

# UK-Controlled Foreign Companies Reform

February 8, 2012

## ***Background***

The UK's controlled foreign companies ("CFC") rules are designed to ensure that certain UK-controlled companies cannot shelter their profits offshore, in low tax jurisdictions, thereby minimizing the actual profits subject to UK tax. Case law dating from 2004 held that the UK's CFC regime was contrary to EU law and, since that time, consultation and interim changes have been in place with a view to the comprehensive changes now introduced in the UK Finance Bill 2012 and updated on 31st January 2012.

The legislation is still in draft form with comments invited until 10th February 2012. The legislation is expected to come into force for accounting periods commencing on or after 1st January, 2013.

Some points in the legislation still remain outstanding and further drafts are to be expected. Specifically, further consideration is due be given to how the CFC rules should apply to funds and some specifics are to be expected in this area which will be important to the investment funds industry. The government's most recent publication acknowledges that this remains an area requiring attention.

This alert gives a summary of the new rules.

## ***General scope***

A corporation tax charge will arise to UK companies with a 25 percent or greater interest in the relevant CFC if all of the following apply:

1. The CFC is controlled from the UK;
2. The CFC has "chargeable profits"; and
3. None of the safe harbours or exemptions apply.

A group may apply the above tests in any order, a point which, in practice, will be important in relation to the last two. For example, if one of the exemptions clearly applies then the group may rely on this rather than go through the exercise of ascertaining whether or not the CFC has chargeable profits.

A finance company partial exemption ("FCPE"), providing an effective tax rate of 5.75 percent (from 2014) on intragroup finance income, will be available for all CFCs and not just pure finance companies. This is subject to certain full exemptions in some circumstances described below. A charge normally will not arise on finance profits outside the FCPE. Finance profits incidental to a CFC's trade or property business will be exempt if its trading or property business profits are exempt.

### ***"Controlled from the UK"***

Broadly speaking, a company will be regarded as a CFC if it is controlled by a UK person or persons by means of shareholding, voting rights or rights to assets on winding-up. Special rules also apply to joint ventures in which a UK person controls at least 40 percent while a non-UK person controls between 40 percent and 55 percent. Such joint venture companies will be CFCs. Additionally, various tests aggregate the interests of connected persons and all tests are subject to a purposive anti-avoidance rule.

### ***The "Gateway" test***

There is a special set of rules which define those profits which are artificially diverted from the UK and which, therefore, become potentially subject to the CFC charge. If these rules, which have become known as the "gateway", are applied and the result is that there are no chargeable profits, then no CFC charge arises.

Profits will only be within the scope of the charge if the following tests are met:

1. The majority of the profits of the CFC arise from assets held or risks borne in connection with UK activities. This is arrived at by attributing profits to what are termed UK "significant people functions" ("SPFs") or, in the context of finance, key entrepreneurial risk takers ("KERTs"). These terms are imported from OECD attribution of profits principles.

2. The separation of assets or risks from UK activity does not result in substantial nontax value. A substantial nontax value arises if the net economic value to the group resulting from the profit bearing assets and risks residing in the CFC (rather than in UK group companies) derives substantially from something other than a reduction in UK tax. In general, HMRC would require nontax value to be at least 20 percent for it to be substantial.

3. The arrangement creating the separation of assets or risks from UK activity would not be entered into with an independent company, i.e. it is not on an "arm's-length" basis.

### ***Safe harbours***

Mechanical safe harbours will be introduced which, if met, exclude the profits of a CFC from the tax charge. The safe harbours, which exclude specific types of income, are:

1. Commercial activities: This excludes from the CFC regime trading profits of the CFC provided that a number of conditions are met, including that the CFC has a local business establishment; it does not hold significant intellectual property transferred from the UK within the previous six years; no more than 20 percent of its trading income is from, or from goods delivered to, the UK; and no more than 20 percent of its expenditure on the management of its assets and risks is incurred in the UK. This provides a mechanical alternative to identifying the SPFs that generate the CFC's profits.

2. Incidental finance income: This is defined as 5 percent of trading, or property business, profits (before interest and tax). There also will be a safe harbour for holding companies for investments up to 5 percent of their exempt dividend income.

3. Property income: The profits of a property business (a business carried on to generate income from land) will be exempt.

Specific safe harbours will apply to the insurance and banking industries. The government also has decided not to introduce a safe harbour for leasing as the other tests are thought to be sufficient.

### ***Entity level exemptions***

The following exemptions relate to the circumstances, or characteristics, of the CFC rather than the nature of its profits:

1. Lower level of tax: This applies if the CFC's local tax is not less than 75 percent of the UK tax that would be chargeable on those profits.
2. Low profits: This applies if the accounting profits are £500,000 or less, with a limit on investment income of £50,000 (unless the CFC is loss making). This exemption will not apply to managed service companies providing the services of UK individuals for UK residents and is subject to specific anti-abuse measures.
3. Low profits margin exemption: This will apply if a CFC's profits do not exceed 10 percent of its operating expenses, which excludes related party business expenditure other than goods delivered into the CFC's territory.
4. Excluded territories exemption: This will apply to territories with a headline tax rate greater than 75 percent of the UK main corporation tax rate. A list of excluded territories will be included in regulations. A CFC will qualify for the exemption if its total income from specified categories of income (essentially, income exempt from tax, or taxed at a reduced rate, locally) does not exceed the greater of 10 percent of its pre-tax profits and £50,000. It will not apply if significant IP has been transferred to it from the UK in the previous six years.
5. Temporary period exemption: The government will exempt companies, for a limited period, that fall within the CFC tax charge because of an acquisition or group reorganisation. The latest proposal is that such period of exemptions will be for 12 months from the date of the event leading to the company becoming subject to the CFC rules.

### ***Finance company partial exemption ("FCPE")***

The FCPE will exempt 75 percent of its profits (including foreign exchange differences) from "qualifying loan relationships", which from 2014 (when the main UK rate of corporation tax will be 23 percent) gives an effective tax rate of 5.75 percent. Furthermore, the amount chargeable is limited to the net borrowing costs of UK group members. For example, if the finance profits of the group's CFCs is £400 million and the net borrowing costs of UK group members is £60 million, the chargeable amount would be limited to £60 million (rather than £100 million). Additionally, finance profits arising from a loan which is made without reliance on wider group funds (e.g. as a consequence of a share-for-share exchange) will be completely exempt.

## ***Banking and insurance groups***

For banks and insurance companies, the chargeable profits test will include a capitalisation condition for CFCs conducting financial trades. The trading finance profits of such a CFC will be subject to the tax charge if they are attributable to excess capital (compared to that which would be held by an independent entity) and there has been capital invested, directly or indirectly, by a UK connected company.

Profits from insurance will not be subject to the tax charge if they pass the capitalisation condition. If the KERT functions of underwriting and acceptance of risk are performed outside the UK, the profits arising from that insurance business should fall outside the CFC charge.

## ***Comment***

Generally, the changes have been welcomed in the business community. However, there have been some criticisms. Commentators have noted that ascertaining the application of the chargeable profits test requires a full transfer pricing analysis to be carried out, which might be unduly burdensome. Equally, commercial joint ventures between UK and non-UK enterprises, which some had hoped to see excluded from the regime, will still be within it. Overall, however, the new rules are regarded as a significant improvement on past provisions.

## ***Enquiries***

Any enquiries on the new CFC regime should be directed to Jenny Wheeler in the London office ([jwheater@proskauer.com](mailto:jwheater@proskauer.com) or +44(0)207 539 0647).

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