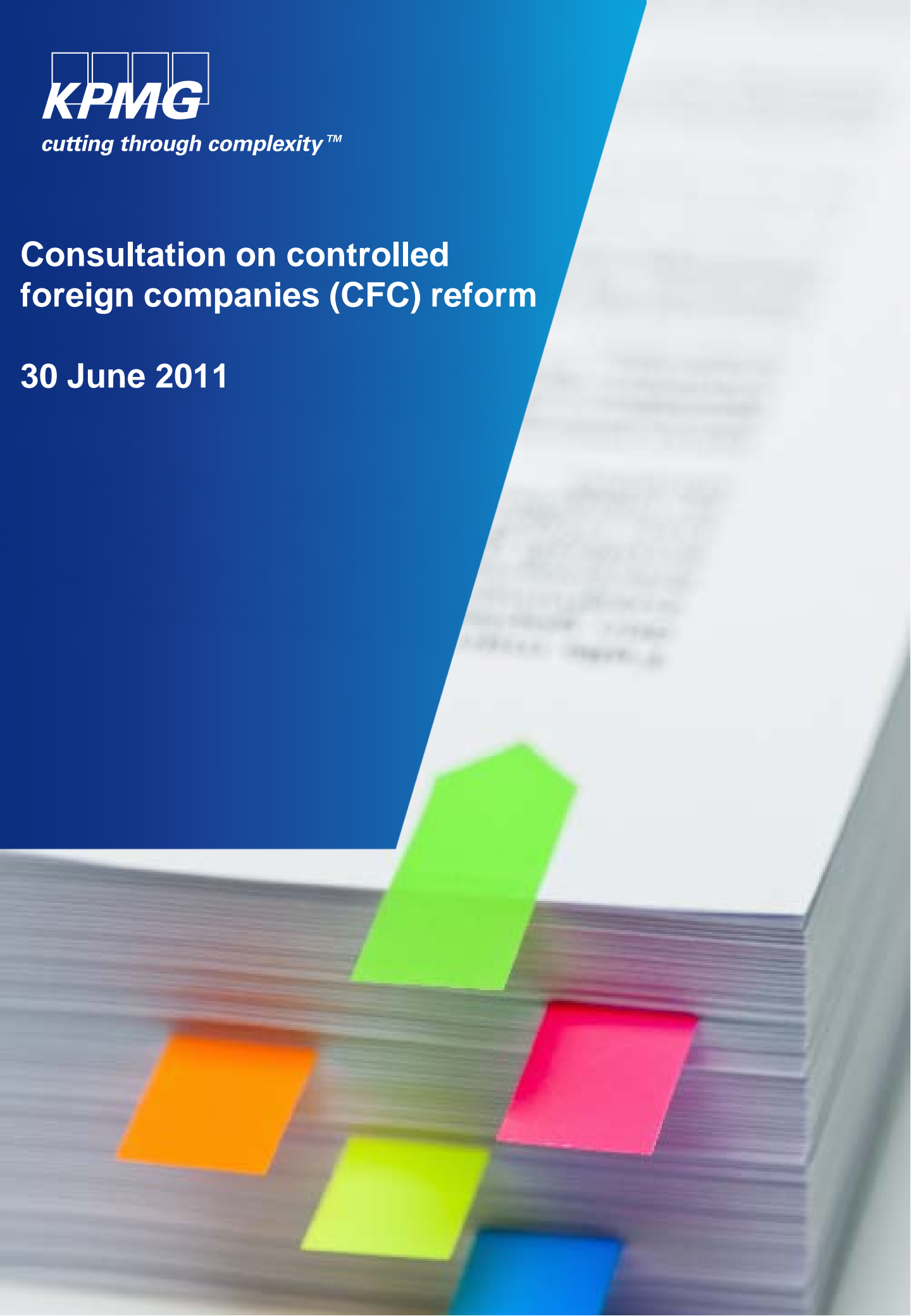




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Consultation on controlled foreign companies (CFC) reform

30 June 2011



Consultation on CFC reform

Key proposals

On 30 June 2011, the Government published a consultation document setting out proposals for a new CFC regime to be introduced in Finance Bill 2012. The intention is to deliver a new regime which is competitive for business while providing adequate protection to the UK tax base. The key proposals are summarised below.

The consultation document can be found [here](#).

Overall framework of the new CFC regime

In line with recent moves to create a more territorial corporate tax system, the intention is to introduce a modernised CFC regime which does not tax profits arising from genuine economic activities undertaken overseas but instead focuses on taxing foreign profits that have been artificially diverted from the UK.

The new regime will operate in a similar way to the existing CFC rules. Thus, where a company is a CFC, its chargeable profits (computed broadly following UK tax principles) will be apportioned to the UK and taxed on any UK company with a 25% assessable interest in the CFC, unless one of the available exemptions (see below) applies.

While under the existing rules (leaving aside the recent CFC interim improvements) there is no CFC charge if an exemption applies, under the new regime there may still be a charge, based on the proportion of a CFC's profits that is considered to have been artificially diverted from the UK. Thus, there is a move away from the current "all or nothing" approach towards a "proportionate" approach, which the Government sees as being consistent with EU law.

As with the current rules, credit will be allowed against a CFC charge for any foreign tax suffered by the CFC (or an appropriate proportion where there is a partial apportionment) and for the offset of relevant UK reliefs.

A CFC will also be defined in broadly the same way as under the current rules, although the Government is considering whether to change how "control" is determined, which could involve moving away from the current mechanical rules to either a principles-based or accounting standards approach. These are seen as potentially providing simpler and more effective rules which could address some of the issues arising from the use of partnerships, trusts and protected cell companies.

HMRC plans to continue with the existing non-statutory clearance procedure in relation to the new CFC regime.

Following the introduction of the new foreign branch exemption, the new CFC regime will apply to exempt foreign branches as well as foreign subsidiaries (although, subject to further consultation, the intention is not to apply the proposed finance company partial exemption to branches).

The proposed exemptions

It is proposed that there will be eight main exemptions under the new CFC regime, as follows:

- 1) Low profits exemption.
- 2) Temporary period exemption.
- 3) Excluded countries exemption.
- 4) Territorial business exemptions.
- 5) Banking exemption.
- 6) Insurance exemption.
- 7) Finance company partial exemption.
- 8) General purpose exemption.

These are considered in more detail below:

1) *Low profits exemption*

This exemption will apply to CFCs with low levels of profits where the risk to the UK tax base is low. Following the alternative *de minimis* exclusion included in the interim improvements, the measure of profits will be the CFC's accounting profits subject to certain adjustments and with a TAAR to prevent exploitation of the exemption (e.g. by fragmentation of profits).

Three design options are being considered here – retaining the current profit threshold of £200,000 per annum, increasing it to £500,000 but with a limit on the amount of investment income, or applying a threshold which increases in line with a measure of the group's size (e.g. a percentage of the group's turnover), although with an upper and lower limit of £1 million and £200,000 respectively. Business has been asked whether it sees a benefit also to retaining the existing *de minimis* exclusion based on chargeable profits.

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2) *Temporary period exemption*

This exemption, which will be similar in scope and structure to the temporary exemption introduced as part of the CFC interim improvements, will apply for up to three years for foreign companies which come under UK control as a result of third party acquisitions or group re-organisations.

Transitional rules will ensure that any exempt period applying under the existing temporary exemption or “period of grace” granted under the existing motive test will continue as expected. The Government is still considering whether existing motive test clearances given in other circumstances will be “grandfathered” under the new CFC regime.

3) *Excluded countries exemption*

This exemption will apply to CFCs resident in territories with tax regimes that have broadly similar rates and bases to the UK. The Government is considering identifying “normal” rate territories which fall into three broad categories:

- category 1 territories with corporate tax regimes sufficiently similar to the UK that any CFC could be exempt without satisfying further conditions (this would be expected to be a relatively short list);
- category 2 territories with generally acceptable corporate tax regimes where a CFC could be exempt provided it meets general conditions regarding the proportion of its total income derived from transactions with the UK, investment income and low-taxed branch income; and
- category 3 territories where a CFC would need to meet specific conditions which ensured it did not benefit from particular local tax breaks, as well as potentially the general conditions.

Three design options are being considered here – a single list consisting of category 1 and 2 territories subject to the general conditions, a two-part list with the first part consisting of category 1 and 2 territories subject to the general conditions and the second part consisting of category 3 territories subject to the specific conditions and potentially the general conditions (similar to the existing excluded countries regulations), or a three-part list where no conditions would apply to category 1 territories, the general conditions would apply to category 2 territories and the specific conditions, and potentially the general conditions, would apply to category 3 territories.

Whichever option is chosen, the intention is to include a TAAR to prevent exploitation of the exemption and for the general conditions to be adapted for income that is integral to a banking or insurance trade.

4) *Territorial business exemptions (TBEs)*

Three separate TBEs are proposed covering CFCs that undertake genuine commercial activities and do not pose a significant risk of artificial diversion of UK profits:

- TBE 1 will apply to CFCs which meet a “profits rate” safe harbour with no or minimal conditions regarding the activities carried on. The Government is considering a safe harbour of 10% of operating expenses, other than the cost of goods acquired for resale and related party business expenditure.
- TBE 2 will apply to CFCs which are substantially engaged in manufacturing activity provided that they use only “local” IP, regardless of the extent of any transactions with the UK.
- TBE 3 will apply to CFCs which carry on commercial activities where there is a low risk of artificial diversion of profits from the UK. It is proposed that this will apply to:
 - trading and certain business activities between a CFC and other foreign companies (connected or unconnected);
 - trading and certain business activities between a CFC and UK persons (connected or unconnected) where there is no arrangement in place to artificially divert profit from the UK; and
 - trading activities relating to exploitation of IP which does not pose a significant risk to the UK tax base (see below).

TBE 3 will apply provided that a CFC is not engaged to a substantial extent (greater than 20%) in investment activities. However, the following will not be considered investment activities and so will be “acceptable” business activities:

- the holding/managing of shares and securities of other group companies (excluding intra-group finance companies);
- certain property investment business – which is currently proposed to include the long-term rental of overseas property to unrelated tenants where the risks and rewards of the property ownership belong to the CFC (it is also being considered whether the property should be situated in the same territory as the CFC); and
- certain operating leasing of tangible assets – which is currently proposed to include the fixed-term hiring of assets where the CFC retains ownership/control of the asset, the leased asset has an individual value exceeding £10 million and has not been the subject of a claim for UK capital allowances, and the activities are not such that a UK connection condition is failed.

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4) Territorial business exemption – cont'd

Each TBE will include a local management condition and will only permit incidental amounts of finance, royalty and other investment income. Different options have been put forward as to how incidental finance income might be defined, ranging from a fixed percentage of the CFC's profits or gross income to a definition which reflects the particular facts of the CFC's business, to a combination of these.

The Government is also considering, as an alternative or supplement to the mechanical exemptions above, applying a "principles-based" approach to excluding CFCs carrying on low risk business on the basis that this has the potential to produce shorter and better targeted legislation. Such an approach would not apply to exempt finance income that is more than incidental or to other investment income.

With regard to the exploitation of IP, the TBEs will generally not apply to the following "high risk" situations, and instead the general purposes exemption (see below) 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 six years, or before this if the transfer has given rise to an apportionment or other UK tax charge within the last two years;
- the CFC exploits IP and more than 50% of the CFC's business expenditure relating to IP is with UK related parties or more than 20% of the CFC's gross income involving the exploitation of IP is from the UK; or
- where more than incidental amounts of the CFC's gross income are attributable to the passive ownership of IP.

The term "transfer" here is used in a broad sense so that it covers not only disposals of IP but also, for example, the granting of a licence (other than on a limited basis to a manufacturer or only for use in the CFC's territory), 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.

Local holding companies which hold only trading companies and which receive almost all of their income from within their territory will be exempt under the TBEs. Other holding companies which only hold shares in group companies should be exempt where the dividends they receive would be exempt from UK tax. The treatment of holding companies carrying on other activities will be determined by the nature of those other activities.

Separate exemptions are proposed for CFCs engaged in banking and insurance activities (see below).

5) Banking exemption

A specific exemption will apply to CFCs carrying on banking business. Such companies will need to meet basic residence, establishment and local management requirements. A capitalisation test will also be included, the Government currently favouring an approach similar to the "capital structure" test in the existing exempt activities test (whilst acknowledging that any reduction in the current compliance burden would be welcomed). Other capitalisation test options put forward are based on an assessment of the capitalisation of the CFC by reference to either UK regulatory capital requirements or the local equivalent where the company is resident.

The Government acknowledges that this exemption requires further development, taking into account the various changes in this area including the Basel III proposals on capital, and considering factors such as debt funding from the UK, how interest income is defined, the treatment of intra-group guarantees and when and how regularly the test has to be satisfied. The provisions in the existing exempt activities test relating to gross trading receipts and interest income from UK associates are likely to be carried over into the new exemption.

A CFC which fails the banking exemption may still be able to benefit from the general purpose exemption, where it can be demonstrated that profits have not been artificially diverted from the UK. The proportional charging mechanism should mean that where the capitalisation test is failed, the CFC charge would be limited to the profits reasonably attributable to the "excess" capital.

6) Insurance exemption

A specific exemption will also apply to CFCs carrying on insurance business, including reinsurance, but only where they are part of an insurance group. Such companies will need to meet basic residence, establishment and local management requirements and also pass a test intended to identify the risk of UK tax leakage.

Under this test, it will first be necessary to determine to what extent insurance business is written with UK counterparts (whether third party or intra-group). If it is 50% or more, the exemption will not be available, although the general purpose exemption may apply. If UK business is less than 50%, the insurer may (depending on the final form of the exemption and the level of third party business) still have to pass a "capitalisation" test.

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6) *Insurance exemption – cont'd*

The capitalisation test is intended to identify those insurance companies which are excessively capitalised and deny them the exemption (on the basis that such companies would be using their insurance business to swamp what is effectively investment income). Two forms of capitalisation test are considered – a mechanical test or a “self certification”. The mechanical test would likely be based on specified percentages of regulatory capital. It is less clear how self certification would operate (the document refers to requiring objective measures against which to certify).

Finally, the Government is consulting on whether any changes are required to the relaxations for UK life assurance and large risk insurance, and also on whether a more competitive regime might apply for reinsurance of non-UK risks originally written by UK insurers.

7) *Finance company partial exemption (FCPE)*

As signalled in the Budget, a partial exemption will apply to overseas finance companies leading, in most situations, to an effective UK tax rate on profits from overseas intra-group financing of 5.75% by 2014.

Originally this exemption was intended to operate by assuming that a debt to equity ratio of 1:3 applies to overseas finance companies, but the Government is now proposing to adopt an apportionment approach, which is seen as being simpler than imputing a UK taxable return on any excess equity. Depending on the mechanics of the rules, this will result in an apportionment of, broadly, one-quarter of the chargeable profits of the finance company, automatically reflecting fluctuations in loan balances, foreign exchange and interest rate movements during the relevant period. Finance income will also include income from finance leases. Relief for foreign tax suffered by the finance company will be proportionate to the profits which are subject to tax in the UK (i.e. normally one quarter will be creditable).

Four design options have been put forward (including worked examples) with differing levels of complexity and approaches to arriving at the apportionment of profits. If the simplest option were adopted the exemption would only apply to wholly equity funded CFCs that only lend to other overseas group companies that are exempt from the new CFC rules. This would mean that intra-group finance activity in excess of an incidental amount in mixed activity companies would need to be restructured to fall with the FCPE. The other options are more flexible and so could be designed so the FCPE applied equally to the finance income of mixed activity companies. We would expect this to be more popular with business, despite the increased complexity of the rules.

Consideration is being given to whether a full exemption could apply to finance profits in limited circumstances (in particular where the substantial majority of the group's profits are made and reinvested overseas and UK members have no net borrowing costs).

Finance companies will also need to meet basic residence, establishment and local management requirements. Such management is expected to include decision-making relating to initiating and refinancing intra-group loans, managing foreign exchange exposure and setting and enforcing terms and conditions of loan agreements.

The FCPE will not apply to finance income arising on upstream loans to UK group entities (with the possible exception of certain short-term loans) or to finance income earned on monies held on deposit with third parties (a TAAR is to be included to ensure that the latter restriction is not artificially circumvented).

The Government appears minded to reject a proposal that the FCPE should apply equally to foreign branches of UK companies, on the basis that it will be difficult under OECD principles to attribute monetary assets to the branch where initial decision-making has been undertaken by the company's UK board. In addition, it is not proposed to apply the exemption to banking and insurance groups, although the Government says it will consider further the case for the rules to apply to structural lending in these sectors.

Where hybrid instruments or entities are used in overseas financing arrangements, the document indicates that the existence of a finance company subject to the FCPE will not make it more likely that the tax arbitrage rules will apply. HMRC guidance will incorporate examples to illustrate this, and the arbitrage clearance procedure will be available.

8) *General purpose exemption (GPE)*

This exemption will apply to exempt profits of a CFC that have not been artificially diverted from the UK (particularly where the other exemptions are not available). It will effectively fulfil the same role as the motive test in the current CFC rules but there will be no default assumption that profits received by a CFC would have arisen in the UK if the CFC did not exist, and genuine foreign profits will be exempt.

In order to qualify, a CFC must have a territory of residence and sufficient local management. A CFC's profits will be exempt to the extent that they are commensurate with the CFC's own activities. Where profits have been artificially diverted to the CFC, only the profits that have been diverted from the UK to avoid UK tax will be subject to a CFC charge, together with any investment income that is not incidental to the CFC's activities (non-incidental finance income will be dealt with under the finance company partial exemption).

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8) General purpose exemption – cont'd

It is considered that profits will be “commensurate with CFC activity” if they would more than likely accrue to the CFC if it were an independent entity and not a member of a group (referred to as “uncontrolled conditions”). This will require the determination (it is suggested following principles based on those set out in Article 7 of the OECD Model Treaty) of the likely assets (in particular intangible assets) and risks that the CFC would own and bear under uncontrolled conditions. The profits which accrue to these assets and risks, together with those relating to the activities actually performed by the CFC's staff, will be the commensurate profits.

It is said that in the case of intra-group financing activities it would be necessary to consider the source of capital. A pure treasury company should, therefore, be exempt under the GPE as its profits would be expected to be commensurate with its activities. However, it is suggested that, in almost all cases, the FCPE will be the better exemption for an equity funded group finance company as it will exempt more profits than the application of the commensurate with activities test.

Who is affected?

UK companies with overseas subsidiaries or exempt foreign branches.

Timing

The Government considers that the earliest date from which the new CFC regime could apply is for CFC accounting periods beginning on or after the date on which Finance Act 2012 receives Royal Assent.

Comments are invited on the specific questions raised in the document, as well as more generally on the proposals, by 22 September 2011. The intention is to publish draft legislation in Autumn 2011 for consultation ahead of introducing the legislation in next year's Finance Bill.

Our view

Overall framework and timetable

Although the new CFC regime will primarily operate on an “entity” basis, where a CFC has mixed activities it may well be necessary to focus on the different activities to determine whether, or to what extent, the related income is exempt. This will inevitably mean that the new regime will be more complex than the existing CFC rules and could still create a significant compliance burden; even if the end result is generally that less foreign profits are caught (although it should be noted that “swamping” will no longer be possible).

The complexity of the new regime is reflected in the length of the consultation document. Additionally, many of the proposed exemptions still seem to be at the design stage with only broad options set out as to how they might work, which must raise concerns over whether the proposed timetable for implementing the new regime will be met.

Monetary assets

The FCPE certainly provides an attractive regime for UK groups to finance their foreign subsidiaries using an overseas company. The finance company will need to be located in an appropriate jurisdiction to minimise any foreign tax, as this will only be partially creditable against the CFC charge, and there will be numerous issues to be managed, including any foreign exchange exposures. It is still not entirely clear what local substance will be required. The Government does not expect the FCPE to apply to foreign branches, which is disappointing.

Somewhat curiously profits from treasury management activities (e.g. cash pooling) are expected to be exempt under the GPE if carried on in a separate company, but subject to the FCPE if carried on in a finance company undertaking structural lending.

It will be important that the definition of incidental finance income is sufficiently flexible, given that this could vary considerably depending on a company's particular activities, working capital requirements and other circumstances. It seems unreasonable for it to be based simply on a fixed percentage of profits or income.

Intellectual property

The treatment of IP has been controversial since the CFC reform process commenced. The Government has more clearly set out the areas of concern, but we are left with a regime that is likely to become more subjective and could lead to more companies being subject to the CFC rules than is currently the case. The rules will catch not just swamping (which to be fair the Government has consistently flagged as being an issue) but also other commercial situations where IP which originated in the UK is used overseas. Consumer goods businesses and other users of IP will likely face an increased compliance burden and potential additional tax cost. This should be examined further during the consultation process.

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Banking

The introduction of a specific banking exemption is to be welcomed, given the complexity and compliance difficulties faced by many banks with the current CFC rules. It will, however, be a difficult task to craft an exemption that deals with those difficulties whilst accommodating the ongoing regulatory developments, but without being too rigid.

The Government's intentions behind the exemption are to exempt profits from genuine overseas banking operations and appear to focus not only on substance concerns, but also on what the Government considers is the ease with which capital can be transferred between banking entities. The proposal to introduce a capitalisation test similar to the existing capital structure test is perhaps a mixed blessing given the considerable compliance obligations the current rules demand, but there is clearly much further work to be done.

Additionally, the Government acknowledges that it is not yet clear how the capitalisation test might apply in the context of an exempt foreign branch. Engagement and consultation with business will be key in developing an exemption that has practical and commercial application, adopting a pragmatic approach to the regulatory pressures and governance requirements that this sector faces.

Insurance

The current CFC rules contain a number of difficulties for insurance groups, particularly as regards reinsurance of risks originally written by other members of the group. The recent interim improvements have done little to address these problems so it is encouraging to see a specific insurance exemption being proposed. An effective exemption would be very welcome particularly given the capital efficiencies potentially available to insurance companies that are able to pool their capital and demonstrate its fungibility to regulators.

On the details of the proposals, the limitations in respect of those companies with substantial UK business are understandable. The capitalisation test will be more difficult to frame in a way that is effective in countering avoidance while not impeding genuine commercial business activities. A mechanical test appears undesirable unless it is set at a very high level. Self certification ought to be more flexible to individual companies' needs. However, the document's references to objective measures, solvency levels and rating agency requirements do not suggest a genuine self-assessment by the board, for example, that the company is not excessively capitalised by reference to its business plan and the group's risk appetite. This is a pity.

The most intriguing element is the mooted discussion on the treatment of reinsurance of non-UK risks written by UK insurers. Given the significance of the Lloyd's and London Market, UK insurers currently write substantial amounts of non-UK risk in the international market. Such reinsurance is treated as UK business under the current rules, increasing the risk of non-exemption for the CFC. However, this is not a competitive approach in the international insurance market and many of the participants in this market have non-UK holding companies as a result. If the Government could reach an outcome that facilitated this type of reinsurance it could be a major boost to the UK's insurance industry and help it attract capital globally.

Since the insurance exemption will apply only to insurance groups, insurers in non-insurance groups (including banking groups) will need to consider if the GPE is available.

Property and leased tangible assets

It is to be welcomed that overseas property companies and companies engaged in a leasing business involving operating leasing of large capital assets (such as ships, aircraft and oil rigs) will, in appropriate circumstances, be exempt under the TBEs. One of the key areas still to be resolved is how to apply the local management requirement to these activities which do not necessarily require significant substance in the form of employees located physically near the property or asset. It is not immediately clear why the operating lease exemption has been restricted to assets with a value in excess of £10 million.

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