It is proposed that the measure of profits for all options would be the accounting profit of the CFC subject to adjustments similar to those introduced for the new small profits exemption in Finance Bill 2011.

**4.9** In introducing the new accounts based small profits exemption in Finance Bill 2011, the existing de minimis exemption based on chargeable profits was retained to avoid disadvantaging some businesses that could be worse off after making this change. It would be possible, at the cost of more complexity, to retain both measures.

**4.10** It is also proposed that a targeted anti-avoidance rule would be included to protect against exploitation of the exemption, for example by fragmentation of profits.

**Question 4A: Which option for the low profits exemption is preferred? The Government would welcome views from groups on the options outlined, and the proportion of their CFCs that could potentially qualify under each option.**

**Question 4B: The Government would welcome views on the suggested percentage of group turnover for option B, including data on the proportion of CFCs which could potentially benefit from this approach.**

**Question 4C: The Government welcomes views from business about whether they would prefer a single accounts based exemption, or an option to apply a UK chargeable profits basis despite the anticipated additional compliance burden.**

## Excluded countries exemption

### Policy objective

**4.11** The excluded countries exemption aims to provide a proxy for the lower level of tax test by exempting CFCs that are located in jurisdictions with tax regimes that have broadly similar rates and bases to the UK. The Government recognises that an excluded countries exemption is an important part of the new regime to remove CFCs that pose a low risk to the UK tax base as straightforwardly as possible. This exemption will primarily be based on consideration of the CFC's territory of residence.

### Proposed approach

**4.12** The Government is considering whether it a reasonable starting condition to include a particular territory if its main rate of corporation tax or corporate income tax is no less than 75 per cent of the UK main rate.

**4.13** The Government is considering the following broad categories to determine the composition of the territories to be included in this exemption:

Category 1: Territories with corporate tax regimes sufficiently similar in terms of base and rate to the UK so that any CFC could be exempted without further conditions. It is expected that this category of territories would be small.

Category 2: Territories with generally acceptable corporate tax regimes where CFCs could be exempt, subject to some general conditions in relation to the CFC's income.

Category 3: Territories for which specific conditions would be required to take into account features of the tax regimes in those territories, potentially in addition to general conditions.

## General conditions

**4.14** The general conditions to be applied to the relevant territories under the new exemption would be related to the proportion of the CFC's total income that is derived from:

- income arising from transactions with the UK;
- investment income such as finance and royalty income; and
- branch income where a CFC in one territory has a branch in another territory whose income is subject to a lower tax charge.

**4.15** These conditions would effectively replace the non-local source income condition in the current rules.

**4.16** The limits to be applied to these conditions will be dependent on the likely Exchequer cost. The Government would like to consult on what the appropriate limits should be and on what basis they should be applied. For investment income, it may be appropriate to align this with the chosen definition of incidental finance income for the TBE (see paragraph 5.26).

**4.17** There is a clear interaction between the level of protection offered by the general conditions and the number and type of territories that can then be included on the new list.

## Specific conditions

**4.18** Specific conditions to be included for the relevant territories (the approach taken by part 2 of the current excluded countries regulations) would need to identify specific tax breaks. These could include whether overseas companies are subject to the full rate of corporation tax on their worldwide income; whether there are special rules or tax incentives for the treatment of finance income such as interest, royalties and similar receipts; and whether there are other tax incentives on offer such as extended tax holidays. Including specific conditions would add complexity and such a list would need to be updated regularly, introducing some uncertainty and HMRC resource costs.

## Design options

**4.19** The Government considers that the lead options for the structure of the new exemption are:

Option A: A single list with general conditions, exempting CFCs located in categories 1 and 2.

Option B: A two-part list with the first part consisting of territories within categories 1 and 2 that would be subject to general conditions; the second part consisting of category 3 territories that would be subject to territory specific conditions and potentially the general conditions. This would operate in a similar way to the current excluded countries regulations.

Option C: A three-part list that is a refinement of option B. No conditions would apply to category 1 territories; general conditions would apply to category 2 territories; and specific conditions, and potentially general conditions, would apply to category 3 territories.

**4.20** A short list with no conditions, exempting only CFCs in category 1 territories, would be the simplest option. However, only a small number of territories would be included on such a list, making the exemption very limited in scope, and the Government is not attracted to such an approach.

## Other issues

**4.21** There is a risk that this exemption could be exploited, for example via arrangements to circumvent the income limits for the general conditions, and the Government therefore proposes to include a targeted anti-avoidance rule.

**4.22** The current excluded countries regulations contain specific rules for banking and insurance which disregard certain non-local source income to the extent that it is integral to those trades and a similar approach will be required. The interaction of this exemption with the proposed exemptions to remove genuine overseas insurance and banking operations (Annex B and Annex C) requires further consideration and will be discussed in consultation.

**Question 4D: Which of the proposed options for an excluded countries exemption would be the easiest to operate and is preferred?**

**Question 4E: The Government welcomes views on what the appropriate limits should be for the general conditions set out in paragraph 4.14, and on what basis they should be applied.**

## Temporary period exemption following acquisitions and reorganisations

### Policy objective

**4.23** The Government proposes to provide a temporary period exemption for entities that are brought within the UK's CFC rules as a result of a commercial acquisition or certain group reorganisation. Such restructurings generally carry a low level of risk in terms of artificial diversion of profits from the UK.

### Design options

**4.24** The Government intends to include a temporary period exemption which is similar in scope and structure to the period of exemption introduced by Finance Bill 2011. This will offer an exemption for up to three years for potential CFCs which come under UK control as a result of third party acquisitions or group reorganisations. The exemption to be introduced in Finance Bill 2011 works by setting out general conditions in relation to the potential CFC, and a number of specific circumstances in which the exemption will apply. The exemption also includes anti-avoidance provisions.

### Transitional rules

**4.25** The transition from the current regime will require further consideration to ensure that any period of exemption granted under either the Finance Bill 2011 changes or the motive test will continue as expected. So, for example, an exempt period which is due to end on 31 December 2012 should still do so, irrespective of when the new regime comes into force.

**4.26** Retaining the current approach of offering motive test exemptions in relation to certain acquisitions will not be possible in the new regime, as the motive test will not be retained in its current form. The motive test "period of grace" approach is more limited in scope than the period of temporary exemption introduced by Finance Bill 2011 and so its removal is not expected to cause particular difficulties.

**Question 4F: Is the scope of the temporary period of exemption in Finance Bill 2011 sufficiently wide to cover the majority of commercial acquisitions and reorganisations?**

**Question 4G: Are the anti-avoidance rules (which focus on transactions with the UK) included in Finance Bill 2011 for the temporary period of exemption sufficiently well targeted?**

**Question 4H: Are specific rules needed to deal with circumstances where an overseas subsidiary is transferred from one UK group to another, for example a third party sale during a period of exemption?**



# 5

## Territorial Business and Sector Specific Exemptions

### Key points from Chapter 5

- Three territorial business exemptions (TBEs) are proposed to provide relatively straightforward exemptions for CFCs that undertake genuine commercial activities and do not pose a significant risk of artificial diversion of UK profits. They are:
  - Exemption 1: an exemption based on the CFC passing a profits rate safe harbour;
  - Exemption 2: an exemption for a CFC carrying on a manufacturing trade; and
  - Exemption 3: a more general exemption for a CFC carrying on commercial activities.
- Incidental finance income that arises from the working capital of that business will be exempt. Three different options are proposed for how this could be defined.
- As an alternative, or supplement to the mechanical TBEs, a principles-based approach is also being considered. The Government would welcome an early indication from interested parties as to whether such an approach should be adopted.
- Separate exemptions are proposed for CFCs engaged in insurance and banking.

**5.1** This chapter sets out proposals for three mechanical territorial business exemptions (TBEs) and explores an option to adopt a principles-based approach.

### Policy objective

**5.2** The TBEs aim to provide relatively straightforward exemptions for CFCs that undertake genuine commercial activities and do not pose a significant risk of artificial diversion of UK profits.

**5.3** These exemptions are designed to be flexible so that businesses can organise their overseas operations in a manner that best meets their commercial needs and to minimise the impact of the new CFC regime on commercial decisions. As part of a move towards a more territorial tax system, foreign to foreign intra-group transactions that do not pose a risk to the UK tax base will also be exempt.

**5.4** Incidental finance income that arises from the working capital needed for that business will be exempt under the TBEs. Three options are proposed for how this could be defined (see paragraph 5.26). The treatment of intra-group finance income in excess of this is discussed in Chapter 6 which deals with the finance company rules. It will no longer be possible to shelter large amounts of finance income from a CFC charge by the trading activity carried on by the CFC, a practice known as “swamping”.

**5.5** Activities outside the scope of the TBEs include investment activities, captive insurance, and IP exploitation where there is a significant risk of artificial diversion of UK profits. Where these situations arise the general purpose exemption (GPE) will be available to determine whether profits have been artificially diverted from the UK (Chapter 7).

**5.6** The Government recognises that for the insurance and banking sectors finance income forms an integral part of their trade. Separate sector specific rules are proposed and are described in Annexes B and C. Alternatively, it would be possible to include the insurance and banking rules as part of the TBEs rather than as separate exemptions, which could offer more flexibility for a CFC with mixed activities that included banking or insurance. Whilst the Government understands that insurance and banking activities are not generally combined with other trading activities in the same CFC, views on this alternative are invited.

**5.7** This chapter mainly focuses on proposals for TBEs which rely on a series of mechanical tests based on the characteristics of the CFC. These tests will operate by reference to a CFC's level of profitability, or to its activities and level of economic connection with the UK.

**5.8** An alternative approach could be to design a principles-based TBE (see paragraph 5.42). Previous experience suggests that producing effective principles-based legislation is likely to require significant input from businesses, advisers and the government. An early indication from interested parties as to whether such an approach offers sufficient advantages over the mechanical tests to make this additional investment worthwhile would be welcomed.

## **Mechanical TBEs**

**5.9** It is proposed that the mechanical TBEs would comprise three independent exemptions. A CFC would need to meet the conditions of only one of these to be exempt. A CFC could meet all three exemptions, but can rely on whichever is the simplest to apply in the circumstances.

Exemption 1: An exemption based on the CFC meeting a profits rate safe harbour.

Exemption 2: An exemption for a CFC carrying on a manufacturing trade.

Exemption 3: A more general exemption for a CFC carrying on commercial activities where there is a low risk of artificial diversion of profits from the UK.

## **Local management condition**

**5.10** It is proposed that there would be a local management condition for the TBEs. This would be met provided that the CFC is controlled and managed by sufficient staff of the necessary expertise and seniority. The CFC would, for instance, need to have the capacity to evaluate investment proposals, decide whether it is in the CFC's best interests to proceed and be capable of appointing, instructing and managing sub-contractors and other consultants to work on specific aspects of projects. One issue for consideration is the application of this condition to those CFCs managed by individuals who are not based in the CFC's territory, for example where genuine commercial activities are managed on a regional rather than local basis.

## **Exemption 1: For CFCs that satisfy a profits rate safe harbour**

**5.11** This exemption would apply to a CFC which makes a low level of profits by reference to its cost base. Such CFCs generally pose a low risk of artificial diversion of profits from the UK regardless of their activity. It is proposed to place no or minimal conditions on the CFC's activities and aim for a simpler local management condition.

**5.12** Exempting a CFC by reference to its rate of profit would limit the exemption to CFC's with relatively small amounts of investment income and so specific limits on investment income are unlikely to be needed. In determining the profits rate, dividend income that would be exempt if it were received by a UK company would be excluded.

**5.13** Consultation on the safe harbour introduced as part of the interim improvements in Finance Bill 2011 indicated that setting a single profit rate was simpler and generally preferred to introducing different sector specific rates. Designing a workable but effective profits rate is

dependent on what is included in the cost base. The Government is considering a safe harbour of 10 per cent of operating expenses, other than the cost of goods acquired for resale and related party business expenditure.

**Question 5A: Would the proposed safe harbour be effective at removing CFCs that make a low level of profit and pose a low risk to the UK tax base?**

**Question 5B: The Government invites views on the preferred basis and limit for this safe harbour, and is particularly interested in the impact of different rates and bases on the number of CFCs that would qualify for this exemption.**

**Question 5C: Are there specific situations where a different safe harbour could be useful?**

## **Exemption 2: For CFCs carrying on a manufacturing trade**

**5.14** Most manufacturing activity poses little risk of artificial diversion of profits from the UK. The Government therefore proposes to offer a second, relatively simple exemption for CFCs that are engaged in manufacturing. By applying this exemption, manufacturing CFCs could be exempted more easily than by applying the more detailed third TBE.

**5.15** The exemption would apply to a CFC that is not involved to any substantial degree in activities other than manufacturing and which met a local management condition. This exemption could apply regardless of the extent of its transactions with the UK and would permit incidental amounts of investment income, including finance and royalty income.

**5.16** Manufacturing activity often involves IP. To make the exemption as simple as possible to apply the aim would be to exempt manufacturing companies which use only “local IP” and which do not act as an IP hub. An IP hub that holds foreign IP that does not have a significant UK connection could be exempt under the third TBE, with the GPE applying in other cases.

**5.17** “Local IP” could be defined as IP:

- developed by the CFC's own staff allowing intra-group subcontracting up to, say, 50 per cent of the activity;
- developed by third parties that is integral to the CFC's trade; or
- acquired by, or licensed to, the CFC where the IP rights do not extend substantially beyond what is necessary for the CFC to carry out the manufacturing activities it undertakes in its territory.

**Question 5D: Would the proposed manufacturing TBE be useful to remove manufacturing CFCs from the rules? How many CFCs would it apply to?**

## **Exemption 3: General exemption for CFCs carrying on commercial activities**

**5.18** This general TBE aims to exempt CFCs that perform commercial activities where there is a low risk of artificial diversion of profits from the UK. It is proposed that this will apply to the following activities:

- trading and certain business activities between a CFC and other foreign companies (whether between connected or unconnected persons);

- trading and certain business activities between a CFC and UK persons (whether between connected or unconnected persons) where there is no arrangement in place to artificially divert profit from the UK; and
- trading activities relating to the exploitation of foreign IP which does not pose a significant risk to the UK tax base.

**5.19** As identified in paragraph 2.8, IP that has been transferred from the UK or IP that has a significant economic connection with the UK could pose a significant risk to the UK tax base. It is therefore proposed that activities that involve IP exploitation can apply this exemption provided that:

- no more than 50 per cent of the CFC's business expenditure relating to IP is with related parties in the UK and no more than 20 per cent of the CFC's gross income involving the exploitation of IP is from the UK; and
- the CFC does not perform activities that to a substantial extent relate to IP that has been transferred from the UK within a certain period. This means IP that has been transferred within the last 6 years, or transferred earlier than this if the transfer has given rise to an apportionment or other charge to UK within the last two years.

Further details relating to the proposed treatment of IP under the new CFC rules including consideration of transitional provisions are provided in Chapter 8.

**5.20** This exemption would include an establishment requirement and a local management condition. Incidental amounts of investment income would be exempt.

**Question 5E: If a CFC currently qualifies for the exempt activities test is it likely to qualify for this exemption? If not, why not? Please distinguish between the changes which address "swamping" and other aspects of the rules. If the failure is marginal or a minor adjustment to the TBEs would result in exemption please provide details.**

### Interaction with investment activities

**5.21** This TBE will exempt a CFC that undertakes a range of different activities, provided that it is not engaged to a substantial extent in certain investment activities. It is proposed to permit around 20 per cent of the CFC's business to consist of such activities, but without creating a cliff-edge or detailed rules to quantify the level of activity.

**5.22** The relevant activities would comprise:

- holding and managing shares and securities other than those of companies in the same group as the CFC. This would be defined to exclude intra-group finance companies as there is a specific exemption available (see Chapter 6); and
- leasing, other than certain types of property leasing and operating leasing of tangible assets.

**5.23** The treatment of certain property and leasing activities will be relaxed compared to the current rules. The Government proposes that activities which meet the conditions set out below will be exempt and not treated as relevant investment activities:

- leasing of property as part of a property investment business. A property investment business where the long-term rental of property is to unrelated tenants and the risks and rewards of the property ownership rest in the CFC will be exempt. This would simplify

the treatment of foreign property investment companies, including those held by property groups, insurance groups and similar; and

- operating leasing of tangible plant and machinery. Where UK capital allowances have not previously been claimed on the leased asset and the income from lease payments are not from a UK person such activity will be exempt. The identification rules for this activity could be simplified by setting a minimum value for individual assets of, say, £10 million, but the Government would welcome views on the consequences of not setting a minimum value.

More information on these proposals is provided in Annex A.

**Question 5F: Would setting a minimum value of assets leased under an operating lease at £10 million per asset provide a reasonable approach to identifying business activity for this purpose?**

### Other issues

**5.24** There are circumstances in which the allocation of risk to a CFC engaged in certain activities can pose a significant risk to the UK tax base. Where for example the CFC provides goods or services directly or indirectly to the UK, or where a high proportion of the costs of the activity are incurred in the UK, such arrangements have the potential to give rise to the artificial diversion of UK profits.

**5.25** One way to address this issue would be to introduce a TAAR so that these activities would be exempt unless the CFC is party to arrangements to artificially divert profit from the UK. An alternative would be to set limits for receipts from the UK or costs undertaken in the UK.

**Question 5G: The Government would be interested in views on how adequate protection of the UK tax base could be provided against such tax driven arrangements without introducing rules which would have a disproportionate effect on supply chains, procurement companies and intra-group service provisions.**

### Incidental finance income

**5.26** The TBEs aim to exempt finance income that is incidental. This will include the finance income arising on the CFC's short term working capital. The Government is considering how best to define incidental finance income for TBEs and for the new regime more generally. The Government is considering a number of alternative options for the definition of incidental finance income:

- Option A: A simple fixed percentage (10 per cent) of the CFC's profits using a profits measure such as earnings before interest, tax, depreciation and amortisation (EBITDA);
- Option B: A simple fixed percentage of the CFC's gross income. Given the need to contain the costs of this reform within the Budget 2011 estimate, the presumption is that the percentage would need to be set at a level which gave rise to Exchequer costs equivalent to the profits based measure in option A; or
- Option C: A definition which reflects the particular facts of the CFC's business. This would reflect that some types of business may need more short term working capital, therefore giving rise to more incidental finance income, than others. This approach

offers the potential of a flexible limit that better reflects the underlying business of the CFC, but would be less certain and more complex than the other options.

**5.27** Further options could consist of a combination of these options, such as a capped business specific definition, or the lower of a percentage of profits and a (different) percentage of gross income.

**5.28** This approach is not suitable for the insurance and banking sectors which will have separate rules (see below and Annex B and Annex C).

**Question 5H: The Government invites views on the options for defining incidental finance income set out above.**

## Incidental investment income

**5.29** To keep the TBEs as straightforward as possible a single condition could be applied to investment income that would cover finance, royalty and other investment income. Another option could be to offset a separate limit for non-finance investment income in addition to the condition for incidental finance income. The Government is interested in views on whether the proposed options for finance income could offer sufficient flexibility to also cover other types of investment income where they arise. If not, the Government welcomes views about what an appropriate level of non-finance investment income should be.

**Question 5I: The Government welcomes views on the preferred option to define incidental investment income more generally, and how that should interact with the incidental finance income definition.**

## Holding companies

**5.30** It is intended that holding companies which hold only trading companies, and which receive almost all of their income from within their territory of residence (i.e. local holding companies), will be exempt as part of the TBEs.

**5.31** More generally, the treatment of holding companies should follow from their activities. Those which only hold shares in group companies should be exempt where the dividends they receive would themselves be exempt from UK tax. The treatment of holding companies which carry on other activities will be determined by the nature of those other activities, so that a trading/holding company could be exempt, while the finance profits of a finance/holding company would fall within the finance company rules.

**Question 5J: Does the proposed treatment of holding companies raise any issues? Would an alternative approach to this be preferred and, if so, what would the advantages be?**

## Sector specific rules

**5.32** As set out above, separate rules for the insurance and banking sectors are proposed given the different role played by finance and similar income in these sectors (Annex B and Annex C).

**5.33** There are two specific risks to the UK tax base on which these rules will be focused: firstly the ease with which capital can be moved between entities and territories; and secondly the risk

of profits being artificially diverted from the UK where there are significant transactions with the UK.

## **Insurance business**

**5.34** The Government recognises the need to provide certainty to insurers on how the new CFC rules will operate to facilitate preparations for the introduction of the new EU wide Solvency II regime. The exemption should be consistent with a more territorial approach to the taxation of UK profits.

**5.35** It is proposed that the insurance exemption will:

- exempt profits arising from overseas insurance operations;
- exempt foreign to foreign intra-group insurance activity in line with a more territorial approach; and
- focus on design options for an updated gross trading receipts test based on the extent of connection with the UK, including a targeted and workable capitalisation test.

**5.36** Discussions on the design of the most practical form for these conditions are already underway and will continue as part of the consultation process. The proposals for the new insurance exemption assume that it will apply only to insurers that are part of an insurance group. Further work is needed to confirm whether this will be possible.

**5.37** Further details of the proposals are provided in Annex B.

## **Banking business**

**5.38** The banking exemption will exempt profits arising from genuine overseas banking operations and aims to improve the way artificial diversion of profits from the UK is targeted.

**5.39** The Government proposes that the banking exemption should include a capital test that is simple to apply, gives certainty to business and operates in a proportionate manner. The Government is proposing to improve, but maintain a similar approach to, the capital structure test in the current rules.

**5.40** The Government also proposes that the exemption for banking includes a test similar to the gross trading receipts test for banks contained in the current rules, but welcomes views on the structure of such a test.

**5.41** Further details of the proposals are provided in Annex C.

## **Principles-based approach**

**5.42** An alternative approach to using mechanical rules could be to exclude CFCs with low risk businesses by reference to a principles-based approach. This could be based on a rule that would not exempt a CFC's profits if they arose in whole, or in part, from arrangements where there has been a separation of risk and/or intangibles originating from the UK, therefore resulting in artificial diversion of UK profit.

**5.43** As with the more mechanical approach, the aim of a principles-based TBE would be to exempt CFCs that are unlikely to give rise to artificial diversion of profits from the UK. Although the underlying principle would be similar to the GPE, it would not replace the GPE. The aim would be to design a principles-based TBE that is more straightforward to use than the GPE. In cases where a principles-based TBE did not apply, the GPE would be available.

**5.44** The approach would not apply to finance income in excess of an incidental amount (the finance company rules would apply instead) and other investment income.

## Possible approach to designing a principles-based TBE

**5.45** The paragraphs below set out one way in which a principles-based TBE might be structured, but this will require detailed examination against a range of scenarios.

**5.46** If a CFC being tested under a principles-based condition is reporting profits that exceed a routine return on its activities, the explanation for this may be that the profits arise from intangibles owned, risk undertaken, or other value adding functions of the CFC.

**5.47** Applying this principle to identify profits artificially diverted from the UK could be achieved in the following way. Having identified the sources of non-routine profitability, the business would then identify the day-to-day active decision-makers and other value-adding functions associated with those sources. The greater the extent to which those day-to-day decision-makers and other value-adding functions are located in the UK, rather than in the CFC or elsewhere, the more likely that, given the full business structure and intra-group arrangements, profits have been artificially diverted from the UK.

**5.48** Given that the aim would be to produce rules that are generally simpler to use than the GPE, one option might be to take the costs of the day-to-day active decision makers and other staff performing non-routine functions and test whether the expense in the UK was greater than that in any other single territory. A test of this sort could form the basis for a threshold for this exemption. In terms of compliance burden, it would be helpful to know to what extent this sort of analysis is already undertaken for transfer pricing purposes.

**5.49** A principles-based element to the TBE offers the potential to produce shorter and better targeted legislation that remains effective even if business models and activities change in a way that a more mechanical option does not always do. However, this needs to be balanced against the resources required, and the timetable for the CFC legislation, together with the inherent challenges in designing principles-based legislation.

**5.50** The Government would be interested in early views on whether a principles-based approach, along the lines proposed or some alternative, would be attractive to business. Alternatively, the TBE could incorporate elements of both the mechanical approach and a principles bases approach. The Government welcomes views on this proposal.

**Question 5K: Could a principles-based approach to drafting the TBE offer an alternative to the more mechanical TBE proposals? The Government welcomes early views on this.**

**Question 5L: Is the proposed approach a reasonable starting point for drafting the exemption? Or would a different approach be preferred (please provide details)?**

**Question 5M: Alternatively would there be advantages in using both mechanical and principles-based approaches to design the TBEs?**

# 6

## Finance Company Rules

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### Key points on Chapter 6

- The Government will introduce a finance company partial exemption (FCPE) that, in most situations, will give rise to an effective UK corporation tax rate on profits from overseas intra-group financing of 5.75 per cent by the year 2014.
- Different design options are available for FCPE including a simple approach that may require restructuring of overseas finance arrangements and more flexible, but detailed, rules that can cater for more complex situations so minimising the need to restructure.
- The Government is considering the limited circumstances in which it could be appropriate to offer full exemption of a finance company's profits.

**6.1** This chapter sets out the Government's proposals to introduce finance company rules.

### Policy objective

**6.2** The Government stated in the November consultation that it did not intend to pursue significant changes to the UK's competitive regime for interest and that it would be necessary to use CFC rules to protect the UK tax base against the risk of artificial diversion of profits involving monetary assets.<sup>1</sup> The Government proposed a finance company partial exemption (FCPE) as a pragmatic and competitive approach which would give groups greater freedom to manage overseas financing operations while maintaining protection of the UK tax base.

**6.3** Budget 2011 announced that the exemption would operate by assuming that a debt:equity ratio of 1:3 applies to overseas intra-group financing companies. A partial exemption modelled on this assumption will, in most situations, give rise to an effective UK corporation tax rate on profits from overseas intra-group finance income of 5.75 per cent by the year 2014. This is on the basis that most finance companies are likely to be wholly equity funded.

**6.4** Multinational businesses prefer to manage their finances on a centralised or global basis to allow them to respond to the different needs of the group and to effectively manage the group's capital. The proposed rules for intra-group finance companies avoid the need for complex legislation to trace transactions or financial flows.

**6.5** The Government recognises that for banks and insurers, where to different extents monetary assets are an intrinsic part of their trade, different rules will be required. However, some businesses from these sectors have suggested that there is a case for applying finance company rules to structural lending within these groups and the Government will consider those views further during the consultation process.

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<sup>1</sup> Para 2.9, Part 2A: *Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

**6.6** This chapter sets out in more detail the possible design options for FCPE. Additionally the Government wishes to consider the limited circumstances in which a full exemption might be appropriate. This is covered in paragraph 6.27.

**6.7** The Government considers that the finance company rules should:

- provide a partial exemption for profits arising to a CFC from finance income from lending to overseas group companies;
- apply to overseas intra-group finance income that represents the structural surplus cash reinvested within a group to the extent that it exceeds amounts incidental to the CFC's business. Where intra-group finance income is incidental to a trade, it would be exempt under the territorial business exemptions (TBEs) or the general purpose exemption (GPE); and
- be as simple as possible to apply while recognising that businesses may prefer more detailed and flexible rules to provide greater freedom to manage their overseas finance operations.

**6.8** To provide adequate protection of the UK tax base, the Government proposes that FCPE will not apply in the following circumstances, when a full apportionment would normally arise:

- finance income arising on upstream loans to UK group entities (where this is in excess of incidental finance income). However, the Government is considering whether certain short-term loans could have a different treatment (see paragraph 6.30); and
- finance income earned from monies held on deposit with third parties (which is not incidental finance income).

**6.9** As set out in the November consultation a targeted anti avoidance rule (TAAR) will be included.<sup>2</sup> Situations where this might apply include artificial arrangements to include finance income from monies held on deposit with third parties in the partial exemption rules, when it should be subject to a full CFC charge. The Government wants to work with businesses and other interested parties to ensure that any TAAR is appropriately targeted.

### **How will the FCPE regime work?**

**6.10** As for the TBEs, to qualify for FCPE, the CFC must have a territory of residence and be established and locally managed in that territory (see paragraph 5.10). It would be expected that the management of monetary assets would include decision making relating to initiating and refinancing of intra-group loans, managing foreign exchange exposure and setting and enforcing terms and conditions of loan agreements. In setting the conditions for the FCPE the Government recognises that finance companies may not necessarily require significant substance in the form of employees located in the company's territory of residence, although this will depend on the level of activities being undertaken by the CFC.

**6.11** There are two possible approaches to applying the proposed FCPE: an imputation or an apportionment approach. An imputation approach would focus on the balance sheet of the CFC. To the extent that a CFC is excessively equity funded, it would deem the excess part of the equity of the CFC to be a loan from the UK. An appropriate interest rate would then need to be applied to the deemed loan to determine the amount of income that would be taxable in the UK for these purposes.

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<sup>2</sup> Para 2.14, Part 2A: *Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

**6.12** The Government has concluded that imputation would add complexity to the rules and create an additional compliance burden for businesses. It would for example be difficult to determine the debt to equity position of the CFC; the quantum of any deemed loan from the UK where loan balances fluctuate throughout the year; and an appropriate interest rate to apply to any deemed loan (particularly if the CFC provides intra-group finance in different currencies).

**6.13** The Government therefore proposes to adopt an apportionment approach that focuses on a CFC's profit and loss account. This approach would require the finance company to undertake a UK chargeable profits calculation or calculate its chargeable finance income, depending on the mechanics of the rules. This approach should be simpler and give a more suitable proxy for the amount that should be taxed in the UK compared to an imputation approach. Adopting an apportionment approach is also consistent with views expressed in the working group and from wider consultation. It will also automatically reflect fluctuations in loan balances, foreign exchange and interest rate movements during the period.

**6.14** Familiar concepts within the loan relationship and derivative contract rules will be used as far as possible to determine finance income or profits for these purposes. Finance income will also include income from finance leases.

## **Design options**

**6.15** The Government recognises that businesses would like the finance company rules to be easy to operate but during consultation the point was made that overseas finance structures of multinational businesses tend to be complex. For example they can involve arrangements with several CFCs and for those CFCs to undertake mixed trading, finance and/or holding activities.

**6.16** The Government has developed four different design options: the simplest option and three more flexible options. Views are invited from businesses on which option, or any alternative option, provides the most suitable solution. The Government acknowledges that some businesses may find the simplest model too restrictive and so has developed more flexible options that cater for complex overseas finance arrangements. But these will necessarily require more detailed rules.

### **The simplest option**

**6.17** The simplest approach would be to apply FCPE to wholly equity funded CFCs that only lend to other overseas group companies that are not themselves subject to a CFC apportionment (including not being subject to a partial apportionment under FCPE). This approach avoids the need for complex rules to deal, for example, with the treatment of debt funding of a finance company; the treatment of loans between multiple CFCs that are subject to finance company rules; and rules for where finance activity is held alongside other activities such as trading operations.

**6.18** Where this approach is applied, one quarter of the chargeable profits of the finance company would be subject to an apportionment to the UK. It is recognised that although this would give the simplest solution it would be inflexible and may require businesses to restructure their current finance arrangements to fit within the rules to take advantage of FCPE.

### **More flexible options**

**6.19** Following consultation with businesses, further options have been developed that illustrate how the finance company rules could account for more complex overseas financing operations and remove the need for groups to restructure current operations. Due to the nature of certain overseas financing arrangements that often involve multiple finance companies or different types of financing instruments (for example, interest free loans, profit participating loans and hybrid instruments), these options can be more complex. They aim to ensure that where finance

is provided between CFCs, the same finance income or profits are not subject to more than one UK tax charge and that the treatment of the finance instrument is symmetrical between the lender and borrower.

**6.20** These options are outlined in Annex D with illustrative case studies, and in summary are:

- Option A. Comprises a mechanical set of rules that focuses on chargeable finance income of the CFC. It seeks to make adjustments to reflect the finance income that should qualify for the regime and provides deductions for certain finance expenses. Where a finance company is appropriately debt funded, no apportionment will arise;
- Option B. Focuses on chargeable finance profits of the CFC. It allows a group to elect to disregard three quarters of intra-group finance income and three quarters of the corresponding finance expense in the borrower. As with option A, if a finance company is appropriately debt funded, no apportionment will arise; and
- Option C. This option seeks to apportion one quarter of chargeable finance profits of the CFC. The rules could be simpler to apply than option A or B, but this option will not accurately reflect the debt:equity ratio if the finance company is debt funded.

**6.21** Although these options will involve more detailed rules, where a business has simple finance arrangements these options should be relatively straight forward to apply.

**Question 6A: Do businesses prefer the simplest option, one of the more flexible options (as outlined in Annex D) or an alternative approach? Would the benefits of the simplest option outweigh the cost of any intra-group debt restructuring where required?**

## Credit for overseas tax suffered

**6.22** As under the current rules, credit for foreign tax paid in respect of the apportioned profits will be given. For FCPE the relief will be proportionate to the profits that are subject to tax in the UK. So if 25 per cent of an overseas company's intra-group finance income is subject to an apportionment to the UK, tax relief will be given in respect of 25 per cent of the overseas tax that would otherwise be creditable.

## Interaction with treasury management

**6.23** Profits of group treasury companies generally arise from the provision of treasury services, including cash pooling (rather than the structural lending provided by a finance company). This includes interest rate differentials on short term amounts borrowed and lent to other group companies (and related foreign exchange movements). These activities are unlikely to pose a risk to the UK tax base and the Government aims to exempt them under the GPE.

**6.24** Where treasury company activities are held alongside finance company activities in the same entity, it is recognised that identifying the profits from these two activities can be complex. The Government therefore considers that, for simplicity, the finance company rules should apply to this combined activity.

## Interaction with the general purpose exemption

**6.25** It will also be possible for businesses to demonstrate that some or all of the finance profits of a CFC are commensurate with its activity under the GPE so that the relevant proportion of profits would be exempt. In almost all cases it is expected that FCPE will exempt more profits of an equity funded finance company that makes its profits from intra-group lending, than applying the commensurate with activities component.

**6.26** The GPE would generally exempt the profits of a pure treasury company.

**Question 6B: Do businesses agree that the proposed treatment of companies that carry out both treasury and finance company activities is a satisfactory approach? If not, do businesses consider that it would be practical to separately identify the profits from treasury and finance activities?**

**Question 6C: Do businesses agree that applying the GPE to treasury companies is an appropriate approach to exempt them from the rules?**

## Full exemption

**6.27** The Government wants to explore whether there is a case for providing a full exemption for overseas finance income in certain situations.

**6.28** Circumstances in which full exemption might be appropriate could include where a group makes the substantial majority of its genuine commercial profits overseas, these profits are reinvested overseas and the UK members of the group have no net borrowing costs, whether as a consequence of having only limited economic presence in the UK or otherwise. An alternative might be where the CFC is funded in a particular way, for example by a rights issue.

**6.29** The Government wishes to consult on the circumstances in which a full exemption might apply, bearing in mind the need to deliver an affordable regime and not to discourage the location of additional activity in the UK.

**Question 6D: Bearing in mind the need to deliver an affordable regime, what circumstances and qualifying conditions should the Government consider when determining when a full exemption might apply?**

## Other issues

### Upstream loans

**6.30** It has previously been stated that that the FCPE proposal will not generally apply to intra-group finance income arising on loans to a UK connected party. However, it is recognised that it would be helpful if the rules could accommodate short-term loans made to the UK in particular commercial situations, for example:

- where there are temporary legal obstacles which prevent a CFC paying a dividend until after a certain time (for example, corporate law in certain jurisdictions only allows a final dividend to be paid once the financial statements have been approved for the year);
- as part of a group's wholly commercial treasury management policy (for example, cash pooling arrangements);
- to comply with bank restrictions imposed by legal or regulatory requirements; or
- where insufficient distributable reserves (for example, caused by an impairment) temporarily prevent the repatriation of funds by way of a dividend.

**6.31** The Government does not expect these situations to arise in a CFC set up solely to provide intra-group finance activity. The Government will consider including some flexibility to deal with these situations in other cases where they might exist, for example in a mixed activities company. Depending on the approach taken to define incidental finance income, the exempt amount should normally be sufficient to allow cash balances to be lent to the UK as part of the

CFC's commercial operations, but this may not be sufficient in all circumstances. One way of identifying short term loans might be to use the approach taken by the worldwide debt cap interest restriction.

**Question 6E: Do the circumstances above in which upstream loans can arise cover the majority of the instances where funds are lent to the UK for genuine commercial reasons?**

**Question 6F: Would using the worldwide debt cap approach to short term lending produce a workable solution to allow short term upstream loans in these circumstances while protecting the UK tax base?**

### Mixed activity companies

**6.32** The Government recognises that some overseas subsidiaries in a group have a dual purpose, encompassing trading activities and the management of funds that have accumulated over time. The Government received mixed views in response to the November consultation on whether the finance company rules should apply to mixed activities companies due to the potential computational difficulties.

**6.33** If the simplest option was adopted, intra-group finance activity in excess of an incidental level undertaken in a mixed activity company would need to be restructured to apply FCPE.

**6.34** In contrast the more flexible options could be designed to apply to intra-group finance income held in mixed activity companies. In a trading/finance company the trading profits would be exempt if it satisfies the TBE and intra-group finance income that exceeds an incidental amount would be subject to FCPE. Finance income earned from monies held on deposit with third parties above an incidental level is likely to be subject to a full UK tax charge.

**Question 6G: Based on the design options available, do you think that the finance company rules should apply to mixed activity companies, despite the added complexity? If so, what would be the most appropriate way to identify the profit arising from each activity?**

### Transitional rules

**6.35** The Government recognises that under the simplest option outlined in paragraph 6.17, businesses may need to restructure their current overseas finance arrangements. The same issue would arise if, to reduce complexity in the rules, the more flexible options do not apply to mixed activity companies. The Government would like to hear views from businesses on the practical difficulties that could arise if current intra-group debt had to be restructured, and the time required to undertake any restructuring. One option in such circumstance would be to include transitional rules to give time for any necessary restructuring. In considering the case for this, the affordability of any such rules would be a relevant factor.

**6.36** The Government would also like to hear of specific issues which would prevent businesses from restructuring their overseas financing activity to bring it within the new finance company rules on the basis of any of the options discussed, or specific cases where businesses consider the proposals would not deliver the policy objective.

**Question 6H: Would any practical issues arise if the design option chosen meant that intra-group debt had to be restructured? How long would it take to restructure such**

arrangements?

**Question 6I: What specific issues would prevent businesses from restructuring their overseas intra-group finance arrangements?**

### Interaction with arbitrage rules

**6.37** The Government recognises that businesses may structure their overseas intra-group financing using hybrid entities or instruments. In these circumstances, businesses would have to consider whether the arbitrage rules (Part 6 TIOPA 2010) applied.

**6.38** Where such arrangements are used in conjunction with a finance company, the facts and circumstances would need to be considered. However, the existence of a finance company subject to the FCPE in combination with a hybrid entity or instrument should not of itself make it more likely that the arbitrage provisions would apply. Businesses will be able to apply for an arbitrage clearance if required and additional examples will be included in HMRC guidance to cover the interaction with the finance company rules. The Government welcomes additional real life examples from businesses so that the interaction can be considered further.

**6.39** The introduction of FCPE should not of itself have an impact on the arbitrage position of current structures.

### Application of the finance company rules to branches

**6.40** During consultation, businesses have suggested extending the finance company rules to apply to exempt foreign branches of UK companies. The Government recognises that this could be useful for businesses, offering more flexibility in how they structure their overseas operations.

**6.41** However, initial discussions have highlighted some difficulties with how a finance branch exemption might work. Where a permanent establishment (PE) is recognised in the overseas territory, difficulties arise in determining the amount of finance income that would be attributable to the PE. Following Article 7 of the OECD Model treaty, profit from investment activity is allocated by reference not only to the ongoing management but potentially also to the location of the initial source of the income i.e. where the decision to invest was made. Typically, this is often at board level and for a branch of a UK resident company the board would be located in the UK.

**6.42** The Government considers that these difficulties may undermine the potential application of the finance company rules to finance branches and that businesses could have greater certainty on the tax treatment of its finance operations if they were carried out through a company.

**Question 6J: Would it be of benefit to consider the application of these rules to branches at this stage despite the practical difficulties and issues raised?**

### Insurance and banking

**6.43** As set out in the November consultation, it is not proposed to apply this regime to banking and insurance groups, as monetary assets to different extents are intrinsic to their trade. It is inherently difficult to try and separate monetary assets which support the trading operations of companies operating in these sectors from those that support the capital structure of the business. This complexity was a factor in the exclusion of regulated insurers and banks from the application of the worldwide debt cap rules.

**6.44** However, notwithstanding this concern some groups have proposed that there is a case for applying the finance company rules to structural lending within businesses in these sectors. The Government will consider this further.

**Question 6K: Should the finance company rules be extended to the insurance and/or banking sectors? If so, how will groups identify those finance costs and income that are not part of trading operations?**

**Question 6L: In what circumstances would insurers or banks envisage using the finance company rules if it were made available?**

**Question 6M: Given the risks to the UK tax base, what commercial factors would need to be considered to determine the extent to which an insurer or bank could borrow in the UK to fund capital offshore?**

# 7

## General Purpose Exemption

### Key points from Chapter 7

- The new regime will include a general purpose exemption (GPE) that effectively fulfils the same role as the motive test in the current rules and can be applied to a CFC to exempt profits that have not been artificially diverted from the UK.
- It is expected that the GPE will generally be relied upon in situations where other exemptions are not available, although any CFC can apply the GPE.
- The GPE will consider the facts and circumstances of that CFC to assess whether any profits have been artificially diverted from the UK.
- There will be no default assumption that profits received by a CFC would have arisen in the UK if the CFC did not exist.
- Where profits have been artificially diverted to a CFC, only the profits that have been diverted from the UK to avoid tax will be subject to an apportionment. Profits arising from genuine foreign to foreign business activity will be exempt.

**7.1** This chapter sets out the Governments proposals to introduce a general purpose exemption (GPE).

### Policy objective

**7.2** The Government proposes that the new CFC regime should have a GPE that will apply in any situation to determine whether, and if so to what extent, a CFC has been involved in the diversion of UK profits that is tax-driven and therefore artificial. It is expected that the GPE will generally be relied upon in situations where other exemptions are not available, in particular where the risk of artificial diversion of profits from the UK is high. However it will also be flexible enough to accommodate CFCs that marginally fail some of the other exemptions.

**7.3** The GPE is consistent with the policy objective of moving towards a more territorial regime and will be proportionate in that only profits artificially diverted from the UK will be apportioned. There will be no default assumption that profits would have arisen in the UK, and genuine foreign profits will not fall within the UK tax charge.

**7.4** The GPE provides a flexible exemption that can apply to any CFC, and effectively performs the same function that the motive test fulfils in the current rules. So although the GPE will work on a different basis to the motive test, it can be seen as fulfilling the same broad purpose.

**7.5** Profit from finance income may qualify for the GPE on the grounds that it is incidental to the business activity (see paragraph 5.26), or to the extent that the finance income is commensurate with the activity of the CFC (see paragraphs 7.24 to 7.26 below).

**7.6** The test will allow any CFC to demonstrate by reference to its own facts and circumstances that all or part of its profits should be exempt from apportionment, and guidance will be published to assist businesses in doing so. In situations where it is clear that no profits have

been artificially diverted from the UK it is expected that the GPE will be simple to apply and that an in depth analysis of the profits will not be required.

**7.7** Under the new CFC regime the exemptions will have equal precedence so it will be possible to self-assess by reference to the GPE alone, whether or not the CFC qualifies for other exemptions. Recognising that in complex situations businesses are likely to want certainty on how the GPE will operate, it is proposed that advance clearances will be available from HMRC. These will be based on the existing non-statutory procedure under which businesses will be able to seek HMRC's opinion on the application of the new test.

### How the GPE would operate

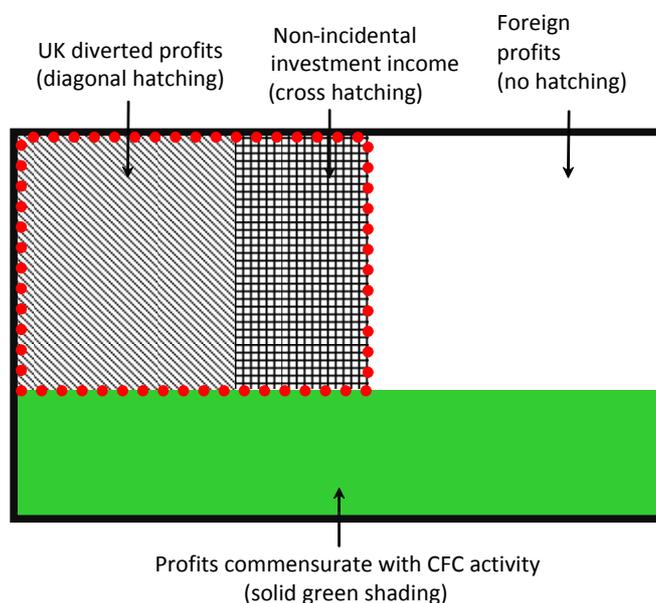
**7.8** As for the TBEs, in order to qualify for exemption under the GPE the CFC must have a territory of residence and be established there with sufficient local management.

**7.9** The GPE will exempt a CFC's profits to the extent that they are commensurate with the CFC's own activities and have not been diverted from the UK for tax purposes. It will also exempt profits in excess of this to the extent that they are not:

- diverted from a connected company in which they would otherwise have been subject to tax in the UK ("UK diverted profits"); or
- investment income that is not incidental to the CFC's activities (non-incidental finance income will be dealt with under the finance company rules).

**7.10** This is represented diagrammatically in Figure 1.

**Figure 1: Analysis of CFC's Profits**



**7.11** In Figure 1, the bold black rectangle encloses the total profits of the CFC, calculated using UK tax rules and after any transfer pricing adjustments and corresponding adjustments. The profits that would not be exempt under the GPE are enclosed by the red dots. It is possible that another exemption would provide a different amount of exempt profits; for example to the extent that the non-incidental investment income is intra-group finance income, those profits would be subject to FCPE (see Chapter 6) and so partially exempt.

**7.12** Profits that are “commensurate with CFC activity” are essentially those profits that would more likely than not accrue to the CFC if it was operating under “uncontrolled conditions”. Such conditions are those that would exist if the CFC was an independent entity and not a member of a group.

**7.13** The basis for calculating profits that are commensurate with CFC activity is not a mechanical test but requires an approach that examines the attribution of a CFC’s profits to its business activities and assets. The first step is to determine the assets (in particular intangible assets) and risks that the CFC would more likely than not own and bear under uncontrolled conditions. The profits that accrue to these assets and risks will be commensurate profits, together with the profits arising to the CFC in relation to the activities it actually performs, using the staff it employs and the tangible assets it uses in its territory. In the case of intra-group financing activities it is also necessary to consider the source of capital; this is discussed in paragraphs 7.24 to 7.26.

**7.14** Where a CFC’s existing and established staff perform sufficient day-to-day active decision-making and other core functions related to its assets and risks, then this is likely to be an indication that the associated profits arising in the CFC are those that would arise under uncontrolled conditions. There may be situations, for example where the transfer of staff forms part of the arrangements under which the assets and risks are themselves transferred, which may not have happened under uncontrolled conditions, where management by the CFC’s staff may not therefore necessarily be determinative. Where the decision-making and other core functions are performed by another group entity, it may be less likely that the assets and risks would be owned by the CFC under uncontrolled conditions.

**7.15** In assessing the likely ownership of assets and risk, one option would be to use principles based on those set out in Article 7 of the OECD Model Tax Convention and the 2010 Report on the Attribution of Profits to Permanent Establishments. The principles would be applied as if the CFC and any other group entity developing, managing or using the asset or risk were different parts of the same entity.

**7.16** Article 7 principles could also then be used to determine the amount of the profit that would be made by the CFC if it had the assets and risks thus attributed to it. These would establish the dealings the CFC would have with unrelated entities and price them accordingly.

**Question 7A: The Government welcomes views on applying principles based on those set out in Article 7 to apply the GPE, and any alternative methods for the calculation of “commensurate with activities” profits.**

**Question 7B: The Government welcomes views on the likely compliance impacts of adopting this approach, and any situation in which this attribution may significantly increase compliance burdens.**

**7.17** To reflect a more territorial approach to the taxation of UK company profits, the CFC rules will focus on profits that have been artificially diverted from the UK. The CFC’s profits in excess of those that are commensurate with its activities (its “excess profits”) may represent an artificial diversion of UK profits to the CFC. Profits that arise outside the UK should be outside the regime’s scope and those foreign profits (represented by the plain white area in Figure 1) will be exempt.

**7.18** To determine whether profits have been artificially diverted from the UK, the same approach described above in paragraphs 7.12 to 7.16 could be used. Indicators of profits that have been artificially diverted from the UK for tax purposes would include:

- transactional diversion – for example a transaction giving rise to a UK tax deduction that would not have arisen had the arrangements been at arm’s length; or
- diversion through the transfer of assets – for example the separation of an intangible asset (previously in the UK) from the active decision-making regarding the risks inherent in the ownership of the asset.

## Practical ways to calculate the amount to be apportioned

**7.19** Given the availability of other exemptions and as the CFC regime is intended to deter artificial diversion of UK profits, the Government expects that only in a minority of cases in which the GPE is applied will it be necessary to calculate a partial apportionment.

**7.20** In simple cases where there are no profits artificially diverted from the UK (for example, where under uncontrolled conditions the assets or risks owned by the CFC would be owned by non-UK members of the group and the CFC only has incidental finance income), it will not be necessary to calculate what profits are commensurate with the activities of the CFC as all the profits will be exempt.

**7.21** It may also be the case that all the profits of the CFC are commensurate with its activities, so there is no need to assess whether any have been diverted from the UK. So again all the CFC’s profits would be exempt.

**7.22** In more complex cases, the most practical way to calculate the profits that would be subject to a CFC charge might be as follows:

- start with the UK chargeable profits of the CFC, after any transfer pricing adjustments and corresponding adjustments;
- subtract the commensurate with activities profits to leave the excess profit;
- identify the part of the excess profits that has been artificially diverted from the UK (for IP transfers use the indicators set out in Annex E). These are the profits that are not exempt under the GPE and so will be apportioned to the UK; and
- identify any non-incidental finance income in the excess profit that can be considered under the finance company rules in Chapter 6.

**7.23** In determining the profits that are “commensurate with CFC activity” and whether there are any “excess profits” it may be helpful to look to identify profits that would most likely have arisen to a UK company absent the controlled arrangements. These profits might be identified by considering whether profits formerly earned by a UK person are now earned by the CFC.

**Question 7C: Does the GPE provide a suitable and effective replacement for the motive test that can be applied to any CFC to determine whether and to what extent profits have been artificially diverted from the UK?**

## CFCs with intra-group finance income

**7.24** The profits of a CFC that arise from intra-group financing which is not incidental to the business activities will be dealt with under the finance company rules. This is the case even if the CFC has other profits that are exempt under either the TBEs or GPE. As with the TBEs, any finance income that is incidental to profits earned on business activities that are exempt under the GPE will be wholly exempt. There is discussion on what constitutes incidental finance income at paragraph 5.26.

**7.25** However a CFC that undertakes a treasury or finance business can consider the extent to which its financing profits are commensurate with the activity carried on by it. As stated in paragraph 6.26 a pure treasury company should generally be exempt under the GPE as its profits are expected to be commensurate with its activities. For a finance company, profits from financing activity that are not commensurate with the CFC activities are profits that have been artificially diverted from the UK. In determining profits commensurate with activity, it is necessary to consider not only finance income, but also the interest cost arising from the provision of loan capital that would be associated with such businesses under uncontrolled conditions. In almost all cases it is expected that FCPE will exempt more profits of an equity funded financing CFC that makes its profits from intra-group lending, than by applying the commensurate with activities test to those profits.

**7.26** Non-incidentally finance income profits arising on monies invested with third parties cannot qualify under FCPE, but can be considered under the commensurate with activity test outlined above. Any such profits are likely to be subject to a full CFC charge.

### **Examples of how the GPE will apply**

**7.27** To provide more clarity around how the GPE will apply to different situations, some examples are provided below.

#### **Example A: UK sets up a CFC to provide intra-group services**

**7.28** A UK headed group sets up a CFC to provide sales services to group companies including UK subsidiaries. It buys from third parties and sells to group companies at differing margins depending on the territory it is selling into.

**7.29** A review of the arrangements shows that the CFC does not own any intangibles and the risks associated with the stock are borne by the acquiring group companies. The sales to the group companies are priced in line with the arm's length principle. All the profits are commensurate with the CFC's activities and the CFC has only incidental finance income. All the profits are therefore exempt.

#### **Example B: A UK company transfers IP to a CFC**

**7.30** A CFC is incorporated with a board comprising individuals who are knowledgeable and experienced in respect of the group's IP and meet quarterly to set parameters for the CFC's investment in IP.

**7.31** IP is transferred from a UK company to a CFC through a transfer that, although priced in accordance with the OECD's transfer pricing guidelines, would not have taken place (under the more likely than not consideration in paragraph 7.13) if the CFC had been an uncontrolled party. Prior to the transfer, substantial profits from the IP were generated by the UK company.

**7.32** Following the transfer the CFC uses the IP to generate substantial profits from related parties in the UK, which are subject to a low tax rate. But most of the group's substantial maintenance and development of the IP and the day-to-day active decision-making about the risks connected with the IP is retained in the UK although the UK is only remunerated as a service provider.

**7.33** In the circumstances described, under uncontrolled conditions the transfer would not have taken place and the IP together with the profits arising from its exploitation would have remained in the UK. There has therefore been an artificial diversion of profit from the UK that should be subject to a CFC apportionment. Assuming that the CFC does not have any transactions with other entities, the calculation of the artificially diverted UK profits will be the profits of the CFC less any profits that are commensurate with its activities.

### **Example C: UK sets up a CFC to undertake extended warranties business through a captive insurance company**

**7.34** A UK headed retail group sells extended warranties on goods to third parties in both the UK and Germany through subsidiaries that own stores in each territory. The insurance contracts entered into under these agreements are written by a CFC in a low tax territory. None of the profits made by the CFC over a particular three year period are distributed. The insurance liabilities remain stable over the period. Accumulated profits are retained in the CFC and invested in third parties. The value of investments now exceeds that required to operate the CFC's extended warranty business.

**7.35** In the UK the company selling the goods has self-assessed the transactions with the CFC as being at arm's length over the three years and the captive insurer's chargeable profits have been returned as nil under the GPE for the same period.

**7.36** A transfer pricing and GPE review finds that the provisions entered into between the captive insurer and the UK retail company are not at arm's length. The UK company has not been rewarded for facilitating the captive's easy access to the market. Accordingly a transfer pricing adjustment is made to the UK company's profits and a compensating adjustment claimed as a deduction in the CFC's chargeable profits.

**7.37** The activities performed by the staff working for the CFC and the investments required to operate the CFC's business will generate a profit. To the extent the profit is commensurate with the CFC's activities it will be exempt.

**7.38** The excess profits do not include any profits relating to the UK retailer's introduction service, as these will have been excluded by means of the compensating adjustment. The excess profits which would fall to the German retailer under competitive conditions will not be subject to tax in the UK as they do not reflect profits that have been artificially diverted from the UK (i.e. no apportionment will be made of profits arising on these German activities).

**7.39** This will leave only the finance income arising on investments that exceed those required for the warranty business, which are essentially the investments acquired from the retained earnings that would be unlikely to have arisen under uncontrolled conditions. As the finance income arises from monies held on deposit with third parties, they will not qualify for FCPE and will be apportioned to the UK.

### **Example D: UK banking group has a bank based in a low tax territory that fails the capital test**

**7.40** A CFC carrying on banking activities has tier 1 capital of 9 per cent, comprised solely of ordinary share capital and retained profits. It has tier 2 capital of 3 per cent in the form of subordinated debt. Its total capital is therefore 12 per cent of its risk weighted assets. This reflects a market premium on the minimum regulatory capital in its territory of residence and initially passes the capital test (see detail in Annex C).

**7.41** The bank's business is overwhelmingly the making of long term corporate loans to unconnected parties in two adjacent territories. Over a period of six months the credit worthiness of most of its clients in one of the territories is severely compromised as a result of a major natural disaster. The consequential economic difficulties spread to the other territory in which the bank operates.

**7.42** As a result the risk weighting of the bank's financial assets shifts drastically. To continue complying with local regulations and retain market confidence the bank's parent injects additional capital. Its tier one capital almost doubles and as a result it fails the proposed capital test and self-assesses under the GPE.

**7.43** In the circumstances described above the capital has been injected for commercial reasons by the UK parent to enable the bank to continue to operate under competitive conditions in its territory of residence. So long as local regulatory requirements and market sentiment continue to demand that the increased amount of capital be retained in the CFC, no apportionment of its profits will be made in respect of that capital as all the CFC's investments are commensurate to its activity.



# 8

## Treatment of Intellectual Property

### Key points from Chapter 8

- The territorial business exemptions (TBEs) are available to exempt CFCs involved in the exploitation of IP that do not pose a significant risk to the UK tax base and will exempt:
  1. IP income that is related to the holding and exploitation of foreign IP which has not been transferred from the UK, nor has significant economic connection with the UK;
  2. Local IP that is integral to a genuine overseas manufacturing trade; and
  3. IP royalty income that is incidental/ancillary to the trade.
- More complex cases that pose a higher risk of artificial diversion of UK profits, where IP has been recently transferred from the UK or the IP is effectively managed in the UK (and hence has a significant UK economic connection), will be dealt with by the general purpose exemption (GPE).

**8.1** This chapter brings together the proposals on the treatment of IP under the new CFC regime and covers the application of the previous material on the TBE and GPE to CFCs which undertake activities involving IP exploitation.

### Policy objective

**8.2** In line with a more territorial approach, the Government has committed to designing CFC rules for IP that will focus on taxing artificially diverted UK profit. The Government wants the CFC rules to work so as to protect the UK tax base without distorting or inhibiting the way in which groups manage their commercial operations overseas. The CFC rules should not facilitate or encourage the movement of IP out of the UK. The Government wants innovative activities to take place in the UK and is introducing a patent box to encourage companies to locate the high-value jobs and activity associated with the development, manufacture and exploitation of patents in the UK.

**8.3** CFC rules are needed to protect the UK tax base against risks associated with IP. Although transfer pricing rules and exit taxes help combat tax avoidance in this area, they cannot cover all aspects of artificial diversion of profits and would come under excessive pressure in the absence of CFC protection.<sup>1</sup>

**8.4** Following discussions with business and other interested parties since the publication of the November consultation, a two-step approach to identifying IP profits which have been artificially diverted from the UK has been developed. IP activity that does not pose a significant risk to the UK tax base will be exempted through the TBEs. The other exemptions will also apply to

<sup>1</sup> Para 3.6, Part 2A: *Controlled Foreign Companies reform*, November 2010 ([http://www.hm-treasury.gov.uk/d/corporate\\_tax\\_reform\\_part2a\\_cfc\\_reform.pdf](http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part2a_cfc_reform.pdf))

qualifying CFCs with IP activities. More complex cases that pose a high risk of artificial diversion of UK profits will be dealt with by the GPE. The remainder of this chapter covers the way that the TBE and GPE will apply.

**8.5** The TBEs aim to exempt CFCs with activities that are unlikely to give rise to artificial UK profits diversion. Instead the CFC rules will be targeted at CFCs where the exploitation of UK derived IP or the nature of continuing UK involvement leads to greater potential for artificial diversion of UK profits. These are where:

- IP that has been developed in the UK is transferred to a low tax jurisdiction;
- IP held offshore is actively managed or developed in, or from, the UK. This would not include all situations where there is UK involvement - for example where there is substantial activity (say clinical trials, or other repetitive testing) performed in the UK but day-to-day co-ordination of, and detailed decision-making regarding, the overall development of the product is performed outside of the UK; and
- an equity funded CFC invests in IP that is held offshore as an investment.

## The exemptions

**8.6** Based on the objectives set out above, the aim is to exempt the following activities under the TBEs:

- IP income that is related to the holding and exploitation of foreign IP which has not been transferred from the UK, nor has significant economic connection with the UK;
- local IP that is integral to a genuine overseas manufacturing trade (as discussed at paragraph 5.16); and
- IP royalty income that is incidental or ancillary to the CFC's trade (see paragraph 5.29).

**8.7** The proposed TBEs will generally not apply in the following high risk situations, where the GPE will need to be considered:

- the CFC is engaged to a substantial extent in activities relating to the exploitation of IP which has been transferred from the UK within the last 6 years, or before this if the transfer has given rise to an apportionment or other charge to UK tax within the last two years (see paragraph 5.19);
- the CFC exploits IP and more than 50 per cent of the CFC's business expenditure relating to IP is with related parties in the UK or more than 20 per cent of the CFC's gross income involving the exploitation of IP is from the UK (see paragraph 5.19); or
- where more than incidental amounts of the CFC's gross income are attributable to the passive ownership of IP; these situations are sometimes referred to as IP money boxes. This is discussed in greater detail in paragraph 8.11.

**8.8** In this chapter the term "transfer" is used in a broad sense and is not limited to disposal but instead encompasses all arrangements that can lead to IP rights being held outside the UK despite an original association with the UK. This may include, for example, the granting of a licence, the creation of new IP that owes much of its value to an existing UK asset or the creation of IP through sub-contracted R&D, marketing, etc. However, licensing IP on a limited basis to a manufacturer should not prevent it obtaining the TBE. Nor should the grant of a sub-licence which is territorially restricted to the CFC's territory.

**Question 8A: The Government welcomes views on ways to distinguish high risk from low risk licensing for the purposes of defining the term “transfer”.**

**8.9** Where IP has been transferred from the UK, profit attributable to the mere holding of the IP will not generally be exempted by the TBEs. Instead, the GPE will need to be considered to determine whether a relocation of IP is a tax driven artificial diversion of UK profits (see Chapter 7). In determining the intangibles allocated to the CFC it will be necessary to consider whether the transfer would have taken place between independent persons under competitive conditions and whether the profits are commensurate with the activity of the CFC. Factors that may be taken into account to determine whether the transfer is tax driven, and so results in artificial diversion of UK profits, have been discussed with business during consultation and are included in Annex E.

**Question 8B: The Government welcomes views on the indicators described in Annex E that may indicate whether a transfer of IP has given rise to an artificial diversion of UK profits or not, and whether inclusion of such indicators in guidance would be helpful in assisting with interpretation of the CFC rules as they relate to IP.**

**8.10** Detailed guidance will be published to enable businesses to self-assess under the GPE. However, there will be situations with complex fact patterns where the application of the GPE requires a greater degree of judgement. As with the current CFC regime the Government will provide a non statutory clearance mechanism under which business will be able to seek certainty as to the application of the GPE to their specific circumstances. Any clearance would be subject to the same general conditions as current clearances.

## **IP money boxes**

**8.11** Consultation to date has indicated that IP is not generally held as a passive investment such that the income would take the form of “pure income profit” as active management is normally required to maintain or enhance the IP’s value. But where a CFC holds IP as an investment in this way, and more than an incidental amount of the CFC’s profits consists of investment income, then it is intended that a CFC charge should arise on the excess. This apportionment would be calculated as described in Chapter 7. The Government therefore expects that the IP money box rules should not have wide application, acting primarily as a deterrent.

**Question 8C: The Government welcomes views on whether the above proposals are appropriate to deal with CFCs where IP is held as a passive investment.**

**Questions 8D: Is the pure income profit approach to determining whether IP is held as an investment workable?**

## **Tapering charge for IP**

**8.12** Whilst the initial transfer of IP to a low tax jurisdiction may have been tax driven and resulted in the artificial diversion of UK profits, the argument has been made that if enough related activity subsequently migrates to the CFC, the proportion of profits artificially diverted from the UK will reduce over time.

**8.13** Whether this is an appropriate analysis for a CFC will depend on factors such as the nature of the IP, the type of business activities being undertaken by the CFC and the company from which the IP has been transferred. Where the facts are consistent with this, it could provide a

context for applying the GPE in determining the amount of any CFC charge. For example the CFC charge could be based on a reducing percentage of the CFC's profits, starting at 100 per cent in the year of transfer and reducing to zero over say ten years.

**8.14** During earlier consultation it was suggested that this model, which is sometimes referred to as "wither on the vine", could be used as part of a mechanical rule for determining the amount of any CFC charge. To protect the tax base any such rules would need to be tightly drawn. Relevant conditions might be a high proportion of active IP management and development in the CFC after transfer, together with limited economic connection with the UK after transfer.

**8.15** While such an approach could be relatively simple to apply, it would not be appropriate in all cases. Even in a case where the general conditions were met, the issue of the right taper rate would arise. For example, the simplest and most pragmatic solution of using a fixed rate may not align with a CFC's fact pattern. The Government is not convinced that the limited scope of a mechanical tapering rule merits the additional complexity but is interested to receive views on this.

**Question 8E: Is there a case for the tapering charge? Are there sufficient instances to which a tapering charge could fairly be applied to justify the additional rules that would be needed?**

## **Interaction with tax paid on transfer of UK IP**

**8.16** Where a CFC makes a payment for the transfer of IP that is revenue in nature, such as a royalty, it is generally deductible in the CFC. Where transfer pricing adjustments are made to increase the amounts taxable in the UK in relation to such transactions, compensating adjustments will continue to be available to reduce the CFC's chargeable profits. There should therefore be no risk of double taxation as a result of such payments.

**8.17** In addition to the interaction with transfer pricing rules, the CFC rules may interact with the UK's capital gains rules. For example, where a CFC purchases IP from a UK company as part of an arrangement that would not take place under competitive conditions, there may be a chargeable gain on the transferor and a CFC charge on the CFC's profits. During consultation it has been suggested that in these circumstances there is a risk of economic double taxation.

**8.18** The extent of any economic double taxation will depend on the particular circumstances. The Government is interested in learning of examples in which businesses have paid tax on IP transfers from the UK and whether these are sufficiently frequent to merit the additional complexity that relieving rules would introduce. Subject to this, the Government is considering two possible options to provide a measure of relief.

### **Option 1 – Relief for amortised tax charge on disposal**

**8.19** The first option would be to allow, on an elective basis, a credit for corporation tax paid on disposal of IP to a CFC against subsequent CFC charges that arise in respect of that IP. The amount of credit would correspond to the CFC charge on profits artificially diverted from the UK, and would be spread over a period of years, rather than being given as a single sum in the first year following transfer.

**8.20** The simplest approach would be to limit credit to tax paid as a direct consequence of the IP disposal. The appropriate amount of credit would be deducted from the CFC charge on the amount of profits apportioned to the UK company.

**8.21** In cases where the tax charge is deferred, or losses are used to reduce the charge, it would be possible in theory to offer a credit as the related tax charge crystallised in future accounting periods, but the rules for this aspect of the relief would be complex and the Government is not attracted to such an approach.

**8.22** It would be necessary to set a suitable rate of amortisation. One option would be to amortise the tax charge over the shorter of ten years and, in the cases of IP rights such as patents with a fixed duration, the remaining legal life of the asset.

### **Option 2 – Tax charge on disposal set aside**

**8.23** A second option would be to exempt a UK company from the tax charge that would otherwise arise on its disposal of IP to a CFC in circumstances where, by electing to “switch off” the GPE and other exemptions, the CFC would be subject to a CFC charge on the profits from the IP.

**8.24** To enable the CFC to benefit from appropriate exemptions in the future, the election could be revocable on terms such that the taxable nature of the disposal previously relieved would be reinstated, but with the charge based on the market value of the asset at the time of revocation rather than transfer. So a group could choose to revoke the election at a time that it considered that the CFC would qualify for an exemption in respect of the transferred IP.

**Question 8F: The Government invites views on these proposals and whether in practice tax is paid on IP transfers sufficiently frequently to merit the additional complexity that relieving rules would introduce.**

### **Illustrative examples**

**8.25** In order to assist with the next stage of consultation a number of examples have been provided in Annex F together with a preliminary analysis of the possible outcome when the new CFC rules for IP are applied to the facts and circumstances described.

**Question 8G: The Government welcomes comments on the examples in Annex F and analysis provided, and would also welcome any other practical examples which might assist with the development of the CFC rules for IP during the next stage of consultation.**

### **Transitional provisions**

**8.26** It is proposed that the TBE will not apply to CFCs to which IP has been transferred from the UK during the preceding six years. Whilst the GPE will be available for such CFCs, the possibility has been raised in consultation that this rule should be subject to transitional provisions to take account of design differences between the current and proposed rules for IP. The Government wants to consider this carefully to ensure that the transition from the current to the new rules for IP does not create significant difficulties for business.

**Question 8H: The Government welcomes views on an appropriate transitional provision, setting out its purpose and justification.**



# 9

## Foreign Branches

### Key points from Chapter 9

- The Government intends the CFC rules, as far as possible, to apply equally to exempt branches of UK companies and foreign subsidiaries. However, differences between these operating models necessitate some variations.
- The regime will apply to all exempt foreign branches of UK companies with profits taxed at a lower effective rate than if they were resident in the UK.
- In Finance Bill 2012 the anti-diversion rule in the current branch exemption legislation will be repealed and the new CFC rules will be applied to branches and subsidiaries.

**9.1** This chapter provides details of how the CFC definition and exemptions will apply to exempt foreign branches.

### Policy aim

**9.2** In Finance Bill 2011 the Government is introducing an opt-in exemption for the taxation of foreign branches of UK companies. This forms part of the Government's aim to attract and retain private sector investment in the UK, by delivering a more competitive tax system.

**9.3** CFC reform will align the tax treatment of exempt foreign branches with that of foreign subsidiaries as far as possible. This alignment and the application of the rules below refer only to branches of UK companies which have opted into branch exemption. Where a CFC itself has a branch or branches it will be treated as a single entity unless specific provisions are made.

### Mechanical approach

**9.4** Foreign branches are subject to UK tax, unless exemption is given, whereas foreign subsidiaries are usually not subject to UK tax, unless there is a CFC apportionment. Therefore, achieving alignment of outcomes necessitates a different mechanical approach. When a company elects into exemption:

- it will consider whether any of its branches are subject to a lower level of tax;
- it will consider whether those branches meet any of the CFC exemptions;
- if a CFC exemption is met, profits remain exempt; or
- if no CFC exemption is met, the branch profits, or an appropriate proportion of those profits, will remain chargeable to UK tax.

**9.5** Credit relief will be available for any foreign tax paid on profits which are subject to UK tax.

## Defining a 'controlled foreign branch'

9.6 The new CFC regime will apply to all foreign branches of any UK company which has opted into exemption. Regardless of the approach that is adopted, all branches will be considered to be 'controlled' from the UK, on the basis that their results are captured in the accounts of a UK company and 'foreign' and 'resident', on the basis that they are a permanent establishment (PE) in a foreign tax jurisdiction. Conditions of residence for any of the CFC exemptions will be deemed to be met by exempt branches.

9.7 A number of the exemptions, including the TBEs and GPE, also have local management conditions (see paragraph 5.10). The Government would welcome views on whether this would be met by all branches carrying out those activities expected to be exempt.

**Question 9A: Is the local management requirement proposed for the CFC regime appropriate for foreign branches?**

9.8 The lower level of tax test is being retained to remove a significant number of overseas companies from the scope of the CFC rules. The preferred option is that companies subject to a lower level of tax are identified using a UK chargeable profits computation. Branches are already required to compute a UK chargeable profits computation and therefore this will not represent an additional compliance burden.

## Low profits threshold exemption

9.9 Eligibility for the low profits threshold exemption will broadly be determined by the profits of the branch (see options in Chapter 4). The preferred option for branches, to minimise compliance burdens as detailed above, is for the profit amount to be taken from the branch's UK chargeable profits computation.

## Excluded countries exemption

9.10 The excluded countries exemption is intended to exempt entities located in jurisdictions in which there is a low risk of artificial diversion of profits from the UK. The intention is to allow branches established in the relevant territories to qualify for this exemption, subject to the same conditions as apply to CFCs.

9.11 The general conditions, which may apply to certain territories, will impose a limit on the proportion of a branch's transactions which can be with the UK and on the extent to which the branch receives investment income. Transactions with the UK will include any transactions between the branch and head office that are taken into account in calculating branch profits in accordance with the Business Profits Article (Article 7) of the applicable OECD Model Tax Convention.

9.12 No other specific issues are foreseen with applying this exemption to branches.

## Territorial business exemptions – general

9.13 The objective of the territorial business exemptions (TBEs) is to provide relatively straightforward and flexible exemptions for CFCs that undertake genuine commercial activities and do not pose a significant risk of artificial diversion of profits from the UK. Chapter 5 sets out the potential approaches being considered which will apply equally to foreign branches and CFCs.

## Territorial business exemptions – sector specific

**9.14** Branch exemption is available to all sectors and following its introduction the use of branches may increase in some sectors due to increased tax neutrality across different business operating models. However, exempt foreign branches are expected, in the short term, to be of particular interest to the insurance and banking sectors where regulatory capital requirements may encourage greater use of capital efficient branch structures. The application of the sector specific rules for insurance and banking to branches is addressed below.

**9.15 Application to insurance branches:** To qualify for the insurance business exemption branches will need to be part of an insurance group and engaged in the business of effecting or carrying out contracts of insurance. The Gross Trading Receipts Test (GTRT), UK connection and intra-group activities tests will apply to branches in the same way as they do to CFCs.

**9.16** Where a capitalisation test applies it may be possible to apply the test to the company which owns the branch to establish if it is overcapitalised. If the company as a whole is not overcapitalised then the Article 7 profit allocation will ensure that its branches will also not be overcapitalised. Alternatively, the capitalisation test could be applied to the allocated branch capital but it is thought that this might give rise to significant complexity.

**9.17 Application to bank branches:** The Government is considering how a capital test might apply in relation to exempt branches. One approach could be to apply the capital test to allocated branch capital, but it is thought that this might give rise to significant complexity. It may be possible to apply the test to the capital employed in the banking business of the company as a whole to establish if the company is overcapitalised. If the company holding the branch passes the test then the branch should also be appropriately capitalised. The GTRT and UK business tests will apply equally to branches and subsidiaries.

**Question 9B: The Government is keen to hear the views of businesses on the application of the banking and insurance exemptions to exempt foreign branches and to see examples of how the capitalisation tests might apply to the foreign branch or UK company in practice.**

**Question 9C: Do you see any issues with the proposed approach to the application of the sector specific TBEs to exempt foreign branches?**

## Finance income

**9.18** Finance income may be included in the profits attributed to a branch where the income is effectively connected with branch business. In the case of a trading branch, this makes it possible for an element of finance income to be exempt on the basis of the same incidental income limits as apply to CFCs, for example through the TBEs.

**9.19** The Government is not currently proposing to extend the finance company rules to branches of UK resident companies at this time. This issue is discussed in paragraphs 6.40 to 6.42.

**9.20** If a PE does not conduct any trade, it will often be difficult to conclude that finance income ought to be attributed to it, or to determine an appropriate amount to be attributed. Therefore, when a PE does not conduct any trade, or has attributed finance income which is not incidental to its trade, it is likely that this income will be subject to a UK tax charge.

## General purpose exemption

**9.21** The policy intention is for the GPE to apply equally to branches and subsidiaries, although a different approach will be necessary to achieve alignment of outcome. It is expected that the

GPE will generally be relied upon in situations where other exemptions are not available as other exemptions can be applied with greater ease and certainty. Broadly, the GPE exempts a CFC's profits to the extent that they are commensurate with the CFC's activities and have not been artificially diverted from the UK.

**9.22** The Government is considering using principles based on Article 7 of the OECD Model Tax Convention as one option to determine whether profits are commensurate with activities. For branches, Article 7 is the basis on which the amount of profits eligible for branch exemption is determined. Therefore, providing that the UK company of which the branch is a part has profits that are commensurate with its activities, the amount of profit attributed to the branch should normally qualify for the GPE.

**9.23** If the UK company of which the branch is a part had profits that were not commensurate with its activities, and could be considered to be excessive, this could be an indication that the group may have artificially diverted profits to a that exempt foreign branch. The Government therefore proposes that when considering whether profits are commensurate with activities, this test will be applied at the level of the UK company of which the branch is a part in the same way as it is applied to a CFC.

**9.24** If the company does have profits in excess of those commensurate with its activities and those profits are attributed to the exempt foreign branch, only those profits which have been artificially diverted from the UK will be excluded from foreign branch exemption.

**9.25** The most practical way to calculate the profits that would be subject to tax in the case of a branch might be to:

- start with the total profits of the UK company including the branch, calculated using UK tax rules, after any transfer pricing adjustments and corresponding adjustments;
- subtract the commensurate with activities profits to leave excess profit. (If the answer to this is nil, then the branch will pass the GPE);
- identify the part of the excess profit that relates to the activity of the branch. (If the answer to this is nil, then the branch will pass the GPE); and
- identify whether any part of the excess profit relating to the branch has been artificially diverted from the UK. These will be the profits that will not qualify for branch exemption and will be subject to UK tax.

**Question 9D: Do you foresee any issues with the application of the general purpose exemption to foreign branches?**

**Question 9E: Are there any other issues that should be considered to ensure that the CFC reform and proposed exemptions apply in a workable way to exempt foreign branches?**

# 10

## Next Steps and Engagement

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### How to Respond

**10.1** The Government welcomes views by 22 September 2011 on the issues raised in this document to:

Jennifer Payne or Robert Edwards

Corporate Tax Team  
HM Treasury  
1 Horse Guards Road  
London SW1A 2HQ

E-mail: [robert.edwards@hmtreasury.gsi.gov.uk](mailto:robert.edwards@hmtreasury.gsi.gov.uk)  
Telephone: 020 7270 5072 or 020 7270 5276

**10.2** It is not necessary to send a paper copy of your comments. A confirmation of receipt will be sent in response to all electronic submissions.

**10.3** The Government would welcome earlier, or staged responses, ahead of the consultation deadline where this is possible. Businesses are invited to respond to all questions and proposals but are also welcome to respond to only those questions which are relevant to them.

### Consultation Approach

**10.4** As set out in the “Tax policy making: Consultation Framework”<sup>1</sup> the Government recognises the value of effective consultation. Businesses can and should play a key role in developing and testing tax policy. The Government wants to continue its dialogue with businesses and other interested parties to ensure it delivers on its objective to create a more competitive tax system. The Government encourages all interested parties to engage in consultation to ensure that a full range of views are heard.

**10.5** An open and consultative approach to policy development must be balanced with a timetable that permits officials to undertake the work necessary to deliver these reforms. This approach needs to be flexible and adaptable to deal with the different issues that will arise as policy develops. For example, the working groups (see paragraph 10.9) will meet when appropriate, rather than on a pre-set schedule.

**10.6** The Government is committed to open and transparent consultation and will use the HM Treasury website to provide updates including, where possible, dates and minutes of working group meetings. Should it be considered necessary to publish any further policy papers they will be made available on this site. If you would like to be added to the email distribution list, please contact [robert.edwards@hmtreasury.gsi.gov.uk](mailto:robert.edwards@hmtreasury.gsi.gov.uk).

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<sup>1</sup> Tax Consultation Framework, ([http://www.hm-treasury.gov.uk/tax\\_policy\\_making\\_new\\_approach.htm](http://www.hm-treasury.gov.uk/tax_policy_making_new_approach.htm))

**10.7** It should be noted that the proposals in this document are to aid discussion and policy development. No final decisions have been made on the design of the regime and all decisions are subject to ministerial approval.

**10.8** Representations on all options, or alternatives to these proposals, are welcomed. Any analysis and percentages set out are for illustrative purposes, but should be a reasonable guide to the policy options.

### **Policy development: working groups**

**10.9** The existing CFC working groups on monetary assets, IP, insurance, banking and property will continue in their current forms. Officials will consider the remit of these groups to ensure that the proposals and various exemptions in this document are discussed by an appropriate working group. More details on these working groups can be found at [http://www.hm-treasury.gov.uk/consult\\_cfc\\_reform.htm](http://www.hm-treasury.gov.uk/consult_cfc_reform.htm).

### **Wider engagement**

**10.10** Alongside these consultation groups, officials will continue to meet separately with businesses, representative bodies, tax advisers and other interested parties. Given the impact on a broad and varied cross-section of businesses, the Government would welcome a wide range of views.

**10.11** Following the success of previous open events the Government intends to hold an open event at HM Treasury, 1 Horse Guards Road, London on the CFC proposals included in this document on 8 July 2011 starting at 2.30pm. To attend please email [corporatetaxreform@hmtreasury.gsi.gov.uk](mailto:corporatetaxreform@hmtreasury.gsi.gov.uk).

### **Timetable**

**10.12** This is a Stage 2 consultation focused on developing policy; the consultation is open for 12 weeks until 22 September 2011.

**10.13** The Government will publish draft Finance Bill 2012 legislation in Autumn 2011, ahead of introduction of the legislation in Finance Bill 2012. These draft clauses will also be subject to consultation following publication.

### **Confidentiality**

**10.14** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOI), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

**10.15** If you want the information that you provide to be treated as confidential, please be aware that, under the FOI, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) and HM Revenue and Customs (HMRC).

**10.16** HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

# A Property and Leased Tangible Assets

## Key points from Annex A

- Property investment business that relates to foreign property located in a CFC will generally be exempt as part of the general territorial business exemption (TBE); and
- Where a CFC is engaged in a leasing business involving operating leases of large capital assets (such as vessels, aircraft and oil rigs etc) it is proposed that these should be exempt as part of the general TBE.

**A.1** This annex sets out proposals for how the new regime will apply to property investment business and high value operating leases.

## Property

### Policy objective

**A.2** Property in the form of land and buildings is not a mobile asset and so in most circumstances a property owning CFC is not likely to give rise to a significant risk of artificial diversion of profits from the UK. The Government therefore proposes that for the purpose of the general TBE, activities which meet the conditions set out below will not be treated as investment activities. The Government recognises that international property investment structures can be complex and varied and therefore wishes to design rules that cater for this whilst being simple to operate and without creating risks of erosion of the UK tax base.

**A.3** By introducing these proposals it is anticipated that CFCs undertaking property investment activities such as those which form part of Real Estate Investment Trusts, insurance groups and similar investment businesses would generally be exempt in respect of their rental income.

### Design option

**A.4** It is proposed that activities would not be investment activities for the purpose of the TBE if:

- the activities relate to the carrying on of a property investment business. The Government proposes to define property investment business as the long-term rental of property outside the UK to tenants where the risks and rewards of the property ownership belong to the CFC;
- the property investment business does not include more than insignificant amounts of owner occupied property. That is, the property is occupied by persons who are not connected or associated with the CFC; and
- the activities include the appropriate degree of local management. The Government recognises that property investment activity does not necessarily require significant substance in the form of employees located physically near the property. The Government therefore wishes to consult on the appropriate level of local management that is in line with commercial structures and mitigates against the risk of wholly artificial structures being created.

**A.5** Consideration is being given to a further condition, namely that the property being leased is situated in the same territory as the CFC. While this is understood to be generally the case, the Government is interested to know whether, and to what extent, this condition would limit the value of the proposed change in treatment, and to understand the circumstances in which this condition could not be met.

**A.6** There may be circumstances in which a CFC with property investment activities which generally meet the third party occupation requirement cannot do so because they, or a connected person, occupy a small part of a larger property for commercial reasons. The Government would be interested to understand more about the circumstances in which this can occur, and their frequency.

**A.7** Consideration has been given to whether a capitalisation condition should be included. The Government has concluded that provided that the design parameters set out above can be realised effectively, such a condition should be unnecessary.

### **Inadvertent breach of finance income condition**

**A.8** It is recognised that there are circumstances in which a CFC which is engaged in property investment may hold relatively large amounts of capital following the disposal of one property but before the acquisition of another. The case for relaxing the limitations on incidental finance that would otherwise apply is being considered. In the case of such an “inadvertent breach”, if the cash proceeds remain on deposit for a specified period pending reinvestment, it may be appropriate to exempt any excess over the incidental amount of finance income unless and until the proceeds remain on deposit for longer than the specified period.

### **Treatment of holding companies**

**A.9** Local holding companies owning exempt property investment companies should also generally be exempt from the CFC rules. Where the holding company has a mixture of exempt dividend income from wholly owned property investment companies, management services income and financing income then the effect of the TBE would be to exempt the qualifying rental income and the services income, together with any incidental finance income. Any finance income above an incidental amount would fall within the finance company rules (Chapter 6).

**Question A1: It is not intended that the property investment exemption will apply to rental income received by owner occupiers. Instead activities in relation to rental to owner occupiers will be treated as non-investment activities. Will this approach raise any practical issues?**

**Question A2: Will the proposed property exemption, when considered in conjunction with the proposals for the low profits and excluded country exemptions reduce the compliance burden currently faced by property investment businesses?**

**Question A3: Do you agree that management service companies should qualify for the TBE and, if so, are they likely to benefit from exemption under the safe harbour?**

## **Operating leasing of tangible assets**

### **Policy objective**

**A.10** The Government recognises that a number of groups have leasing businesses which involve operating leases of large capital assets. Under a more territorial approach where a CFC is engaged in a leasing business involving operating leases of large capital assets (such as vessels,

aircraft and oil rigs etc) it is proposed that these should be exempt from the new CFC rules where there is limited economic connection with the UK. It is proposed that such activity will be exempt and not treated as investment activity for the purposes of the general TBE.

**A.11** Determining whether a leasing business is undertaking investment or trading activity is not always straightforward. It seems unlikely that accounting standards will provide a suitable way to define operating leasing activities for the purposes of this exemption. Further work on this point will be necessary to develop suitable definitions.

**Question A4: The Government's initial view is that this change in treatment in comparison with the existing CFC regime is more likely to be of relevance to the operating leasing of small numbers of large high value assets than of large numbers of small lower value assets, but is interested in hearing views on this.**

## **Design options**

**A.12** It is proposed that leasing activity would not be an investment activity for the purposes of the TBE if:

- the CFC's business is the fixed term hiring (defined perhaps by reference to a percentage of the useful economic life) of property or assets where the lessor retains the ownership and/or control of the property, including the associated risks and rewards;
- the individual value of the asset being leased is in excess of £10m;
- the property or asset has not been the subject of a claim for UK capital allowances;
- the activities are not such that a UK connection condition in respect of income and/or expenditure is failed.

## **Local management condition**

**A.13** The Government recognises that leasing of the nature described above does not necessarily require significant substance in the form of employees located physically in the territory in which the CFC is resident (e.g. where the asset is held in a separate company vehicle). The Government therefore wishes to consult on the appropriate level of local management that is in line with commercial structures and protects against the risk that artificial arrangements could be created.

**Question A5: Are the qualifying conditions appropriate in the context of what the exemption is seeking to achieve?**

**Question A6: Do you envisage any practical difficulties in being able to meet the conditions proposed? In particular, how should the local management condition be defined in these situations?**

**Question A7: Do you have any views on the definition of an operating lease for this purpose?**



# B

## Insurance Exemption

### Key points from Annex B

- The insurance exemption will cover genuine overseas insurance operations including reinsurance.
- The proposals exempt foreign to foreign intra-group insurance activity in line with a more territorial approach.
- Design options for the proposed exemption are based on the extent of connection with the UK and a capitalisation test which will take proper account of commercial requirements and is simple to operate.

**B.1** Chapter 5 provides an overview of the policy objectives and aims in designing the new insurance exemption. These are to extend the current exemption to improve the treatment of foreign to foreign intra-group transactions reflecting a more territorial approach and to simplify and further improve the exemption where possible.

**B.2** This annex expands on the policy options available to exempt genuine overseas insurance operations, including reinsurance operations, while providing suitable protection against the artificial diversion of UK profits.

### Policy objectives

**B.3** The Government acknowledges the importance of retaining an exemption based on an excluded countries list to remove genuine overseas insurance operations from the new CFC rules. Chapter 4 sets out possible options for how the new excluded countries exemption could be redesigned and the objective for insurers is to ensure that the impact is similar to the current rules and no more complex to apply. No capitalisation test is proposed under the excluded countries exemption.

**B.4** This annex includes proposals that are relevant to the insurance sector. Under the new regime captive insurance CFCs owned by non-insurance groups can apply the general purpose exemption (GPE) to determine whether profits have been artificially diverted from the UK (see Chapter 7).

### Policy design options

**B.5** The Government proposes two options for how the new insurance exemption could operate:

- Option 1: A relatively straightforward exemption for CFCs carrying on overseas insurance business that do not have a significant connection with the UK; under this option more insurance CFCs would need to consider a capitalisation test.
- Option 2: An alternative option to remove lower risk genuine overseas insurance operations without needing to consider a capitalisation test. Instead more detailed rules would be needed to target a capitalisation test on higher risk CFCs where there are significant intra-group transactions.

**B.6** Both options would remove the current limitation on foreign to foreign connected party insurance activity, while providing protection against artificial diversion of UK profits.

**B.7** The Government recognises that the majority of CFCs do not exist to artificially divert profits from the UK, but to undertake genuine trading operations, and that in practice a capitalisation test should not impact on these operations. A capitalisation test would be designed to apply only if the CFC holds significantly more capital than would normally be expected to be held to support its insurance activities.

**B.8** The Government wants to consult on the appropriate parameters for the insurance exemption, including the illustrative percentages set out below. Further work is needed through consultation to assess whether the parameters are suitable to exempt commercial activities and at the same time, protect the UK tax base.

### **Qualifying conditions**

**B.9** To qualify for exemption under either option the CFC:

- must be part of an insurance group. The current statutory definition for large risk insurance in Schedule 25, ICTA 88 could be used as a starting point for this definition, the aim being to include groups where writing third party insurance contracts is a significant activity within the overall group;
- must be engaged in the business of effecting or carrying out contracts of insurance (this would be in line with the current regime's requirements); and
- would need to meet basic residence, establishment and local management requirements in line with those which apply to the TBEs (see paragraph 5.10).

**B.10** The current rules for insurers apply where a CFC's main business is insurance business. In line with the approach applied to the TBEs, there will be a requirement for an insurance CFC's business to consist of around 80 per cent insurance activities in order to qualify for the insurance trading exemption. The Government does not expect this to be an issue as regulated insurers may have restrictions on non-insurance activity; but the Government would welcome views on this approach.

**Question B1: Will the requirement for 80 per cent of a company's activities to be insurance activities cause any issues in practice?**

### **Option 1: A gross trading receipts test (GTRT) dependent on the extent of UK trade**

**B.11** This option (and option 2) could be based on the current CFC regime's gross trading receipts test (GTRT), with trading receipts being commissions and premiums received under contracts of insurance. This option will exempt genuine insurance operations and reinsurance business by targeting the exemption at situations that do not have more than a certain level of UK connection.

**B.12** Where UK connection (which includes third party and intra-group business written with UK insurers) is 50 per cent or more, the intention is that this exemption would not be available and the CFC could apply the GPE (see Chapter 7).

**B.13** Under this option the GTRT could work as follows:

**Table 10.A: Illustration of Option 1**

(i) Below 50 per cent UK connected	CFC to pass an appropriate capitalisation test
(ii) 50 per cent or more UK connected	UK connection too high, CFC can apply GPE

**Option 2: A GTRT dependent upon the extent of UK and connected persons activity**

**B.14** This alternative option could be designed to provide a two stage test which considers the extent to which trading receipts are from the UK (connected and unconnected), and also from connected parties (UK and non UK). The focus on intra-group activity represents a pragmatic solution to minimise the number of CFCs that would need to consider a capitalisation test.

**Table 10.B: Illustration of Option 2**

(i) For CFCs that represent a lower risk so that: (a) a significant part of the trading receipts are from third parties, therefore a limit would be needed on connected party gross trading receipts at a percentage subject to consultation (could be between 20 and 50 per cent); and (b) less than 50 per cent trading receipts with the UK (3rd party and intra-group).	Exemption granted
(ii) For CFCs that may pose a higher risk, i.e. where the connected party gross trading receipts are above the limit set in (i), but trading receipts from the UK are less than 50 per cent.	CFC to pass an appropriate capitalisation test
(iii) For CFCs exposing the Exchequer to the highest level of tax risk i.e. CFCs with a UK connection of 50 per cent or more.	UK connection too high, CFC can seek to apply GPE (Chapter 7)

**B.15** A test which looks at the proportion of business being reinsured out of the UK into an offshore reinsurer has been considered (rather than considering the UK connected profits held by the CFC). Current FSA capital requirements are likely to mean that, in practice, companies would not generally reinsure more than 50 per cent of their business out of the UK. A test based on this approach would be likely to add complexity and to create significant practical difficulties e.g. in obtaining data from the UK company. The Government is therefore not putting this forward as an option but would be willing to listen to any representations on this issue.

**Question B2: Do you prefer the approach in Option 1 or Option 2 to exempt overseas insurance and reinsurance business?**

## Capitalisation safe harbour

**B.16** The current regime includes no capitalisation test, as this risk is addressed by the restrictions on intra-group transactions. As the new regime partly removes that protection (as foreign to foreign connected activity will be unrestricted), the Exchequer risk in some cases could increase.

**B.17** The Government accepts that capital is expensive for insurance groups, it must be used efficiently and it is subject to internal governance and regulatory requirements. However, without a capitalisation test, the rules being proposed do not by themselves address the potential risk of a CFC holding more capital than it needs to support its insurance activities. The Government therefore proposes that an appropriate capitalisation test should apply in situations where there is an increased risk of artificial diversion of profits from the UK.

**B.18** Further work is needed to determine in what circumstances a capitalisation test should apply and what an appropriate level would be. The design options below will benefit from further consideration and development, and the Government would welcome views on alternatives.

### Design options

**B.19** Careful consideration will be needed to design a capitalisation test which takes proper account of commercial requirements and is simple to operate. There are a number of options for its format and the level at which it will apply. The Government considers the two options for the insurance exemption to be:

#### a. A mechanical test.

**B.20** The aim would be to set this at a level where genuine insurance businesses would pass the test and to base the test on simple calculations using information readily available to the CFC. Examples could be:

- a percentage of local regulatory capital;
- a percentage of a Solvency I type test, based on premiums or claims outstanding;
- a comparison of the level of capital or investment income in the local territory to the group level, plus a margin to allow for some fluctuation.

#### b. A self certification test

**B.21** One problem in applying a mechanical approach is that different types of insurance business may require different and varying levels of capital. This will be dependent on the nature of the business written and a “one size fits all” safe harbour may be difficult to design.

**B.22** An alternative approach could be to allow insurance groups, who can be expected to manage efficient deployment of capital within their groups, to self certify the capital levels in their CFCs. Insurers are likely to have capital models to support the running of their business and indications are that existing systems may enable insurers to demonstrate the need for their levels of capital.

**B.23** However, this approach would require some objective measures against which insurers could judge that their capital levels were not excessive as part of the self assessment process. A basic starting point might be to look at solvency capital and rating agency requirements. The challenge would be to encapsulate this in a legislative approach. For example, there may be requirements to hold additional capital to support increased levels of new business. The level of sign off also needs to be considered, whether at a group level or CFC company level, and what documentation might be needed to support this.

**Question B3: What would be the preferred approach to the capitalisation test (mechanical or self certification) and how can these tests be further developed to apply in practice? If you would prefer a mechanical test, what would an appropriate level of capital be?**

## **UK connected and UK unconnected transactions**

### **Life assurance and large risk insurance**

**B.24** The current regime includes relaxations for UK third party premiums on life assurance (excluding protection business) and “large risk” insurance. These relaxations were due to those types of insurance business typically representing a lower risk of profits being artificially diverted from the UK. The Government would expect this to continue and welcomes views from business on whether these should form a part of the new regime and whether any changes are needed.

### **Global business**

**B.25** During the course of discussions with the industry to date, the possibility of providing more flexibility in respect of business written by UK insurers in the international insurance market has been raised. The Government is prepared to explore treating business which is written in the UK, but has limited UK connection in terms of risk, more favourably for the purposes of the exemption. The Government welcomes views on this point, to assist in deciding whether any acceptable proposals can be developed.

**Question B4: Are the current exclusion for large risks and life still appropriate?**





# Banking Exemption

## Key points from Annex C

- The banking exemption will exempt profits arising from genuine overseas banking operations and improve the way artificial diversion of profits from the UK is targeted.
- The Government is proposing to design a banking exemption that operates in a similar way to the current rules with a capitalisation test that is simple to apply, gives certainty to business and operates in a proportionate manner.
- The Government will consider a number of factors to ensure that the new exemption reflects the modern business environment including the impact of regulatory capital requirements on the capital test threshold.

**C.1** Chapter 5 provides an overview of the policy objectives and aims in designing the new banking exemption. This annex expands on the policy options available for the banking exemption.

## Policy objectives

**C.2** The policy objectives are to ensure that genuine overseas banking operations are outside the regime whilst improving the way artificial diversion of profits from the UK is targeted. The Government acknowledges the importance of retaining an exemption based on an excluded countries list to remove genuine overseas banking operations from the new CFC rules. Chapter 4 sets out possible options for how the excluded countries exemption could be redesigned; the objective for banks is to ensure that the impact is similar to that of the current rules and that the exemption will be no more complex to apply.

**C.3** The Government considers the ease with which capital can be transferred between banking entities is a key risk in relation to the banking sector. Whilst the Government recognises that levels of capital are subject to internal governance and regulatory requirements, there is a need to guard against the risk of a CFC holding more capital than it needs to support its banking activities. Banks with overseas subsidiaries that are appropriately capitalised are less likely to give rise to an artificial diversion of profits from the UK. The new regime will therefore continue to focus on the levels of capital employed in overseas banking operations.

**C.4** Another important issue for the banking sector is that of substance, and the interaction between substance and profits. Artificial arrangements, particularly in the case of capital-intensive businesses where not much activity may be required to generate profits, can see those profits held overseas as income streams without adequate substance to justify those profits. The new regime should continue to deter such arrangements.

## Basic exemption requirements

**C.5** The CFC would need to meet basic residence, establishment and local management requirements. The design of these tests in relation to the banking exemption will recognise not

only the way in which banking operations are structured, but also the risks and issues particular to the sector as explained in paragraphs C.3 and C.4.

**C.6** The current rules for banks apply where a CFC's main business is banking. In line with the approach of the TBEs, there will be a requirement for a banking CFC's business to consist of around 80 per cent banking activities in order to qualify for the banking exemption. The Government does not expect this to be an issue as in most cases the majority of activity undertaken by a banking CFC is likely to be banking business. The Government welcomes views on this approach. Paragraph 5.21 sets out how this limit might apply and provides details of the types of activities limited to 20 per cent that may also be relevant here.

**Question C1: Will the requirement for 80 per cent of a company's activities to be banking activities cause any issues in practice?**

## Design options

**C.7** The Government proposes that the new regime includes a specific exemption for banking activities based on the capitalisation of the CFC. The design will take account of views from earlier consultation, which have suggested that while the current capital structure test provides certainty, it can be a significant compliance burden and its operation could be improved.

## Capitalisation test

**C.8** One of the difficulties highlighted by banks in consultation to date is that, following the financial crisis, they are under more pressure from regulators to retain capital in their overseas territories. Some have suggested that the current threshold of 15 per cent in the capital structure test may be too low and managing the risk of failing the test can potentially force the CFC to make uncommercial decisions.

**C.9** One approach would be for the capitalisation test to be based on the regulatory capital requirements of the territory in which the company is resident. However, the disadvantage of this approach is that such requirements would vary from territory to territory, and so, from a compliance perspective, could significantly increase the burden involved and would require more extensive monitoring by both business and HMRC.

**C.10** An alternative might be to adopt the UK regulatory capital requirements regardless of where the company is resident. It is recognised that this type of approach may be more restrictive than the current rules and could present difficulties where another country imposes higher regulatory capital requirements than the UK. This approach would need to take into account the various changes in this area including the forthcoming impacts of the Basel III proposals on capital.

**C.11** The Government proposes that the banking exemption should be based on a single capital requirement test that is simple to apply, gives certainty to business and operates in a proportionate manner. The lead option for how such a test could operate is to maintain a similar approach to the current capital structure test reforming it where possible to ensure that compliance burdens are reduced.

**C.12** The factors that will need to be considered in designing this exemption and that will benefit from further consultation and development include:

- **15 per cent threshold in the current capital structure test** - the Government is committed to full implementation of the Basel III proposals and would like to consult on whether the 15 per cent limit remains appropriate given this and other international regulatory

discussions in relation to bank capital. When considering this approach the Government will have to consider the risks to the UK tax base of extending this threshold.

- **debt funding from the UK** - the current test includes within the definition of 'capital interest' debt funding from the UK. In principle, if a banking subsidiary is funded by debt from the UK and that generates a taxable interest-like return in the UK, it is unlikely that profits have been artificially diverted from the UK. The Government will consult on whether this should be taken into account in any revised test.
- **definition of interest income** - the Government would like to consult on whether definitions in relation to interest income need to be expanded to ensure that the new rules take all interest-like amounts into account.
- **treatment of intra-group guarantees** - the Government will consult on the valuation of intra-group guarantees in relation to the calculation of the capital structure test.
- **when and how regularly the test has to be satisfied** - the current rules require banking CFCs to satisfy the capital structure test throughout the accounting period under consideration. During consultation businesses highlighted the significant compliance burdens generated by this requirement. As part of this consultation the Government will consider whether the test will need to be satisfied throughout the accounting period. The risks to the UK tax base will have to be considered as part of this.

**Question C2: What are the views of businesses on the Government's proposed approach to adopt a modernised capital structure test?**

**Question C3: The Government would welcome further views in relation to what would be considered an appropriate level of capital for such a capital test and would be interested to see examples of where the interaction of the 15 per cent threshold and regulatory capital requirements would cause difficulties.**

**Question C4: Do you agree that the factors identified in relation to the capital structure test should be taken into account in any revised test? Are there any other factors that should be considered?**

### **Gross trading receipts test and interest income from UK associates**

**C.13** The current exempt activities test includes a gross trading receipts test (GTRT) which limits income from connected parties to no more than 50 per cent of total income. However, for banks, the test disregards interest income received from UK associates reflecting the way in which banks structure business operations.

**C.14** The current exempt activities test for banks includes a separate restriction which limits non-interest income from the UK to no more than 10 per cent of total income.

**C.15** The Government considers that similar rules in relation to connected party and UK income will be required in the new regime. A more territorial approach would suggest that further consideration should be given to exempting income from overseas connected parties in the GTRT. However, the Government considers that this, coupled with the current approach to interest income received from UK associates, would present too high a risk to the UK tax base, but would welcome views on which of the approaches would be more beneficial.

**Question C5: How could the current exempt activities test available to banks be simplified to reduce the compliance burden whilst retaining an appropriate level of protection?**

**Question C6: The Government welcomes views on the structure of the test and in particular, whether exempting overseas income would be more beneficial to the banking sector than the current approach of exempting interest income received from UK associates.**

## **Holding companies**

**C.16** It is intended that holding companies which hold only trading companies and which receive almost all of their income from within their territory of residence (i.e. local holding companies) will be exempt under the new TBE (see paragraph 5.30).

**C.17** More generally, the treatment of holding companies should follow from their activities. Those which only hold shares in group companies should be exempt where the dividends they receive would themselves be exempt from UK tax. The treatment of holding companies which carry on other activities will be determined by the nature of those activities, so that a trading/holding company could be exempt.

## **General purpose exemption**

**C.18** Banking entities will be able to access the new general purpose exemption (GPE). Where, for example, a banking CFC fails the capitalisation test, it will be able to apply the GPE which will allow commercial factors to be taken into account when considering whether profits have been artificially diverted from the UK (see Chapter 7 and example D). A CFC which exceeds the set level of capitalisation will not necessarily suffer a CFC apportionment.

## **Proportional charge**

**C.19** A key element of the new regime will be the proportional charging mechanism. In terms of banking activity, a proportional CFC charge could relate to the level of excess capital. For example, assuming for simplicity that the 15 per cent capital interest test level remained unchanged, a CFC which breached this limit would not be subject to a CFC charge on the whole of its profits. Rather, the charge would be limited to the profits which could be reasonably attributed to the "excess" capital.

## **Control and third party lending**

**C.20** The difficulty banks can have in relation to the operation of the existing control rules has been raised in consultation. The existing control rules can give rise to onerous compliance procedures for banks lending to unrelated parties. The issue of control and banking activities will be considered in the design of the new definition of control (see paragraph 3.10).



# Finance Company Rules: flexible options and illustrative examples

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**D.1** This annex provides further details on the three more flexible options summarised in paragraph 6.20, and includes illustrative examples to show how these could operate.

**D.2** As noted in paragraph 6.16, flexible rules are required if the finance company rules are to address more complex overseas financing operations involving multiple entities. These options could also apply to mixed activity companies although this would add some further complexity to the design of the rules.

**D.3** The options outlined below will in most situations seek to tax a quarter of overseas intra-group finance income in the UK. They aim to provide certainty on how overseas intra-group finance income is taxed whilst providing greater flexibility to businesses in managing overseas finance operations. There may be other ways of achieving the intended result and the Government is interested in alternative approaches and would like to work with businesses to design a workable set of rules that are consistent with the policy objectives.

## **Option A. Finance income approach**

**D.4** This approach uses a set of mechanical rules that target the chargeable finance income from financing activities undertaken by the CFC. In most cases a quarter of the overseas intra-group finance income will be taxed in the UK. This option could allow relief for debt provided to the CFC, so that an apportionment to the UK would generally be reduced to nil if the CFC is debt:equity funded at the ratio of 1:3.

**D.5** To calculate any apportionment to the UK, adjustments would be required to the chargeable finance income. These aim to:

- remove finance income that does not represent the structural surplus cash reinvested by the group and that should not fall within FCPE (see paragraph 6.8); and
- allow deductions for appropriate finance costs arising on debt funding provided to the CFC and other allowable expenses attributable to the finance activity of the CFC.

**D.6** Where intra-group loans exist between companies that are both subject to the finance company rules, the treatment of the loan will be symmetrical between the lender and borrower.

**D.7** As the rules focus on chargeable finance income rather than chargeable finance profits, it should be noted that a situation could arise where a CFC is subject to a FCPE charge despite it having an accounting loss.

## **Steps**

**D.8** Set out below are the steps that would be required under this option.

1. Determine the UK measure of the CFC's chargeable finance income that is attributable to its financing activity.

2. Exclude finance income arising on loans to other overseas finance companies (the finance expense would correspondingly not be taken into account in the borrower for these purposes to ensure symmetry of treatment).
3. Exclude non negligible finance income on monies held on deposit with third parties.
4. Adjust for other allowable expenses (on a just and reasonable basis), such as staff costs, expenses relating to business establishment.
5. Calculate one quarter of the remaining chargeable finance income.
6. Deduct finance expense on loans from third parties only to the extent that it exceeds any other income of the company (i.e. allocate it first to any other income).
7. Deduct any finance expense arising on loans from connected UK resident companies.
8. Deduct any finance expense arising on loans from non UK connected companies that are not subject to a CFC apportionment.
9. The amount calculated from steps 1 to 8 (and any finance income removed from the FCPE calculation in step 2) will be apportioned to the UK.

### **Option B. Chargeable profits approach that disregards three quarters of finance income**

**D.9** This approach focuses on the chargeable profits from financing activity undertaken by the CFC and seeks to disregard three quarters of intra-group finance income. Similarly, three quarters of the corresponding finance expense is disregarded in the borrower for these purposes. While it is expected that a finance company is often wholly equity funded, as with option A this option will allow relief for debt provided to the CFC.

**D.10** It is envisaged that this mechanism would operate by way of a claim to which the borrower would need to give consent, as with group relief claims. A claim would only be made where the borrower is an overseas subsidiary that is not subject to a CFC charge. It is not expected that claims will be made on intra-group finance income between CFCs that are both subject to the finance company rules as the symmetry of the claim between lender and borrower would not impact the overall result.

**D.11** This approach could impact on all upstream loans to the UK as a claim to disregard intra-group finance income is unlikely to be made where the borrower is a UK group company. This approach could be refined to take account of certain short term loans to the UK (see paragraph 6.30 for more details).

#### **Steps**

**D.12** Set out below are the steps that would be required under this option.

1. Determine the company's chargeable profits from intra-group lending.
2. Disregard three quarters of intra-group finance income.
3. Disregard three quarters of intra-group finance expense in the borrower, where corresponding intra-group finance income has been subject to an adjustment.

### **Option C. Chargeable profits approach that seeks to tax one quarter of chargeable finance profits**

**D.13** This approach focuses on the chargeable profits from overseas intra-group finance activity undertaken by the CFC and then seeks to tax one quarter of these chargeable profits. It is

expected that a finance company will often be wholly equity funded, and in those situations this option would give the same apportionment as options A and B. If a finance company is partly debt funded, this simpler and more pragmatic approach will give a slightly different appointment to that under options A and B. This option taxes a quarter of chargeable profits that arise, meaning that debt funding of the CFC will only be partially recognised in calculating any apportionment.

**D.14** When calculating the chargeable profits from intra group financing, adjustments would be required for non negligible finance income arising on monies held on deposit with third parties and finance income arising on upstream loans to UK group companies.

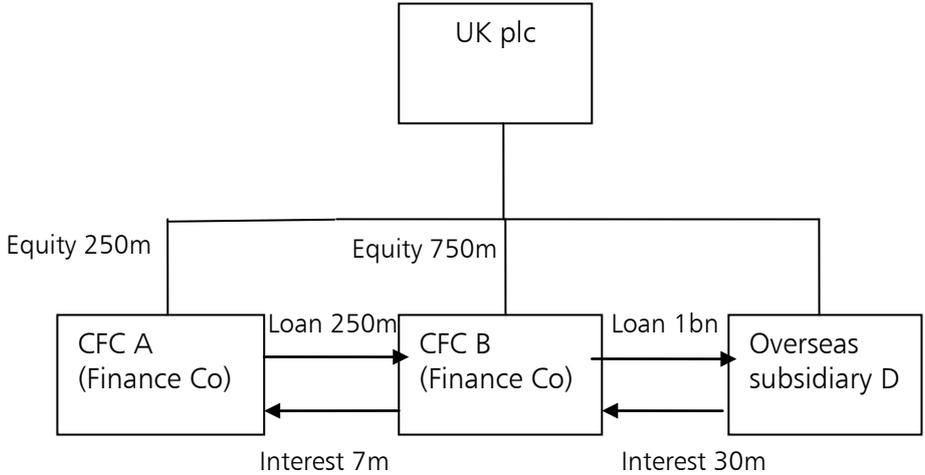
**Illustrative examples**

**Example 1**

A UK multinational group has the following overseas subsidiaries which are involved in intra-group financing arrangements

CFC A has equity funding of £250m. CFC B has equity funding of £750m and debt funding of £250m from CFC A. It pays interest of £7m per year to CFC A. CFC B lends £1bn to overseas subsidiary D and earns interest of £30m per year.

The flows are summarised in the diagram below.



**Application of option A**

**CFC A**

- 1. Chargeable finance income 7m
- 2. Deduct finance income on loans to other finance companies (7m)
- 3. Deduct non negligible finance income on loans to third parties Nil
- 4. Adjust for other allowable expenses such as staff costs etc Nil
- 5. Calculate 1/4 of the sum of 1 to 4 Nil

**Apportionment from CFC A Nil**

**CFC B**

1. Chargeable finance income	30m
2. Deduct finance income on loans to other finance companies	Nil
3. Deduct non negligible finance income on deposits with third parties	Nil
4. Adjust for other allowable expenses such as staff costs etc	Nil
5. Calculate $\frac{1}{4}$ of the sum of 1 to 4	7.5m
6. Deduct finance expense on loans from 3rd parties	Nil
7. Deduct finance expense on loans from UK connected companies	Nil
8. Deduct finance expense on loans from non CFCs etc	Nil
<b>Apportionment from CFC B</b>	<b>£7.5m</b>

The total amount apportioned to the UK is £7.5m.

### Application of option B

**D.15** In this illustration, a joint claim is made to disregard three quarters of the intra-group finance income on the loan from CFC B to overseas subsidiary D. There will be no impact on the borrower as overseas subsidiary D is not subject to a CFC apportionment.

#### CFC A

1. Chargeable profits from financing	7m
--------------------------------------	----

**Apportionment from CFC A** **£7m**

#### CFC B

1. Chargeable profits from financing	23m
2. Disregard three quarters of intra-group finance income ( $30m \times \frac{3}{4}$ )	(22.5m)

**Apportionment from CFC B** **£0.5m**

The total amount apportioned to the UK is £7.5m.

**D.16** Alternatively, CFCs A and B could choose to make a further claim in respect of the £7m paid from CFC B to CFC A. As this would reduce CFC A's apportionment by £5.25m but increase CFC B's apportionment by the same amount, it is not expected that this extra claim is made. If it were made, a total amount of apportionment of £7.5m would still arise.

### Application of option C

#### CFC A

1. Chargeable profits from financing	7m
2. Apportion one quarter of chargeable finance profits	1.75m
<b>Apportionment from CFC A</b>	<b>1.75m</b>

#### CFC B

1. Chargeable profits from financing	23m
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2. Apportion one quarter of chargeable finance profits 5.75m

Apportionment from CFC B 5.75m

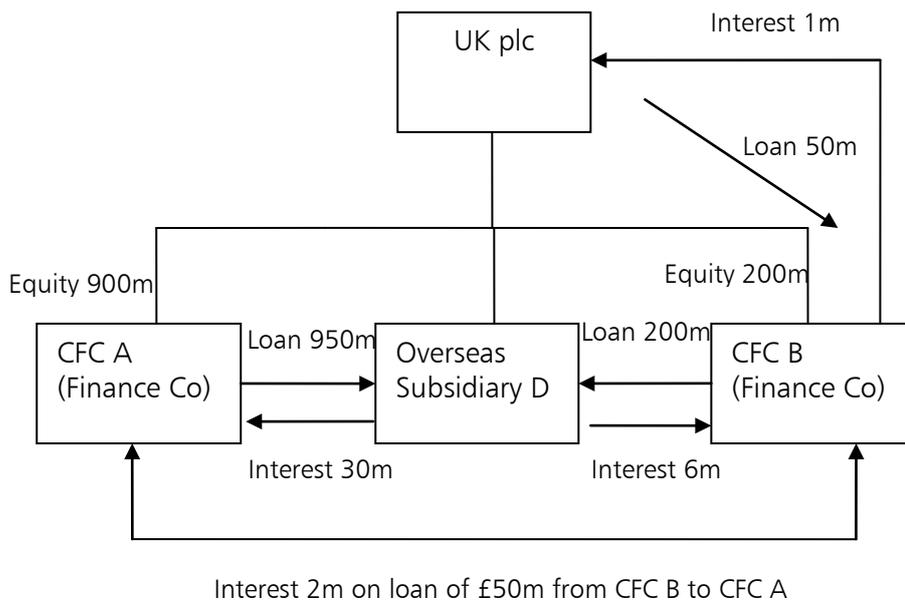
The total amount apportioned to the UK is £7.5m

**Example 2**

A UK multinational group has the following overseas subsidiaries which have external and intra-group financing arrangements.

CFC A has equity funding of £900m and debt funding of £50m from CFC B. It pays interest of £2m per year to CFC B. CFC A lends £950m to overseas subsidiary D and earns interest of £30m per year.

CFC B has equity funding of £200m from the UK and debt funding of £50m from the UK, paying interest of £1m per year. It lends £200m to overseas subsidiary D and £50m to CFC A, receiving £6m interest from D and £2m interest from CFC A per year. The fact pattern is summarised in the diagram below.



**Application of option A**

**CFC A**

- |    |   |      |
|----|---|------|
| 1. | Chargeable finance income   | 30m  |
| 2. | Deduct finance income on loans to other finance companies           | Nil  |
| 3. | Deduct non negligible finance income on deposits with third parties | Nil  |
| 4. | Adjust for other allowable expenses such as staff costs etc         | Nil  |
| 5. | Calculate 1/4 of the sum of 1 to 4                                  | 7.5m |

6.	Deduct finance expense on loans from 3rd parties	Nil
7.	Deduct finance expense on loans from UK connected companies	Nil
8.	Deduct finance expense on loans from non CFCs etc	Nil
<b>Apportionment from CFC A</b>		<b>£7.5m</b>

#### CFC B

1.	Chargeable finance income	8m
2.	Deduct finance income on loans to other finance companies	(2m)
3.	Deduct non negligible finance income on deposit with third parties	Nil
4.	Adjust for other allowable expenses such as staff costs etc	Nil
5.	Calculate $\frac{1}{4}$ of the sum of 1 to 4	1.5m
6.	Deduct finance expense on loans from third parties	Nil
7.	Deduct finance expense on loans from UK connected companies	(1m)
8.	Deduct finance expense on loans from non CFCs etc	Nil

**Apportionment from CFC B** **£0.5m**

The total amount apportioned to the UK is **£8m**.

### Application of option B

#### CFC A

1.	Chargeable profits from financing	28m
2.	Disregard three quarters of intra-group finance income (30m x $\frac{3}{4}$ )	(22.5m)

**Apportionment from CFC A** **£5.5m**

#### CFC B

1.	Chargeable profits from financing	7m
2.	Disregard three quarters of intra-group finance income (6m x $\frac{3}{4}$ )	(4.5m)

**Apportionment from CFC B** **£2.5m**

The total amount apportioned to the UK is **£8m**.

**D.17** Alternatively, CFCs A and B could choose to make a further claim in respect of the £2m paid from CFC A to CFC B. This would reduce CFC B's apportionment by £1.5m but increase CFC A's apportionment by the same amount. This would still give rise to a total amount of apportionment of £8m.

### Application of option C

#### CFC A

1.	Chargeable profits from financing	28m
2.	Apportion one quarter of chargeable finance profits	7m

Apportionment from CFC A	£7m
CFC B	
1. Chargeable profits from financing	7m
2. Apportion one quarter of chargeable finance profits	1.75m
Apportionment from CFC B	£1.75m

The total amount apportioned to the UK is £8.75m

**D.18** It should be noted that this option produces a total apportionment of £8.75m compared to options A and B which give rise to a total apportionment of £8m.

**D.19** A different apportionment arises under this option due to the treatment of the finance expense of £1m arising in CFC B on the loan from UK plc, a company that is not subject to the finance company rules. Under options 1 and 2, three quarters of finance income is disregarded before relief is given for the £1m finance expense. In comparison, this option disregards three quarters of chargeable finance profits.

**D.20** This approach is the simplest and most pragmatic of the flexible options, particularly where finance companies are likely to be fully equity funded.



# E

## Transfers of Intellectual Property: factors to consider

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**E.1** This annex provides factors to consider in situations where intellectual property (IP) is transferred from the UK, to determine whether or not the profits that arise in the CFC post-transfer are artificially diverted UK profits.

**E.2** The Government believes that IP is unlikely to be transferred unless the transferee is better able to develop and exploit the IP than the transferor. This would only be the case where the transferee does in fact actively manage the development and exploitation of the IP after the transfer, so that it effectively controls the additional risks it is subject to as economic owner of the IP.

**E.3** Factors to take into account when determining whether the transfer has resulted in artificial diversion of UK profits:

- there is a lack of or insufficient genuine commercial substance in the transferee;
- the experience and skills of the CFC's staff are appropriate;
- the economic value of cash flows absent tax are significant or there is very little benefit other than tax;
- piecemeal exit/portfolio exits where the value of the IP if it had been transferred as a whole may be more than the sum of the parts;
- the UK IP is transferred without the transfer of the functions needed to continue to develop/exploit the IP;
- in reference to the transfer of UK IP, the UK sub-group's ability to continue to generate income is dependent upon being able to license back the IP that it has just transferred overseas;
- there are significant sales in the UK;
- the UK sub-group forecasts show reduced profitability post transfer of the IP;
- there is evidence of "hand holding" of the CFC by the UK;
- the UK staff involved with the IP management are senior to the CFC IP management personnel and UK IP management goes beyond strategic IP management (that would normally be expected for the board of a UK multinational to exercise);
- the value adding activities connected with the IP are performed in the UK rather than in the CFC's territory of residence;
- in the case of a brand, it is geographically sensitive and its integral value is in the UK;
- quality control takes place in the UK; and
- the UK borrows to fund third party acquisitions of IP by a CFC.

**E.4** Factors to consider which may indicate that the transfer has not taken place to artificially divert UK profit:

- the IP is transferred offshore as part of a trade with all the associated activities and assets;
- there is real substance in the transferee jurisdiction and employees with the necessary expertise, who previously had nothing to do with the IP, actually manage and develop the IP transferred;
- the transfer is of IP which the CFC is better placed to actively manage and develop because of the availability of local expertise specific to that IP;
- the majority of the value adding activities connected with the management and development of the IP happen in the CFC and the expenses are incurred there;
- cash tax is paid on exit of the IP; and
- quality control takes place in the CFC.

# F

## Intellectual Property: illustrative examples

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**F.1** This annex provides illustrative examples of different situations where IP arises in a CFC to demonstrate how the new CFC regime is expected to apply.

### Example 1 – Foreign IP with no UK connection

#### Facts

**F.2** A CFC has been established for many years. Its board comprises individuals who are knowledgeable and experienced in respect of the group's IP and meet quarterly to set parameters for the CFC's investment in IP. The CFC's board decide to buy a foreign brand as part of a third party transaction. The brands were wholly developed offshore and are not sold in the UK market.

**F.3** Day-to-day active management of the group's brands globally is undertaken in the CFC. Legal protection of the global brand is subcontracted by the CFC to another overseas entity. High level strategic direction of the group is undertaken in the UK.

**F.4** The CFC has a significant senior strategic supply chain team for the products in the region. Research and development (R&D) is undertaken in a number of territories (including the territory of the CFC) on a sub contracted basis for the CFC, but not in the UK. The R&D team making day-to-day decisions about R&D connected with the brand are employed by the CFC. The CFC uses a mixture of tolling/contract manufacturing to produce the product, with low risk distributors in a number of territories.

#### Analysis

**F.5** The TBE safe harbour is likely to be failed assuming that the IP is highly profitable. However, there has been no transfer of UK IP and less than 50 per cent of the CFC's business expenditure relating to the IP is with the UK and none of the CFC's sales are to the UK. Therefore it is likely that the CFC will qualify for full exemption under the TBE.

### Example 2 – Transfer of UK IP to a CFC

#### Facts

**F.6** A CFC is based in a low tax jurisdiction where it has a trade, related employees and assets, including IP which is different to the IP owned by its UK parent. UK parent decides that it wants to start a process of centralisation of IP ownership and management and therefore transfers UK IP to the CFC.

**F.7** The IP transferred to the CFC is not related to the CFC's trade and initially the CFC is reliant upon the UK for many of the value added activities related to the management and continuing development of the IP. Over a period of years a number of staff with the knowledge and experience to manage the UK IP transfer to the CFC and the CFC's own staff build their expertise in the UK IP.

## Analysis

**F.8** The TBE safe harbour is failed as the CFC is highly profitable. IP has been transferred from the UK in the previous 6 years. The CFC is therefore not eligible for TBE and applies the GPE instead.

**F.9** The CFC may be subject to an apportionment under the GPE and will exempt profits commensurate with CFC's activity. Whether this includes profits from the transferred IP will depend on the relative extent of the UK company and CFC's day-to-day active decision-making and other value-adding functions relating to the IP. If an exit charge is payable on the transfer of the UK IP, the CFC may wish to consider the impact of any exit charge deferral or credit mechanisms on any potential apportionment.

## Example 3 – IP developed overseas expanding into UK market

### Facts

**F.10** A UK group established a CFC selling products on the high street in its foreign domestic market a number of years ago. The management team, key decisions, business format, brands and other IP related to this business have always been located in the territory of residence of the CFC.

**F.11** The business is successful and expands into the UK through a UK group company. The UK company benefits from the foreign IP developed in the CFC, and grows to five times the size of the CFC. The CFC charges an arm's length fee into the UK for use of the CFC's brand. Cash accumulates in the CFC and is used by the CFC to fund further expansion in the local market, UK and continental Europe.

### Analysis

**F.12** The TBE safe harbour is likely to be failed as the IP is highly profitable. There has been no transfer of UK IP. However, the TBE is likely to be unavailable assuming that more than 20 per cent of the CFC's gross income is from the UK. The group would therefore need to apply the GPE.

**F.13** Profits commensurate with the activity of the CFC should encompass all of the profit of the CFC given active-decision making and core functions connected with the IP that have always been based in the territory of residence of the CFC. Therefore none of the associated profit should be attributable to the UK under the GPE. No CFC apportionment to the UK is therefore expected.

## Example 4 – Grant of a sub-license for UK IP

### Facts

**F.14** A CFC buys several sub-brands from other overseas entities for fair market value. The sub-brands were wholly developed offshore and are not sold in the UK market. However, the overarching group branding is licensed to the CFC, for an arm's length royalty, so that it can incorporate it into its packaging. The CFC is a regional hub for IP and undertakes marketing and development for the sub-brands. The day-to-day active management and legal protection of the sub-brands globally is undertaken in the CFC. Strategic direction of the group and of the overarching brand is undertaken in the UK.

**F.15** The overseas company has a senior individual who directs the strategic supply chain team for the products in region with a team based around the globe (one in the UK). R&D on new formulations for the sub brand is undertaken in a number of territories including the UK on a

contract basis. The CFC uses a mixture of toll/contract manufacturers to produce the product and sells through low risk distributors. All transfer pricing is on arm's length terms.

## **Analysis**

**F.16** IP has been transferred from the UK in the previous 6 years (a transfer includes the grant of a sublicense) and the TBE safe harbour is likely to be failed by CFC as it is highly profitable. The CFC is therefore not eligible for the TBEs and uses the GPE instead.

**F.17** Profit from the overarching brand accrues to the UK via a royalty which is at arm's length. Profits commensurate with the CFC's activity should encompass all of the profit of the CFC given it performs active decision-making and core functions relating to sub-brands and therefore associated profit should be attributable to the CFC under GPE. No CFC apportionment to the UK is therefore expected.



# G

## Charging Mechanics

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### Policy objective

**G.1** This annex sets out proposals for the charging and relieving provisions for the new CFC regime, setting out how a CFC's profits will be calculated, how the profits will be charged to UK tax and the extent to which foreign tax paid by the CFC in respect of the profits will be relieved.

**G.2** As set out in paragraph 2.3, the new CFC regime will primarily be entity based, although the rules will also provide for partial apportionment of a CFC's profits. The new regime will usually require a UK chargeable profits computation as under the current CFC rules.

**G.3** Although the profits will be calculated as though they were profits chargeable to UK corporation tax any charge to UK tax will not be corporation tax but will be treated in the same manner as corporation tax. This approach will ensure that UK Double Taxation Conventions do not conflict with any charge on the profits of the CFC.

**G.4** As no significant issues have been raised in relation to the charging mechanism for the current rules, the Government considers that these rules should form the basis for the mechanics of the reformed regime. This will also help to limit the need for rules to deal with transitional issues that may otherwise arise.

**G.5** The mechanics of the regime will need to:

- calculate the chargeable profits of the CFC, the creditable tax and corresponding UK tax on those chargeable profits;
- calculate the UK charge to tax on the proportion of profits apportioned to the UK; and
- determine the eligibility for any reliefs against the apportioned profits that broadly mirror the reliefs that would have been available had those profits arisen in the UK.

### Proposals for reformed regime

#### The measure of profits

**G.6** As with the current rules, any apportionment to the UK participators will be a notional sum equal to the chargeable profits of the CFC.

**G.7** The current rules for calculating the chargeable profits of a CFC are contained largely within Schedule 24 ICTA 1988. It is proposed to follow these provisions in the new CFC regime whilst recognising there are some areas of uncertainty under the current CFC rules. It is proposed therefore to provide clarification in the following areas:

- brought forward amounts - where the UK rules require reference to figures brought forward from previous accounting periods, the calculation of chargeable profits can take account of this. This will include written down values for capital allowance computations;

- accounting periods where no apportionment falls – the rules will provide for the deemed computation of profits for years where no apportionment is made, but apportionment is made in a later year and requires reference to amounts in the previous years;
- interaction with anti-avoidance legislation – to deter the use of CFCs to artificially shift profits from the UK the new regime will put beyond doubt that anti-avoidance provisions within the Taxes Acts apply in the context of a CFC;
- relief arising from prior years; and
- claims and elections that might normally have been made if the company had been UK resident.

**G.8** Where the calculation of the chargeable profits has to take account of transactions between connected persons these must take account of transfer pricing rules. As with the current rules, corresponding adjustments can be claimed in respect of a CFC or UK person, but the new rules will also take account of the fact that only a proportion of a CFC's profits may be apportioned

**Question G1: The Government would welcome comments on any other areas of perceived uncertainty in the calculation of chargeable profits under Schedule 24 ICTA 1988.**

### **Creditable tax and eligibility of reliefs**

**G.9** The new regime will continue to exercise secondary taxing rights on CFC's profits by ensuring that credit is available for foreign tax suffered on those profits. Provision for calculating the amount of any foreign tax paid on the CFC profits will be based on existing rules. However, the rules will also take account of the fact that in some cases only a proportion of a CFC's profits will be apportioned to the UK.

**G.10** Reliefs (such as trading losses) that are available to set against profits charged in the UK under the current CFC legislation will also be available under the new CFC regime.

### **Apportioning profits to UK participators**

**G.11** As with the current rules the profits of a CFC will only give rise to a UK charge to tax where the participator is a UK company. The charge will only apply where the UK participator has a substantial interest in the CFC. The current legislation recognises a substantial interest as being 25 per cent after attributing the interests of connected or associated parties and the Government does not intend to change this. A participator's interest will generally be determined by rights to ordinary shares. A separate provision will be necessary where other rights exist to determine whether these should give rise to an apportionment. This will continue to be determined on a just and reasonable basis.

**G.12** Where profits are apportioned to the UK, the normal reliefs that would be available to set against the profits of the UK participator company will be available to set against the apportioned profits. The new legislation will also:

- Deal with time limits for claims for relief; and
- Look to eliminate any economic double taxation following an apportionment in instances of share disposals and the receipt of dividends where there has been an election to have the dividend charged to tax in the UK.

## Transitional issues

**G.13** In the absence of any transitional rules, CFCs which are currently exempt under an HMRC motive test clearance will need to qualify for one of the exemptions available under the new CFC regime. The possibility of a transitional rule for “period of grace” clearances under the motive test is referred to at paragraph 4.25. The case for further transitional provisions where motive test clearances have been given in other circumstances is less clear cut but is also being considered.

## CTSA returns

**G.14** A UK company that has at least a 25 per cent interest in a CFC will be required to self assess the charge to UK tax in respect of any apportionment of that CFC’s profits. The current rules also require a UK company to list all overseas companies in which it has at least a 25 per cent interest and where a particular exemption has been claimed.

**G.15** This information is a valuable aid in helping ensure compliance with the current CFC rules. The Government proposes to retain this reporting requirement. To aid risk assessment and inform policy evaluation it would be helpful if the requirement covered all of the new exemptions. In considering this, the Government recognises that there would be an impact on the associated compliance costs compared to the current rules, although this is expected to be small. The Government welcomes views on what the effect of a marginal extension of this requirement to include the excluded country exemption might be.

**G.16** Any proportional apportionment under the TBEs may be different to an apportionment calculated under GPE. Rules are therefore required to identify one of these figures as the appropriate amount for the purposes of a CTSA return. The Government wishes to consult on the simplest way to achieve this.

**Question G2: The Government welcomes views on the preferred approach when an apportionment arises on a proportion of a CFC’s profits, the amount of which differs under the various exemptions.**

**Question G3: Are there any other issues that arise in respect of the charging mechanics proposed?**





# Tax Impact Assessment

**H.1** This annex provides a tax impact assessment that sets out the current understanding of the costs and impacts of the CFC proposals contained in this document. The Government recognises the importance of gaining a thorough understanding of the effects that these proposals could have, and will continue to develop this assessment through consultation with interested parties. In line with the Government's tax policy making approach, an updated impact assessment will be published alongside the draft legislation in Autumn 2011.

## Exchequer impact

**H.2** The following estimate of the cost of CFC full reform was included in the forecasts published in Budget 2011.<sup>1</sup> This costing estimate considers the direct effect on UK corporate tax revenues of introducing these proposals, taking account of the related specific direct behavioural effects.

Estimated Fiscal Impact (£m)				
2011-12	2012-13	2013-14	2014-15	2015-16
0	-210	-540	-770	-840

**H.3** The current proposals are consistent with this estimate. The Government needs to ensure that the final proposals for a new CFC regime are introduced within these cost parameters. When considering representations made in response to this consultation, the overall impact on the cost of the reform as a whole will need to be considered.

**H.4** The Exchequer receives tax from CFCs of UK companies only where there is an apportionment under the current rules. HMRC currently has limited information covering which CFCs are exempt and the reason for the exemption. Therefore, HMRC will be undertaking an extensive survey of CT computations and HMRC Customer Relationship Managers over the Summer and Autumn of 2011 to obtain details of the population of UK-owned CFCs.

**Question H1: The Government would welcome evidence from business to help it refine the estimates of the elements of cost of the CFC reform.**

## Behavioural impact

**H.5** CFC reform is wide-ranging. Fundamentally, a switch to a more territorial regime will give business more freedom to structure their overseas business operations without an undue consequential UK tax charge.

**H.6** The introduction of the finance company rules, and the removal of the ability to "swamp" finance income, should remove the incentive to create artificial business structures which match trading and investment income.

<sup>1</sup> Budget 2011 Policy Costings, HM Treasury, DWP and HMRC ([http://www.hm-treasury.gov.uk/2011budget\\_policycostings.htm](http://www.hm-treasury.gov.uk/2011budget_policycostings.htm))

**Question H2: The Government would welcome comments and evidence from businesses about the expected behavioural impacts on financing income and activities following the introduction of these reforms.**

**Question H3: The Government welcomes comments and evidence from businesses on other expected behavioural impacts following the introduction of these reforms.**

## **Economic impact**

**H.7** CFC reform will allow businesses based in the UK to be more flexible and internationally competitive, and will encourage more businesses to be headquartered here supporting the Government's ambition to promote private sector investment and growth.

**H.8** CFC reform will have a net benefit for a wide range of sectors, though benefits to the banking sector are expected to be predominantly in the form of compliance savings. The impact on individual groups will be defined by their industrial sector, domestic and international structure and a number of other demographic factors.

## **Impact on business**

### **Administrative burdens**

**H.9** The complexity of correctly attributing profit in a multinational group, particularly in the case of mobile income such as profits from financing or IP, leads to some inevitable complexity in the UK's CFC rules. The reforms are designed to better reflect modern business practice and to, as straightforwardly as possible, exempt profits that are not artificially diverted from the UK.

**Question H4: The Government would welcome comments on the administrative impacts of these proposals on businesses, and any areas where administrative burdens could be reduced while still finding the appropriate balance of applying the principles and achieving the aims of the reform.**

**H.10** Relevant administrative costs include:

- one-off costs arising from the new CFC regime. These include, for example, one-off costs associated with becoming familiar with the new regime, as well as any additional IT costs that are likely to be incurred for businesses so that they can correctly account for and pay taxes required under the new regime. The Government would welcome any additional information and data in relation to time and management costs that businesses incur, the likely costs of using advisers and those costs associated with setting-up new processes – management or other – that arise from the introduction of the new regime; and
- continuing costs of complying with the new regime or the administration burden. The Government would welcome data on the time and costs associated with collating information and data that is needed to file tax returns and undertake relevant record keeping requirements, as well as calculating the amount of tax that would need to be paid under the new regime. The Government would welcome information on the time spent by each level of management, as well as grade of staff, that are likely to be involved at each stage with this administrative burden.

**H.11** The Government would also welcome comments on whether the activities involved in determining and paying the appropriate tax charge is likely to be affected by CFC reform. The stages of which are:

- 1 Identifying which entities are CFCs, and where they are resident;
- 2 For each CFC identified, examining whether any of the exemptions are applicable;
- 3 Where an apportionment arises, calculating the apportioned profits;
- 4 Calculating the tax charge resulting from any apportionment; and
- 5 Completing the CT600B supplementary pages of the Corporation Tax Return.

**Impact on small companies**

**H.12** CFC reform will primarily affect large multinational corporate groups based in the UK, but the rules will apply, as now, to any subsidiary of a UK resident company with profits taxed at a lower effective rate than if it were resident in the UK.

**H.13** The proposals for the low profits exemption should exempt the majority of foreign subsidiaries owned by SMEs and therefore in practice the impact on SMEs is expected to be minimal.

**Question H5: The Government would welcome views on the impact of the regime on SMEs.**

**Impact on third sector**

**H.14** This is a corporate tax measure and will only impact subsidiaries of UK headed groups or sub groups. It is therefore not expected to have a significant impact on organisations in the civil society.

**Impact on the public sector**

**H.15** CFC reform should not have a significant impact on HMRC’s costs. Designing a regime that allows a greater number of CFCs to be exempt under the more straightforward tests, may reduce the costs in the medium to long term. Training and familiarisation with the new legislation will be required. It is not anticipated that there will be any significant operational impacts on other government departments.

**Summary of other impacts**

<b>Impact on individuals and households</b>	This is a corporate tax measure so will not impact on individuals and households.
<b>Equalities impact</b>	This is a corporate tax measure. No impacts on race, gender, disability or other equality groups are anticipated.
<b>Wider environment impact</b>	This is a corporate tax measure. No wider environmental impact is anticipated.
<b>Health impact</b>	This is a corporate tax measure. No health impact is anticipated.
<b>Competition</b>	The CFC rules apply to UK companies with foreign subsidiaries or exempt foreign branches. CFC reform includes sector specific rules for banking and insurance

	groups designed to reflect the different role that capital and finance income play in those businesses. These look to achieve the same outcome as the general regime to protect against the artificial diversion of UK profits.
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**H.16** The Government welcomes consultation with, and representations from, all interested parties that could be impacted by these proposals to gain a full understanding of the wider impacts of these reforms.

**Question H6: The Government would welcome comments or evidence to support the assessment of the impacts of these reforms.**

**Evaluation and monitoring**

**H.17** The policy will be monitored and assessed alongside other measures in the Government’s package of corporate tax reforms through regular communication with the business sectors affected, and information collected from tax returns.



# Interaction with EU Law

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**I.1** This annex provides a summary of the Government’s understanding of the relevant ECJ case law in this area.

## **Treaty for the Functioning of the EU – freedom of establishment**

**I.2** Direct taxation falls within the competence of Member States. That competence must be exercised consistently with EU law, including the fundamental freedoms.

**I.3** A tax measure of a Member State which is restrictive in that it is liable to hinder the genuine exercise of a fundamental freedom will nonetheless be consistent with EU law if it is justified, that is, if it pursues a legitimate objective in the public interest, and if it is proportionate to that objective. For example, a tax measure will be in the public interest and proportionate if and to the extent that it does no more than prevent tax avoidance and/or maintains a balanced allocation of taxing rights between Member States.

**I.4** The judgment of the European Court of Justice (ECJ) in *Cadbury Schweppes* established that:

- in the context of the CFC rules, the relevant fundamental freedom was the freedom of establishment;
- since the CFC rules tax a UK company on the profits of its non-UK subsidiary in circumstances where it would not be taxed on the profits of a UK subsidiary then, to the extent that a UK company had genuinely exercised its freedom of establishment, the CFC rules were capable of restricting that freedom since their effect could be to treat the UK company less favourably than a UK company that established a UK subsidiary;
- since the CFC rules were apt to prevent tax avoidance and/or maintain a balanced allocation of taxing rights between Member States, the less favourable treatment was justifiable;
- the less favourable treatment would be justified to the extent that the CFC rules did no more than necessary to prevent tax avoidance and/or maintain a balanced allocation of taxing rights.

## **Genuine exercise of freedom of establishment**

**I.5** In *Cadbury Schweppes*, the ECJ noted, as in previous cases, that:

- the objective of the freedom of establishment is to promote the single market by “assisting economic and social interpenetration within the Community,” allowing self employed persons or companies to “participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom”; and, as such
- the freedom presupposes “actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there” for an indefinite period.

**I.6** The Court held that:

- whether the CFC has an “actual establishment” in the host Member State through which it pursues “genuine economic activity” is to be answered by reference to “objective factors which are ascertainable by third parties”;
- particular regard should be had to “the extent to which the CFC physically exists in terms of premises, staff and equipment”; and
- where the extent to which the CFC physically exists leads to the finding that the CFC is a “fictitious establishment” the CFC “must be regarded as having the characteristics of a ‘wholly artificial arrangement’”.

**1.7** The Government takes the view that:

- “actual establishment” and “genuine economic activity” constitute two separate, interdependent prerequisites for genuine establishment;
- whether a CFC constitutes a genuine establishment is a question of fact and degree; and
- in setting up a CFC in another Member State, a UK parent genuinely exercises its freedom of establishment if and to the extent that the CFC has genuine physical presence in the form of premises, staff and assets (i.e. “actual establishment”) in that Member State that is commensurate with its pursuit of real, profit-making activity (i.e. “genuine economic activity”) through that “actual establishment”.

## Justification

**1.8** In each of *Cadbury Schweppes*, *Thin Capitalisation* and *SGL*, the ECJ

- noted that the objective of CFC (or, as the case may be, thin capitalisation or transfer pricing) rules is to prevent tax avoidance from the artificial transfer of profits from one jurisdiction to another and to thereby maintain a balanced allocation of taxing rights between countries; and
- held that those rules each do no more than is necessary to prevent such avoidance (or, as the case may be, maintain such a balance) if and to the extent that the profits they tax relate only to “wholly artificial arrangements”.

**1.9** There has been some debate since *Cadbury Schweppes* about

- what the term “wholly artificial arrangements” means, and
- whether the CFC rules constitute an unjustified restriction on freedom of establishment unless the CFC is itself a “wholly artificial arrangement.”

**1.10** The Government considers that:

- the term “wholly artificial arrangements” is to be taken to refer to arrangements that do not relate to genuine economic activities pursued through an actual establishment in the host Member State;
- a UK parent company will not have genuinely exercised its freedom of establishment if the CFC is itself a “wholly artificial arrangement”;
- the CFC rules constitute a justified restriction on the freedom of establishment so long as they tax only those profits that are attributable to “wholly artificial arrangements”.

## Proportionality

**1.11** Where a CFC’s profits are partly attributable to genuine economic activities pursued through an actual establishment in the host Member State and partly to “wholly artificial arrangements”,

the CFC rules will constitute a justified restriction so long as they tax only those profits that are attributable to “wholly artificial arrangements.”

**I.12** The Government considers that, in *Cadbury Schweppes*, the ECJ held that CFC rules tax profits that are attributable only to “wholly artificial arrangements” to the extent that the profits taxed are not attributable to genuine economic activities pursued through an actual establishment in the host Member State.

**I.13** This approach is consistent with the ECJ’s approach in *Thin Capitalisation* and *SGI* where it confirmed that a transaction could be a “wholly artificial arrangement” “in whole or in part”. In *Thin Capitalisation*, the Court held that thin capitalisation rules tax profits that relate only to “wholly artificial arrangements” to the extent that they do not relate to arrangements with “commercial justification”. In *SGI*, the ECJ held that transfer pricing rules tax profits that relate only to “wholly artificial arrangements” to the extent that they do not relate to arrangements that would have been made under “fully competitive conditions”.

**I.14** In both *SGI* and *Thin Capitalisation*, the ECJ explicitly noted that the independent enterprise approach to the arm’s length principle as set out by the OECD in, for example, its Transfer Pricing Guidelines constituted a suitable means of determining “wholly artificial arrangements”.

## Application

**I.15** The Government takes the view that, in these cases, the ECJ set out a consistent set of principles for determining the circumstances in which tax rules that neutralise the tax consequences of artificial transfers of profits from one tax jurisdiction to another constitute a proportionately justified restriction on freedom of establishment.

**I.16** Those principles are, in essence, that such rules represent a proportionately justified restriction if and to the extent that they only tax profits (or, as the case may be, disallow only expenditure) that differ from that which would have been made by an independent enterprise under the arm’s length principle.

**I.17** These principles form the foundation for the concept of establishing the profits of a CFC that are commensurate with its activities, which is set out in Chapter 7.

**I.18** The proposed new CFC rules are intended to be consistent with EU law since, if a CFC is genuinely established in its territory of residence, the rules will do no more than tax the UK parent company on the amount of the CFC’s profits that exceeds the profits that would have been made by an independent enterprise under the arm’s length principle.

## Council resolution

**I.19** The Council of the European Union noted in a resolution dated 8 June 2010<sup>1</sup> concerning the co-ordination of CFC and thin capitalisation rules within the EU that restrictions on the Treaty freedoms within the EU are capable of being justified by overriding reasons in the public interest, such as the need to prevent tax avoidance and/or the need to preserve a balanced allocation of taxing powers between the Member States, provided that they are proportionate in relation to such objectives, and that preventing tax avoidance in relation to “wholly artificial arrangements” is generally justified.

**I.20** The resolution went on to recommend principles that Member States adopt in applying CFC and thin capitalisation rules. The Government considers that its views as outlined in this annex and the proposals included in this document are consistent with those principles and the case law from which they are derived.

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<sup>1</sup> The Council of the European Union resolution, 8 June 2010 (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:156:0001:01:EN:HTML>)





# Summary of Responses to the November Consultation

Issue	Summary of business response	Government Position
<b>Chapter 2: Finance company partial exemption</b>		
2A – Do you agree with the pragmatic option of a finance company partial exemption (FCPE)?	Most responses supported the pragmatic proposals and welcomed the certainty it would provide to businesses for long term commercial needs.	The Government noted this.
	Some responses noted that the downside of a pragmatic regime is that the rules could give rise to arbitrary results. It was therefore suggested that the regime should be flexible so that groups with relatively low, or no, UK debt could obtain a full exemption. Elective tracing rules were also suggested by some for groups that could demonstrate there is no UK base erosion and were willing to consider more detailed and complex rules.	The Government proposes to consult on a full exemption for overseas intra-group financing in limited circumstances but has rejected tracing as too complex (see paragraph 6.27).
2B – What would be the behavioural impact?	The responses indicated that it was not possible to assess this without further details of how the regime would operate or draft legislation. Some responses acknowledged that exposure to UK tax could be reduced as businesses will seek to finance overseas operations from an overseas finance company. Other responses noted that the proposals provide certainty to businesses that current overseas finance arrangements could be retained and would be subject to a UK tax charge under the FCPE.	The Government has considered expected behavioural impact, including discussions in the working group, and will consider these further through consultation.
2C - Views on the ratio proposed (and key issues of regime)	Whilst various responses stated that a debt:equity ratio of 1:2 was reasonable, it was suggested by others that a debt:equity ratio of 1:3 would be more competitive internationally.	The Government announced at Budget that a finance company partial exemption would operate by applying a debt:equity ratio of 1:3.
	It was suggested that the effective UK corporate tax rate on overseas intra-group finance income should be reduced to nil where there is a low risk of artificial diversion of profits from the UK.  It was noted that rules aimed at achieving this should not disincentivise groups to locate activity in the UK.	The Government proposes to consult on a full exemption in limited circumstances (see paragraph 6.27).
	Relief should be given for overseas tax suffered on the finance income or profits. Some responses suggested that relief should be given for overseas tax suffered in full even if the UK is only seeking to tax a proportion of those intra-group finance profits.	The Government has confirmed that relief will be given for overseas tax suffered in proportion to any profits that are subject to a UK tax charge (see paragraph 6.22).

	It was suggested that an apportionment approach would be easier to operate than imputation. Particular issues raised with imputation were that a charge would still arise even where the finance company made a loss; that it would be more difficult trying to give a credit for overseas tax suffered; and complexities inherent in determining an appropriate interest rate to apply to any deemed loan from the UK.	The Government proposes to adopt an apportionment approach (see paragraphs 6.11 to 6.13).
	Where overseas financing arrangements involve more than one entity (e.g. finance is provided through a chain of overseas finance companies), the regime should operate to ensure that the overseas finance profits are only taxed once in UK.	The Government proposes options to introduce rules that will only tax the same financing profits once in the UK (see paragraph 6.19).
	There are commercial reasons to support the lending of funds from overseas subsidiaries to the UK. These include cash pooling to treasury operations based in the UK; as an interim measure where it is only possible to pay a dividend once a year under local corporate law; for the management of foreign exchange, due to dividend blocks in a chain of holding companies; to manage overseas withholding tax or for other overseas tax reasons and local restrictions on repatriation of funds.	The Government recognises the commercial reasons for certain short term loans to the UK (see paragraph 6.30).
<b>Chapter 2: Mixed activity companies</b>		
2D - Does the proposed approach (on the treatment of mixed activity companies and excess cash) deliver a competitive and fair result?	Imposition of a UK tax charge on all offshore excess cash would be uncompetitive, therefore it is important that an incidental amount of interest that can be earned without a CFC charge arising and the threshold for incidental is set at an appropriate level.	The Government proposes different options for incidental interest that can be earned in a trading CFC without a CFC charge arising (see paragraph 5.26).
	It was suggested that an approach similar to that under the substantial shareholding exemption could be adopted where surplus cash generated by a business and for example, required as working capital (or retained pending a dividend), should be treated as trading).	See paragraph 5.26 on the proposals for a definition of incidental finance income.
2E - Weighing up additional complexity required for mixed activity companies, do businesses support this proposal?	Mixed views were received. Some considered the proposals to be simple when applying to genuine trading activities which are not supplemented by artificially diverted profits. Others considered this would create an administrative burden for group companies.	The Government notes that where the regime caters for financing activity held alongside trading activity in a CFC, the rules will need to be more detailed than those of a regime that only applied to pure finance companies (see paragraphs 6.32 to 6.34).
2F - How should the debt and equity of the company be apportioned in a mixed activity company?	Various views were raised including the allocation of all the debt to the finance activity of the company; using a just and reasonable approach to allocate the debt between the financing and trading activities; or using the group's overall debt:equity ratio to determine the level of debt that applies to the finance	The Government will continue to consider this during consultation.

	activity.	
<b>Chapter 3: Intellectual Property</b>		
3A – could the proposed option for IP produce a workable set of rules?	Several responses thought transfer pricing and exit charges provided sufficient protection to the UK tax base from IP being artificially moved out of the UK. In particular, transfer pricing should protect the UK tax base even where high value functions are undertaken in the UK. It was recognised in consultation that CFC rules would be needed in some circumstances	The Government’s view is that CFC rules are needed to protect the UK tax base (see Chapter 8).
	IP income embedded in other income such as trading receipts, should not be impacted by these rules as it is complex and difficult to identify the portion of a CFC’s trading profits derived from IP	The Government provides an update in Chapters 5 and 8.
3B - Does this provide more certainty and flexibility compared to the previous proposal to deal with real-life commercial situations?	Some responses suggested that a more tightly drawn definition of IP and UK connection would be welcomed rather than imposing a broad net with a safe harbour. It was suggested that further detail would be required to assess whether these proposals would provide more certainty or flexibility.	The Government noted this.
3C - Would the safe-harbours and carve-outs identified reduce compliance?	It was generally agreed that safe harbours if suitably drafted would assist with reducing compliance burdens.	See update in paragraphs 5.11 to 5.13. A CFC with a low rate of profitability should be able to qualify for a safe harbour.
3D – What are appropriate measures to use for the safe-harbours for CFCs that hold IP to assist with minimising compliance costs?	There was support for basing any safe harbour on local accounting profit. Where the threshold is exceeded, companies should then have the opportunity to demonstrate that a CFC charge should not arise. Flexibility should be available due to variance in trading performance from year to year. For example, where the threshold is exceeded for one year within certain parameters, this should not constitute a breach of the safe harbour.	See update in paragraphs 5.11 to 5.13 on safe harbour.
3E - When the holding of IP as an investment is one of a range of activities carried on by a company how could a debt:equity approach apply?	It was suggested that this approach would give rise to numerous issues and that it should be considered further. Various responses also confirmed that IP is not held as a passive investment.	Following consultation the Government has moved away from this approach. CFCs exploiting IP will have access to all relevant CFC exemptions.



# K

## Summary of Questions

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### Chapter 2

Question 2A: Do the proposals overall strike the right balance to deliver a more competitive corporate tax system while providing adequate protection of the UK tax base?

Question 2B: Do you have any views on how the rules should be administered, and in particular how the clearance process could be improved?

### Chapter 3

Question 3A: Which of the options for defining control would be preferable and why? Or would a combination be preferable?

Question 3B: Are there other options for the calculation of the lower level of tax which would ensure that the UK measure of tax would broadly reflect the figure calculated under the existing rules? Can the chargeable profits approach be simplified?

### Chapter 4

Question 4A: Which option for the low profits exemption is preferred? The Government would welcome views from groups on the options outlined, and the proportion of their CFCs that could potentially qualify under each option.

Question 4B: The Government would welcome views on the suggested percentage of group turnover for option B, including data on the proportion of CFCs which could potentially benefit from this approach.

Question 4C: The Government welcomes views from business about whether they would prefer a single accounts based exemption, or an option to apply a UK chargeable profits basis despite the anticipated additional compliance burden.

Question 4D: Which of the proposed options for an excluded countries exemption would be the easiest to operate and is preferred?

Question 4E: The Government welcomes views on what the appropriate limits should be for the general conditions set out in paragraph 4.14, and on what basis they should be applied.

Question 4F: Is the scope of the temporary period of exemption in Finance Bill 2011 sufficiently wide to cover the majority of commercial acquisitions and reorganisations?

Question 4G: Are the anti-avoidance rules (which focus on transactions with the UK) included in Finance Bill 2011 for the temporary period of exemption sufficiently well targeted?

Question 4H: Are specific rules needed to deal with circumstances where an overseas subsidiary is transferred from one UK group to another, for example a third party sale during a period of exemption?

### Chapter 5

Question 5A: Would the proposed safe harbour be effective at removing CFCs that make a low level of profit and pose a low risk to the UK tax base?

Question 5B: The Government invites views on the preferred basis and limit for this safe harbour, and is particularly interested in the impact of different rates and bases on the number of CFCs that would qualify for this exemption.

Question 5C: Are there specific situations where a different safe harbour could be useful?

Question 5D: Would the proposed manufacturing TBE be useful to remove manufacturing CFCs from the rules? How many CFCs would it apply to?

Question 5E: If a CFC currently qualifies for the exempt activities test is it likely to qualify for this exemption? If not, why not? Please distinguish between the changes which address “swamping” and other aspects of the rules. If the failure is marginal or a minor adjustment to the TBEs would result in exemption please provide details.

Question 5F: Would setting a minimum value of assets leased under an operating lease at £10 million per asset provide a reasonable approach to identifying business activity for this purpose?

Question 5G: The Government would be interested in views on how adequate protection of the UK tax base could be provided against tax driven arrangements without introducing rules which would have a disproportionate effect on supply chains, procurement companies and intra-group service provisions.

Question 5H: The Government invites views on the options for defining incidental finance income.

Question 5I: The Government welcomes views on the preferred option to define incidental investment income more generally, and how that should interact with the incidental finance income definition.

Question 5J: Does the proposed treatment of holding companies raise any issues? Would an alternative approach to this be preferred and, if so, what would the advantages be?

Question 5K: Could a principles based approach to drafting the TBE offer an alternative to the more mechanical TBE proposals? The Government welcomes early views on this.

Question 5L: Is the proposed approach a reasonable starting point for drafting the exemption? Or would a different approach be preferred (please provide details)?

Question 5M: Alternatively would there be advantages in using both mechanical and principles based approaches to design the TBEs?

## **Chapter 6**

Question 6A: Do businesses prefer the simplest option, one of the more flexible options (as outlined in Annex D) or an alternative approach? Would the benefits of the simplest option outweigh the cost of any intra-group debt restructuring where required?

Question 6B: Do businesses agree that the proposed treatment of companies that carry out both treasury and finance company activities is a satisfactory approach? If not, do businesses consider that it would be practical to separately identify the profits from treasury and finance activities?

Question 6C: Do businesses agree that applying the GPE to treasury companies is an appropriate approach to exempt them from the rules?

Question 6D: Bearing in mind the need to deliver an affordable regime, what circumstances and qualifying conditions should the Government consider when determining when a full exemption might apply?

Question 6E: Do the circumstances in which upstream loans can arise cover the majority of the instances where funds are lent to the UK for genuine commercial reasons?

Question 6F: Would using the worldwide debt cap approach to short term lending produce a workable solution to allow short term upstream loans in these circumstances while protecting the UK tax base?

Question 6G: Based on the design options available, do you think that the finance company rules should apply to mixed activity companies, despite the added complexity? If so, what would be the most appropriate way to identify the profit arising from each activity?

Question 6H: Would any practical issues arise if the design option chosen meant that intra-group debt had to be restructured? How long would it take to restructure such arrangements?

Question 6I: What specific issues would prevent businesses from restructuring their overseas intra-group finance arrangements?

Question 6J: Would it be of benefit to consider the application of these rules to branches at this stage despite the practical difficulties and issues raised?

Question 6K: Should the finance company rules be extended to the insurance and/or banking sectors? If so, how will groups identify those finance costs and income that are not part of trading operations?

Question 6L: In what circumstances would insurers or banks envisage using the finance company rules if they were made available?

Question 6M: Given the risks to the UK tax base, what commercial factors would need to be considered to determine the extent to which an insurer or bank could borrow in the UK to fund capital offshore?

## **Chapter 7**

Question 7A: The Government welcomes views on applying principles based on those set out in Article 7 to apply the GPE, and any alternative methods for the calculation of “commensurate with activities” profits.

Question 7B: The Government welcomes views on the likely compliance impacts of adopting this approach, and any situation in which this attribution may significantly increase compliance burdens.

Question 7C: Does the GPE provide a suitable and effective replacement for the motive test that can be applied to any CFC to determine whether and to what extent profits have been artificially diverted from the UK?

## **Chapter 8**

Question 8A: The Government welcomes views on ways to distinguish high risk from low risk licensing for the purposes of defining the term “transfer”.

Question 8B: The Government welcomes views on the indicators described in Annex E that may indicate whether a transfer of IP has given rise to an artificial diversion of UK profits or not, and whether inclusion of such indicators in guidance would be helpful in assisting with interpretation of the CFC rules as they relate to IP.

Question 8C: The Government welcomes views on whether the proposals are appropriate to deal with CFCs where IP is held as a passive investment.

Questions 8D: Is the pure income profit approach to determining whether IP is held as an investment workable?

Question 8E: Is there a case for the tapering charge? Are there sufficient instances to which a tapering charge could fairly be applied to justify the additional rules that would be needed?

Question 8F: The Government invites views on the proposals for tax paid on transfer of UK IP and whether in practice tax is paid on IP transfers sufficiently frequently to merit the additional complexity that relieving rules would introduce.

Question 8G: The Government welcomes comments on the examples in Annex F and analysis provided, and would also welcome any other practical examples which might assist with the development of the CFC rules for IP during the next stage of consultation.

Question 8H: The Government welcomes views on an appropriate transitional provision, setting out its purpose and justification.

## **Chapter 9**

Question 9A: Is the local management requirement proposed for the CFC regime appropriate for foreign branches?

Question 9B: The Government is keen to hear the views of businesses on the application of the banking and insurance exemptions to exempt foreign branches and to see examples of how the capitalisation tests might apply to the foreign branch or UK company in practice.

Question 9C: Do you see any issues with the proposed approach to the application of the sector specific TBEs to exempt foreign branches?

Question 9D: Do you foresee any issues with the application of the general purpose exemption to foreign branches?

Question 9E: Are there any other issues that should be considered to ensure that the CFC reform and proposed exemptions apply in a workable way to exempt foreign branches?

## **Annex A**

Question A1: It is not intended that the property investment exemption will apply to rental income received by owner occupiers. Instead activities in relation to rental to owner occupiers will be treated as non-investment activities. Will this approach raise any practical issues?

Question A2: Will the proposed property exemption, when considered in conjunction with the proposals for the low profits and excluded country exemptions reduce the compliance burden currently faced by property investment businesses?

Question A3: Do you agree that management service companies should qualify for the TBE and, if so, are they likely to benefit from exemption under the safe harbour?

Question A4: The Government's initial view is that this change in treatment in comparison with the existing CFC regime is more likely to be of relevance to the operating leasing of small numbers of large high value assets than of large numbers of small lower value assets, but is interested in hearing views on this.

Question A5: Are the qualifying conditions appropriate in the context of what the exemption is seeking to achieve?

Question A6: Do you envisage any practical difficulties in being able to meet the conditions proposed? In particular, how should the local management condition be defined in these situations?

Question A7: Do you have any views on the definition of an operating lease for this purpose?

## **Annex B**

Question B1: Will the requirement for 80 per cent of a company's activities to be insurance activities cause any issues in practice?

Question B2: Do you prefer the approach in Option 1 or Option 2 to exempt overseas insurance and reinsurance business?

Question B3: What would be the preferred approach to the capitalisation test (mechanical or self certification) and how can these tests be further developed to apply in practice? If you would prefer a mechanical test, what would an appropriate level of capital be?

Question B4: Are the current exclusion for large risks and life still appropriate?

## **Annex C**

Question C1: Will the requirement for 80 per cent of a company's activities to be banking activities cause any issues in practice?

Question C2: What are the views of businesses on the Government's proposed approach to adopt a modernised capital structure test?

Question C3: The Government would welcome further views in relation to what would be considered an appropriate level of capital for such a capital test and would be interested to see examples of where the interaction of the 15 per cent threshold and regulatory capital requirements would cause difficulties.

Question C4: Do you agree that the factors identified in relation to the capital structure test should be taken into account in any revised test? Are there any other factors that should be considered?

Question C5: How could the current exempt activities test available to banks be simplified to reduce the compliance burden whilst retaining an appropriate level of protection?

Question C6: The Government welcomes views on the structure of the test and in particular, whether exempting overseas income would be more beneficial to the banking sector than the current approach of exempting interest income received from UK associates.

## **Annex G**

Question G1: The Government would welcome comments on any other areas of perceived uncertainty in the calculation of chargeable profits under Schedule 24 ICTA 1988.

Question G2: The Government welcomes views on the preferred approach when an apportionment arises on a proportion of a CFC's profits, the amount of which differs under the various exemptions.

Question G3: Are there any other issues that arise in respect of the charging mechanics proposed?

## **Annex H**

Question H1: The Government would welcome evidence from business to help it refine the estimates of the elements of cost of the CFC reform.

Question H2: The Government would welcome comments and evidence from businesses about the expected behavioural impacts on financing income and activities following the introduction of these reforms.

Question H3: The Government welcomes comments and evidence from businesses on other expected behavioural impacts following the introduction of these reforms.

Question H4: The Government would welcome comments on the administrative impacts of these proposals on businesses, and any areas where administrative burdens could be reduced while still finding the appropriate balance of applying the principles and achieving the aims of the reform.

Question H5: The Government would welcome views on the impact of the regime on SMEs.

Question H6: The Government would welcome comments or evidence to support the assessment of the impacts of these reforms.



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