CFC reform – has the UK got it right?

HMRC has published further details of the UK’s new CFC regime, which has been the subject of extensive consultation and is due to replace the existing CFC regime from the middle of next year.

The UK’s existing CFC regime assumes that all foreign subsidiaries of UK companies are CFCs and that all of the profits of that CFC may be apportioned to the UK parent company and therefore be subject to UK tax, unless one of the exemptions applies. This assumption is probably contrary to EU law, and involves significant compliance costs. The UK is therefore keen to adopt a more business and EU friendly regime, whilst retaining some protection against tax avoidance.

THE NEW REGIME

A CFC is a non-UK company controlled by persons in the UK. The new control test will apply not only by reference to voting control or economic rights, but also where the UK company is the non-UK company’s parent undertaking for accounting purposes. If the CFC regime applies, certain of the CFC’s profits will be allocated to its UK parent for tax purposes.

There are two alternative ways to fall outside the new CFC rules.

First, the intention is that the only profits that should be the subject of a CFC apportionment are profits that are being artificially diverted from the UK, as defined in the “gateway” test. If the subsidiary has no such “chargeable profits”, the new CFC rules will not apply to it.

Secondly, there are a series of exemptions based on the existing exemptions that may apply to prevent the CFC rules applying to that subsidiary. These exemptions look at the CFC as a whole and are therefore an “all or nothing” test, unlike the gateway test which can apply to some but not all of the CFC’s profits.

THE GATEWAY TEST

The definition of chargeable profits is a crucial part of the new regime, as it determines both whether the regime applies and, if it does apply, how much of the CFC’s profits are apportioned back to the UK.

A CFC’s chargeable profits include profits arising from assets or risks to the extent that the “significant people function” in relation to the economic ownership of those assets or the management of those risks is based in the UK, but there are exclusions where:
the arrangements create significant non-tax value for the group;

it is reasonable to suppose that the CFC could have entered into similar arrangements with unconnected companies – perhaps because the CFC exercises sufficient scrutiny over the services provided by the UK based related parties;

less than half of the profits attributable to those assets or risks are allocable to the UK; or

another more mechanical exclusion applies.

FINANCE INCOME

Chargeable profits also include non-trading finance profits from loans to UK based affiliates (where the funds are loaned rather than distributed back to the UK for tax (UK or non-UK) reasons) or loans made from funds derived from the UK. There are also special rules for profits from financial trades and captive insurers.

As previously announced, however, the UK will introduce a special regime for group finance companies which make loans to non-UK based group companies. If the conditions apply, only 25% of the profits from such loans and related hedges are included within the CFC’s chargeable profits.

In addition, finance income of a non-financial trader can be excluded from chargeable profits where it represents no more than 5% of total income or is otherwise incidental to the CFC’s trade.

THE EXEMPTIONS

The “all or nothing” exemptions are:

• the low profits exemption, which applies where the annual profits (either accounting profits or notional UK taxable profits) of the CFC are not more than £50,000, or the annual profits are not more than £500,000 and include not more than £50,000 of non-trading profits;

• the low profit margin exemption, which applies where the CFC’s accounting profits (before deducting interest) are no more than 10% of “operating expenditure”;

• the excluded territories exemption, which applies if the CFC is resident in a “good” territory specified by HMRC and most of its income is locally taxed or other “good” income (although this exemption does not apply to certain IP holding CFCs); and

• the tax exemption, which applies if the CFC pays tax on its income in its home jurisdiction equivalent to at least 75% of the UK corporation tax it would have paid as a UK resident company.

There is currently no time limited exemption for groups coming within the CFC rules for the first time, although such an exemption is still envisaged. This is obviously a key feature in making the UK attractive to business, as it gives groups relocating to the UK time to get to grips with the CFC rules and to restructure as required.
DOES THE NEW REGIME GO FAR ENOUGH?

The new rules are complicated, but they will hopefully provide business with a more acceptable CFC regime that should be easier to apply in practice.

In fact, the structure of the new regime is not that different from the existing regime, other than the crucial point that, under the new regime, only certain profits of the CFC will be apportioned back to the UK.

It is a shame, however, that "main purpose" tax avoidance tests currently litter the draft legislation, as these somewhat cut across businesses' desire for certainty. Purpose is often difficult to prove, and certainty may well therefore require an HMRC clearance. A review of each of these provisions before the legislation is enacted would be helpful to test whether they are all actually required.

But, other than that point, at first sight the new regime looks to be a big step forward for the UK's tax regime for multinational companies.