HM TREASURY

HM Revenue & Customs

Controlled Foreign Company (CFC) reform:

response to consultation

December 2011

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Any queries regarding this publication should be sent to us at: public.enquiries@hm-treasury.gov.uk.

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Executive summary

The purpose of this paper is to provide an update on developments on the reform of the Controlled Foreign Company (CFC) rules following helpful and extensive consultation since June. Annex A provides a summary of the responses received from the consultation over the summer and Annex B is a guide to the draft legislation.

Policy aims

The UK needs CFC rules to help maintain sustainable corporate tax revenues by protecting the tax base against artificial diversion of UK profits to low tax jurisdictions, but there is scope for significant modernisation of the current CFC regime.

As outlined in the Corporate Tax Road Map and the June consultation document on CFC reform, the Government wants to introduce a CFC regime that better reflects the way that businesses operate in a global economy and strikes the right balance between making the corporate tax system more competitive and providing adequate protection of the UK tax base.

The aim of the proposed new regime is to target only those circumstances that result in artificial diversion of UK profits. The challenge is to identify such instances whilst exempting all others with the minimum compliance burden.

Responses to consultation

The Government is grateful for the level of engagement during the consultation and as a result has made significant changes to the proposals set out in the June consultation document to ensure that they achieve the intended policy aims. Annex A provides a summary of consultation responses.

Key points

- The new regime will focus on situations that pose the highest risk of artificial diversion of UK profits. All other situations will either be outside the scope of the regime or exempt, significantly reducing compliance burdens. Where a charge does arise it will be proportionate, targeting only artificially diverted UK profits.
- A new 'Gateway' will specifically identify circumstances where there has been artificial diversion of UK profits: broadly, where there is a significant mismatch between key business activities undertaken in the UK and the profits arising from those activities which are allocated outside the UK. Business profits[1], within the Gateway, including 'foreign to foreign' profits, will be outside the scope of the regime.
- The Government remains committed to providing a partial exemption on profits from overseas intra-group financing, which will provide a 5.75 per cent effective UK tax rate by the year 2014. These rules are a pragmatic and competitive

[1] Business profits is used here, and throughout the document, to refer to all profits other than finance profits.

approach to the treatment of overseas finance income, maintaining protection of the UK tax base and avoiding the need for complex legislation to trace transactions or financial flows. The Government is still considering the case for full exemption in limited circumstances.

- Groups will have the opportunity to choose how they self assess. They can focus either on whether foreign subsidiaries are excluded from the regime by the Gateway or whether they meet the conditions of a more mechanical exemption.
- One consequence of the Gateway is that if a group establishes that all of the profits arising from its UK activities (other than its finance profits) are allocated to the UK, then it has shown that all of its business profits are outside the scope of the regime. This precludes the need to look at each foreign subsidiary individually for this purpose.

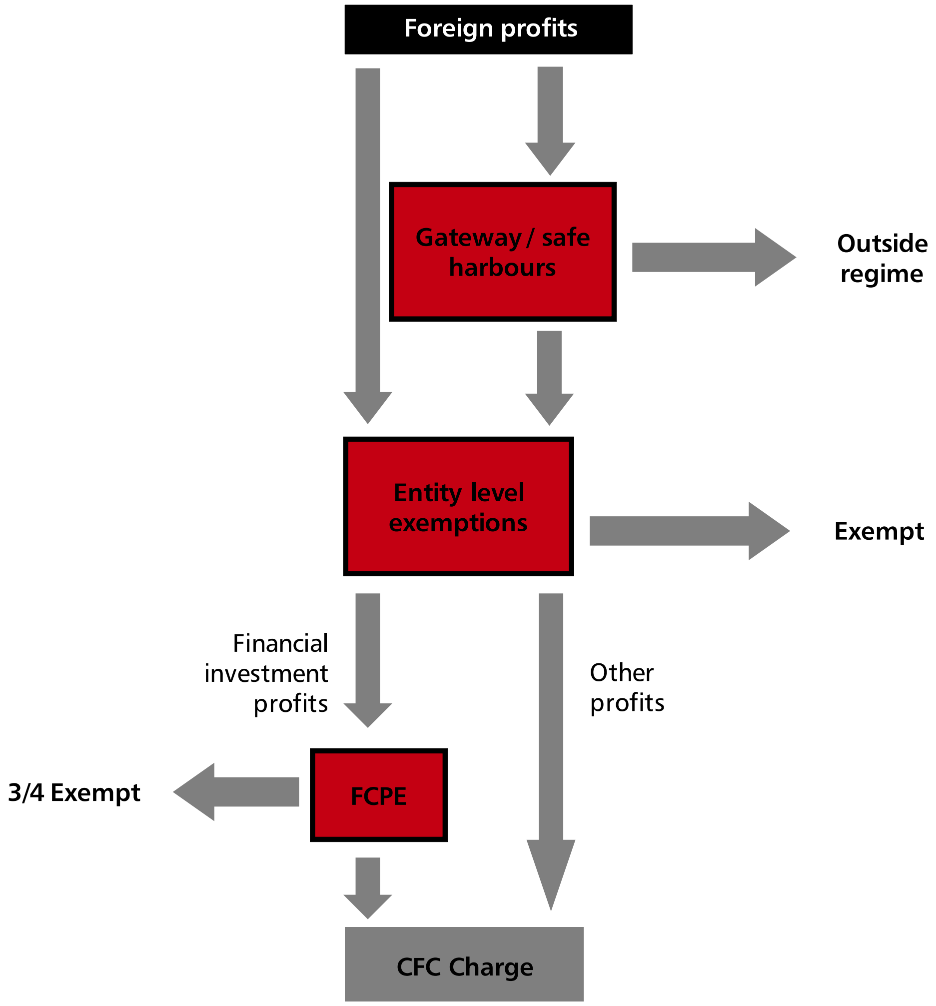
Updated proposals

The Gateway will expressly define profits which are within the scope of the regime, rather than treating all profits of foreign subsidiaries as potentially subject to a charge unless an exemption is met.

Concerns were raised during consultation that the territorial business exemptions proposed were too narrowly drawn. These mechanical tests have been considered further and refined to ensure they are appropriately targeted. Groups not wishing to use the Gateway to self assess can, if they prefer, rely on these more mechanical rules.

In providing both a Gateway and more mechanical exemptions, the aim is that groups will have little difficulty in self assessing with respect to the majority of their foreign subsidiaries. In more complex cases groups may wish to discuss any points of difficulty with HM Revenue & Customs, initially with their Customer Relationship Manager or Customer Co-ordinator.

The diagram below illustrates the broad operation of the regime.



1 Overview of the new CFC regime

1.1 The intention is that it will be straightforward for groups to establish that the majority of their foreign subsidiaries are outside the scope of the new CFC regime or exempt from it. Business profits arising in a foreign subsidiary will only be subject to the regime if they are derived from UK activities that relate to the assets or risks of the foreign subsidiary.

1.2 It should be straightforward for groups to ascertain:

- whether their business profits are within the Gateway or satisfy its mechanical safe harbours;
- whether their foreign subsidiaries satisfy the conditions of entity level exemptions; and
- which profits the finance company rules apply to.

1.3 The Government anticipates that the focus of the regime on profits derived from UK activity will allow groups to self assess that their foreign subsidiaries are outside the scope of the regime (other than for finance profits), by determining where the rewards for the UK activity of the group arise. For business profits, any foreign subsidiaries whose profits are not derived from assets or risks which are managed from the UK are outside the scope of the regime.

1.4 Finance profits will generally be dealt with separately from business profits. The circumstances in which a charge will arise on such profits outside the special rules for financing companies are likely to be rare. Finance profits incidental to a foreign subsidiary's trade or property business will be exempt provided its trading or property profits are exempt.

1.5 Some of the territorial business exemptions set out in the June consultation document have been developed to provide "safe harbours" for the Gateway conditions. Foreign subsidiaries will be able to self assess that their business profits are outside the scope of the regime by using the Gateway, or by applying its safe harbours.

1.6 Additionally, there will be no charge on a foreign subsidiary's profits where it meets the conditions of an entity level exemption, such as the excluded territories or low profits exemptions.

1.7 All foreign subsidiaries must be resident and established overseas to apply the Gateway, safe harbours and entity level exemptions. In line with the move to a more territorial regime, the focus of the regime will be on management activities within the UK. The conditions in the Gateway and safe harbours will focus on UK management activity and therefore it will not be necessary to include a separate local management condition.

The Gateway – business profits

1.8 The Gateway defines those profits that are artificially diverted from the UK for the purpose of the CFC regime. The Gateway deals separately with finance profits and business profits. Business profits that fall within the regime will be those profits arising from arrangements that separate the ownership of an asset or the bearing of a risk outside the UK from the people functions involved with the management of the risk or exploitation of the asset in the UK. The focus on UK activity fits with the move to a more territorial regime. If a foreign subsidiary does not have any such arrangements, all of its business profits will be outside the regime's scope.

1.9 Profits arising in a foreign subsidiary will be within the scope of the regime only where **all** of the following three conditions are met:

- the majority of the profits from the assets or risks are connected with UK activity by reference to 'significant people functions' (SPFs) (the artificiality condition);
- this separation of assets or risks from activity does not give rise to substantial non-tax value (the non-tax value condition); and
- the arrangement which creates this separation would not be entered into between independent companies (the independent companies arrangements condition).

1.10 This more effective targeting of the rules on profit diversion aims to reduce compliance burdens allowing low risk foreign subsidiaries to self assess in a more straightforward way that their business profits are outside the scope of the regime.

1.11 In addition to the Gateway itself there will be a safe harbour for business profits and entity level exemptions. These are discussed in Chapter 3 and 4.

The Gateway – finance profits

1.12 Finance profits from investment that are incidental to the trade or property business of a foreign subsidiary will in general be treated in the same way as its business profits. For non-financial trades this will be those profits earned on funds retained for the purposes of the trade, as discussed in paragraphs 3.4-3.5.

1.13 To establish whether finance profits are connected to their trade, foreign subsidiaries undertaking financial trades including insurance or banking activities will be required to demonstrate that the levels of capital held are not greater than that which would be held by an independent entity. This will be achieved by including a capitalisation condition for these activities in the Gateway. Safe harbours for this condition will be provided for banks and insurance companies.

1.14 The use of captive insurance companies which insure risks that originate within the same group presents a high risk of erosion of the UK tax base. As previously proposed, profits derived from premiums paid by non-UK companies or non-UK branches will be outside the scope of the regime. For captive insurance companies in EEA territories, profits from premiums on UK insurance contracts entered into for significant non-tax reasons will also be outside the regime's scope. For captive insurance companies in non-EEA territories all profits from premiums on UK insurance contracts, including interest on investment of UK premiums, will be chargeable in full. In all cases captive insurance CFCs will be subject to a capitalisation condition.

1.15 Non-incidental finance profits within the scope of the regime will generally be dealt with through the finance company rules, discussed in Chapter 3. In most cases, intra group lending to non-UK borrowers will qualify for the Finance Company Partial Exemption, which will exempt 75 per cent of qualifying profits, giving a 5.75 per cent effective UK tax rate on profits from overseas intra-group financing by 2014. Given the current fiscal constraints further consideration is needed to determine whether there is a case for giving full exemption in limited circumstances and if so how this might be best achieved.

1.16 Additionally, a charge will arise on upstream loans to UK borrowers if a tax benefit is one of the main reasons for returning capital to the UK in this way.

2 The Finance Company Rules

Finance Company Partial Exemption (FCPE)

2.1 There was a clear preference in responses that the finance company rules should apply to mixed activity companies (i.e. those that have a dual purpose encompassing trading activities and the management of funds accumulated over time). Therefore, the "simplest option" outlined in the consultation document was too restrictive as many businesses would need to restructure their overseas financing arrangements to fall within the rules.

2.2 An approach that seeks to apportion one quarter of the chargeable finance profits of the CFC (i.e. Option C as outlined in the June consultation document) was the favoured option as it is flexible and simple to operate. As the chargeable finance profits will include foreign exchange movements, the rules will ensure that profits or losses from arrangements entered into by the CFC to hedge a qualifying loan are also included.

2.3 A foreign subsidiary must have a business establishment in its territory of residence to qualify for FCPE but will not be required to have local management.

Finance Company Full Exemption

2.4 Most respondents welcomed the 5.75 per cent effective rate for finance profits, but a few thought that the approach does not go far enough and that, in certain circumstances, an effective tax rate of 5.75 per cent is too high and not consistent with the general policy aims of the regime. Some responses suggested that where businesses have limited or no borrowings in the UK, there is a reduced risk that monetary assets will be used to artificially divert profit from the UK. A small number of respondents were of the view that finance profits arising on accumulated foreign profits held overseas should always be exempt. Other respondents were concerned that rules such as these might undermine the stability of the regime, which is intended to provide a balanced result without the need to trace funds.

2.5 In response, the Government is considering whether the total CFC charge arising from the application of the FCPE to the profits of a group's CFCs, may be limited to the aggregate net borrowing costs of the UK members of the group. For example, when the qualifying profits of all the group's CFCs under FCPE for an accounting period is £400m and the total net borrowing costs of all the UK members of the group is £60m, then the FCPE charge would be reduced to £60m (rather than £100m). Further work is required, including to establish whether this proposal could advantage any particular sectors beyond what is intended.

2.6 The FCPE has always been intended to be a pragmatic solution. The Government wishes to give further consideration to the case for full exemption in limited circumstances beyond those in paragraph 2.5, bearing in mind the need to deliver an affordable regime.

The finance company rules and insurance and banking groups

2.7 Insurance and banking groups were of the view that excluding them from the finance company rules would put them at a disadvantage compared with non-financial groups.

2.8 The Government will allow insurance and banking groups to access the finance company rules. However, as monetary assets, to different extents, are intrinsic to the trade of these businesses, the finance company rules will not be available to insurance or banking companies themselves, or in respect of loans made to banks or insurance companies. It is expected that additional rules will be required to protect against specific risks to the UK tax base but further consideration is needed on how these will operate.

3 Gateway safe harbours and sector specific rules

3.1 Businesses suggested that the territorial business exemptions (TBEs) proposed in the June consultation document were too narrowly drawn and that they might be less effective in exempting foreign subsidiaries with commercial activities than the exemptions in the current CFC regime. The need for some of the TBE conditions was questioned and it was suggested that further consideration be given to improving the targeting of these conditions on profits which have been artificially diverted from the UK.

3.2 The approach now being proposed is to replace the TBEs with mechanical safe harbours which, if met, will mean that the profits of the foreign subsidiary are treated as being excluded from the regime by the Gateway.

3.3 The mechanical safe harbours, which are described in more detail below, have been developed to provide an alternative route to establish the extent to which a foreign subsidiary's business profits are outside the scope of the regime. Groups can choose to use the Gateway, the safe harbours, the finance company rules or the entity level exemptions.

Incidental finance income safe harbour

3.4 The preferred approach of the majority of respondents was to adopt a definition of incidental finance income that caters for a wide range of business circumstances and factors.

3.5 The Gateway includes an incidental finance income condition. It is proposed to include a safe harbour for this condition defined as 5 per cent of the trade or property business profits before interest and tax. If a company does not meet this safe harbour, its incidental finance income can be excluded from the scope of the regime by the Gateway to the extent that it is earned by a foreign subsidiary on funds retained for the purposes of its trade. There will also be a safe harbour for holding companies for investment income up to 5 per cent of their exempt dividend income.

Commercial activities safe harbour

3.6 In response to the TBEs proposed in the June consultation document the majority of businesses thought a principles-based approach to the commercial activities TBE would give rise to too much uncertainty and that the proposed mechanical conditions, while generally appropriate in terms of approach, were too narrowly drawn.

3.7 It is now proposed to introduce a commercial activities safe harbour in place of both the manufacturing and commercial activities TBEs. Where the conditions of the safe harbour are met, the foreign subsidiary's trading profits will be treated as excluded from the regime by the Gateway's "artificiality" condition.

3.8 The safe harbour will include some conditions which apply to the foreign subsidiary as a whole, covering:

- establishment;
- intellectual property (IP) transfers from the UK;

- proportion of UK income (except income from goods manufactured in the CFC's territory of residence); and
- delivery of goods from the UK (excluding goods delivered into the CFC's territory of residence).

Responding to consultation, the UK income and the IP transfers conditions will be narrower than previously proposed. The definition of an IP transfer will exclude IP that was transferred more than 6 years ago. For this purpose, a transfer will only be relevant if it leads to a significant loss of value for the transferor.

3.9 The safe harbour will also include a limit on UK related party expenditure which can apply to all or part of a foreign subsidiary's business profits. This condition will focus on the location of the expenditure on management (excluding strategic oversight) in respect of a foreign subsidiary's assets and risks. The condition will look at the split between UK and non-UK expenditure rather than the extent of management expenditure in the foreign subsidiary. The effect of this change is to narrow the scope of this condition compared to the proposal in the June consultation document and to remove the need for a local management condition.

3.10 The safe harbour conditions will also be subject to an anti-avoidance provision.

Insurance

3.11 The main concerns raised in consultation were the restrictions on reinsurance from the UK and the inclusion of a capitalisation condition. The insurance exemption proposed in the consultation document has been substantially revised following discussions with the industry and will now take the form of a safe harbour in respect of the capitalisation condition in the Gateway.

3.12 The key change is the removal of the restriction on reinsurance from the UK. As a result, profits from insurance will be excluded from the regime by the Gateway for business profits if they also pass the capitalisation condition. The Gateway's "artificiality" condition for business profits should not be met and therefore profits will be outside the scope of the regime, for the majority of insurance business, where the "key entrepreneurial risk taking" (KERT) functions (in line with OECD guidelines) of underwriting and acceptance of risk are performed outside the UK.

3.13 The Government intends to continue to work with the insurance industry to develop a capitalisation condition that enables insurance companies to self assess with the minimum compliance burden. This will include a safe harbour.

Banking

3.14 The Gateway contains a capitalisation condition for financial sector businesses. A safe harbour will be available as a proxy for this condition for banks. The Government intends to continue to work with the banking industry to design a capitalisation condition based on the Tier 1 regulatory capital of the foreign subsidiary. This should represent a simplification compared to the current capital interest test.

3.15 It is also proposed to include banking subsidiaries within the scope of the commercial activities safe harbour as set out in paragraphs 3.6-3.10. The condition concerning the proportion of UK income will be amended for banks. As in the current regime, related party interest income will be disregarded for the purposes of this condition, while other UK source income will be limited to 10 per cent of total income.

3.16 As a result, profits from banking will normally be excluded from the regime if they do not meet any one of the Gateway conditions and also meet the capitalisation condition, or where they meet the respective safe harbours. There will be anti-avoidance provisions which target particular risks in relation to banking.

Funds

3.17 Further work is still to be done to ensure that the CFC rules apply in an appropriate manner to funds.

Property

3.18 Respondents questioned the rationale of a number of the proposed restrictions to this exemption in the consultation document, arguing that property generally poses a low risk of artificial diversion of UK profits. It is now proposed that property income will be outside the scope of the new CFC regime.

Leasing

3.19 The exemption for operating leasing of tangible fixed assets was welcomed by those businesses that undertake such activity but a number of detailed issues were raised.

3.20 The Government is proposing that the general provisions, the Gateway and commercial activities safe harbour, are made available to leasing businesses and that no additional specific exemption is needed.

Foreign branches

3.21 The new CFC regime will apply to both foreign subsidiaries and exempt foreign branches of UK companies. The proposed approach of adopting SPF or KERT and capitalisation conditions is consistent with the way that profits and capital are attributed to branches. Rules will still be needed to prevent the majority of SPFs relating to a risk or asset held by a branch, existing in other UK resident group companies. However, this approach will simplify compliance for companies with exempt foreign branches.

4 Definition of a CFC and entity level exemptions

Definition of a CFC

Control

4.1 The majority of respondents felt that a mechanical test of control should be retained due to the uncertainty of a principles-based approach. It was thought that relying solely on an accounts-based approach would also be unsatisfactory.

4.2 It is therefore proposed to retain a mechanical approach while incorporating an accounts-based condition and an anti-avoidance provision to ensure that this definition is resilient. While recognising the commercial nature of most joint ventures it has not proved possible to eliminate the risk arising from their use by some to shelter profits artificially diverted from the UK and so joint ventures will continue to be subject to the general control conditions. However, it is expected that foreign joint ventures, the profits of which have not been artificially diverted from the UK, will be able to use the Gateway to establish exclusion from the regime.

Lower level of tax test (LLTT)

4.3 It is proposed that there will be no statutory requirement for a CFC that otherwise qualifies for full exemption to undertake a chargeable profits computation. Instead the lower level of tax test will be available as one of the entity level exemptions.

Entity level exemptions

Profits rate safe harbour

4.4 Respondents were generally of the view that the value of this exemption, which applies to a CFC which makes a low level of profit by reference to its costs, would be limited by the approach taken to defining the cost base. It was suggested that related party business expenditure and the cost of goods acquired for resale should be included in the cost base of the CFC for these purposes. The 10 per cent mark up was generally thought to be reasonable.

4.5 The Government proposes to expand the cost base to include the cost of goods sold for resale where the goods are delivered into the CFC's territory of residence but to retain the related party business expenditure exclusion. The 10 per cent mark up will also be retained.

Low profits exemption (LPE)

4.6 The majority of respondents requested a fixed rate with minimal conditions to minimise the associated compliance burden.

4.7 The Government intends to adopt a simple approach, increasing the current threshold to £500,000 of trading profits per annum, based on an accounting profits measure as introduced in Finance Act 2011 for the equivalent exemption. There will be a limit on investment income of £50,000. Companies making a loss will not need to consider this condition. The provisions introduced in Finance Act 2011 to protect against abuse of the exemption will be retained.

4.8 In addition, the Government proposes that this exemption will not be available to managed service companies that provide the services of a UK individual for another UK resident.

Excluded territories exemption (ETE)

4.9 Respondents favoured a long list of excluded territories with as few conditions as possible. The general conditions proposed in the June consultation document were considered too restrictive and it was suggested they would make the exemption less useful than the current Excluded Country Regulations. Suggestions included removing the proposed investment income condition, or, if it was retained, excluding local source investment income and removing any restriction on income arising from transactions with the UK. There was general acceptance that the availability of the exemption should be denied where a territory offers tax holidays and that a branch income condition is reasonable.

4.10 The Government proposes that territories with a headline rate of greater than 75 per cent of the UK main corporation tax rate will be excluded territories for the purpose of this exemption. The list of excluded territories, which is included in the guide to draft legislation, will appear in regulations and will be updated as necessary.

4.11 The proposed general conditions will be revised. Changes include removal of the condition limiting UK source income. A foreign subsidiary will qualify for the exemption provided the total income from a number of categories of income which are specified in the legislation does not exceed 10 per cent of the company's pre-tax profits for the accounting period (or £50,000 if greater). These categories generally cover income which is exempt from tax, or subject to a reduced rate of tax, in the territory of residence of the foreign subsidiary.

4.12 The ETE will not apply if either a significant part of the CFC's IP, or a part of the CFC's IP that generates significant additional profits, has been transferred to it from the UK in the previous 6 years. As for the commercial activities safe harbour, a transfer will only be relevant if it leads to a significant loss of value for the transferor.

4.13 The exemption will retain an anti-avoidance provision. A specific condition will be included in the regulations to prevent insurance companies in Luxembourg from using the ETE as the measure of profits on which tax is charged in this circumstance is significantly different from the equivalent UK measure of profits.

Temporary period exemption (TPE)

4.14 Some respondents requested that the temporary period of exemption be extended, for example, where there is no change in the nature of the foreign subsidiary's activities. The main concern raised was that the definition of relevant transaction, which would deny the exemption, applied to some commercial circumstances.

4.15 It remains the Government's intention to offer a time limited exemption as part of the new CFC regime. The impact of the revised overall design for the regime on the scope of the exemption is currently under consideration, particularly the absence of a free-standing purpose or motive test.

5 Next steps

Introduction

5.1 The Government welcomes views by 10 February 2012 on the issues raised in this document and the draft legislation and regulations published on 6 December 2011. Further draft legislation covering areas for which legislation was not published on 6 December 2011 will be published in January 2012. As with the consultation over the summer, comments are welcome before the closing date of the consultation.

5.2 The Government will hold an open event at HM Treasury on Wednesday 11 January 2012 at 10am to discuss the CFC proposals and draft legislation. If you would like to attend this event please contact corporatetaxreform@hmtreasury.gsi.gov.uk including CFC open event in the title of the email. To allow a wide range of stakeholders to attend places will be limited to 2 per organisation.

5.3 Officials will spend time between now and spring 2012 consulting with businesses and other stakeholders on these proposals, with the aim of including final legislation in Finance Bill 2012. The current working groups will also continue to meet where required to take these proposals forward.

How to respond

5.4 Any comments or technical queries on the proposals in this document should be addressed to:

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Robert Edwards: robert.edwards@hmtreasury.gsi.gov.uk or on 020 7270 5276

5.5 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.

5.6 The Government would welcome earlier, or staged responses, ahead of the consultation deadline where this is possible.

Confidentiality

5.7 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.

5.8 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).

5.9 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.

Code of Conduct on Consultation

5.10 This consultation is being conducted in accordance with the Code of Practice on Consultation that sets out the following criteria:

- When to consult – formal consultation should take place at a stage when there is scope to influence the policy outcome.
- Duration of consultation exercises – consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- Clarity of scope and impact – consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- Accessibility of consultation exercise – consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- The burden of consultation – keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- Responsiveness of consultation exercises – consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- Capacity to consult – officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

5.11 If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact

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Consultation Coordinator, Better Regulation and Policy Team,
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020 7147 0062 or e-mail: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

A Summary of consultation responses

A.1 73 representations were received from a range of interested parties including 43 UK and foreign headed groups, 16 representative bodies, 10 professional services, consultancy and law firms, 2 Non Governmental Organisations (NGOs) and 2 individuals.

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?

A.2 There was general support for the policy aims and respondents welcomed the level of detail provided in the consultation document. Many felt that it was a constructive step forward but that there was still a lot of work to be done.

A.3 The finance company proposals were broadly welcomed. However, for other areas it was considered that whilst the direction of travel was right, the proposals would increase compliance burdens and might deter groups from locating a headquarter company in the UK.

A.4 The two NGOs that responded raised concerns about the impact on developing countries of a more territorial regime.

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

A.5 The majority requested the existing Client Relationship Manager led non-statutory clearance approach be retained with input from HM Revenue and Customs' Corporate Tax, International and Anti-Avoidance (CTIAA) to ensure consistency of application.

Chapter 3

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

A.6 Representations were overwhelmingly in favour of retaining the existing mechanical exemption. A number of responses suggested that commercial JVs should be outside of the rules.

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?

A.7 It was felt that the rules would apply in a more coherent fashion if UK tax payable could be compared with total foreign tax suffered including withholding tax. A number of respondents also suggested that the loss relief rules should apply in the same way as for UK tax resident members of the group.

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.

A.8 The majority of respondents requested a fixed limit with minimal conditions to minimise the associated compliance burden. A number suggested that the proportionate approach would not be State Aid compliant.

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.

A.9 Very little information was provided in light of preference stated above.

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.

A.10 Most were in favour of the optional approach to minimise compliance burdens where accounts are not required to be prepared for any other reason.

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

A.11 Respondents favoured a long list with as few conditions as possible. Some felt that all EU or EEA member states should be included on the list and a number of other specific requests for territories with a tax rate of less than 75 per cent of the UK headline rate were received.

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.

A.12 There was significant concern that the number of proposed conditions would make the proposed exemption much less useful than the current exemption.

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?

A.13 Respondents generally felt that the scope was sufficient but that the exemption could be improved if it were to be available for any period subject to a change in the nature or conduct of the business activity.

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?

A.14 Some respondents felt that this condition caught a variety of transactions not intended to be included.

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?

A.15 Most respondents thought that specific rules were not needed but a few would welcome the additional flexibility this might afford.

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.

A.16 Some respondents felt that this would be of limited use but others were of the view that, particularly if there were changes to the proposed cost base, it would simply exclude low risk subsidiaries that would not qualify for an alternative entity level exemption and therefore should be retained. Groups requested that additional items such as depreciation, intra group recharges, and cost of goods for resale from unconnected parties were included in the cost base. 10 per cent was generally considered to be an appropriate profit rate.

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

A.17 No detailed responses were received on this issue.

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

A.18 Most respondents felt that the exemption could only be used by toll manufacturers due to the limitations imposed by the proposed IP conditions.

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.

A.19 There was widespread concern that the proposed restrictions on UK connection and IP transfers, including where IP is licensed from the UK to overseas group companies, would mean that many companies that currently qualified for the exempt activities test would not qualify for the TBEs.

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?

A.20 A number of respondents felt that lower value leases should also be included.

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.

A.21 Respondents generally felt that these types of companies were not an appropriate target for the CFC rules and should be adequately addressed by transfer pricing rules.

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

A.22 The majority view was that the divergence of commercial situations necessitates a 'facts and circumstances' based incidental finance income limit with an optional fixed limit as a safe harbour to help with compliance burdens.

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.

A.23 No detailed responses were received on this issue.

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?

A.24 Respondents raised concerns about the treatment of holding companies and some requested that a separate mechanical exemption for holding companies be maintained.

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.

A.25 The majority view was that a principles based TBE would not provide sufficient certainty to be useful and would add to compliance burdens.

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

A.26 The stated principal was agreed to be reasonable but it was felt that the associated compliance burden would not be proportionate.

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

A.27 Respondents felt that there would not be an advantage in using both approaches for the reasons stated above.

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 restructuring where required?

A.28 The clear preference was for a flexible, simple option, to ensure the rules are stable so that business has certainty on the treatment of overseas finance income.

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?

A.29 The majority were in favour of the practical approach with a few requesting the option to be able to separately identify treasury profits.

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

A.30 It was agreed that this approach was reasonable.

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?

A.31 Most respondents felt that the proposed exemption options were reasonable. However, some felt that a company should be able to demonstrate that none of the income of a financing company has been artificially diverted from the UK and that full exemption should be available in these circumstances.

A.32 A few businesses also suggested that where funds invested by equity in a CFC are raised by an issue of shares in the UK, then full exemption should be available on the finance income arising on the funds held by the CFC.

A.33 Other respondents were concerned that rules such as these might undermine the stability of the regime, which is intended to provide a balanced solution to this issue without the need to trace funds.

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?

A.34 It was acknowledged by most businesses that the exclusion of finance income arising on loans to the group's UK companies from the FCPE would be required to ensure the regime would be affordable to the Exchequer.

A.35 Most respondents also welcomed the acknowledgment that loans to the UK can arise for commercial non tax motivated 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?

A.36 It was agreed that this would be reasonable.

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?

A.37 Businesses thought it was important that the finance company rules could apply to mixed activity companies to minimise the need to restructure existing overseas financing arrangements.

A.38 With regard to the allocation of expenses between the financing and trading activities of the company, some respondents suggested that expenses should be allocated between the activities on a just and reasonable basis whilst others suggested that interest expense should not be allocated to holding activity if there are no deductions locally for financing equity investments.

Question 6H: Would any practical issues arise if the design option chosen meant that intra-group debt had to be restructured?

A.39 Practical issues were identified by some respondents who suggested transitional rules should be introduced if restructuring is likely to be required to fit within the finance company rules.

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

A.40 Respondents acknowledged that whilst restructuring financing activities can be more straightforward than restructuring equity interests, it can take time depending on the specific facts and there would be directly attributable costs in the form of legal fees, staff and other internal costs.

A.41 Businesses also noted that bank covenants could restrict the ability for groups to restructure debt (where it is subordinated to external debt) or it simply may not be possible to refinance fixed term debt under the terms of the loan agreements without giving rise to additional costs in the borrower. Businesses would also need to consider local tax issues, foreign exchange movements and transfer pricing provisions for early exit of loan agreements when 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?

A.42 Some respondents suggested that the FCPE should apply equally to finance branches to ensure their tax treatment is aligned and allow businesses to avoid the costs involved in establishing and managing an overseas subsidiary.

A.43 However, it was acknowledged that there were technical issues associated with the allocation of financing profits between a finance branch and the head office of a company under Article 7 OECD Model Convention principles. The respondents were of the view that specific rules would be required to address this issue for businesses to have sufficient certainty to use a finance branch rather that a finance company.

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?

A.44 Some respondents felt that the rules would not be State Aid compliant if banking and insurance groups were excluded from the finance company rules.

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

A.45 Some insurance groups and banking groups suggested that it would be appropriate for only non financial companies within their groups to be eligible for the FCPE.

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 overseas?

A.46 No detailed responses were received on this issue.

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.

A.47 The GPE was not well received by the majority of respondents who felt that it was not workable except in a small range of very high risk circumstances and would significantly increase compliance burdens.

A.48 There were mixed views on the Article 7 approach as this is an unknown area of tax law for many businesses although it was recognised that this would identify those profits that are 'commensurate with activities' and 'derived from UK activity' thereby achieving the aims of the GPE.

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.

A.49 There was concern from a significant number of groups that the GPE will require bespoke analysis which is not currently undertaken for any other purpose to be done on a company by company basis.

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?

A.50 The majority of respondents felt that the GPE would not be a suitable and effective replacement for the motive test due to the complexity of the calculations involved and the lack of flexibility to accommodate new commercial situations which arise over time as commercial activities change. The lack of a specific question on tax motive will mean that it may catch some commercial situations.

A.51 A number of groups were concerned about the treatment of funds.

A.52 Some respondents noted that in situations in which Article 7 is used there should not be a local management requirement as this is indirectly reflected in profit attribution.

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".

A.53 A number of detailed suggestions were made in response to this question which have been factored into the design of the new rules.

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.

A.54 Respondents generally agreed that inclusion of such indicators in guidance would be helpful.

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

A.55 The widely held view was that IP is generally not held as a passive investment.

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

A.56 There were mixed views on this issue with some considering the approach workable and others suggesting that it needed to be supplemented by an integral to the trade test.

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?

A.57 There were some representations in favour of this approach but the majority did not welcome the proposal suggesting that this was a return to the "earn out" discussions of previous consultations on the issue.

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.

A.58 It was suggested that the proposal would prevent double taxation, however no views were received on the extent to which tax is paid on these transfers in practice.

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.

A.59 Some respondents felt the examples were reasonable but it was also noted that the examples demonstrated the complexity of the rules.

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

A.60 No detailed responses were received on this issue.

Chapter 9

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

A.61 The general view was that the process of profit attribution to foreign branches meant that a local management condition was not necessary.

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.

A.62 There was some concern that the updated provisions could be less generous than the FA11 provisions and that if this situation were to arise any election made into branch exemption before FB12 would need to be revocable.

A.63 It was also suggested that any allocation of capital already undertaken for tax purposes should be taken into account.

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?

A.64 No detailed responses were raised on these issues.

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?

A.65 Some respondents requested that grandfathering provisions are made available to branches established before branch exemption as these cannot have been motivated by diversion of UK tax.

A.66 Some respondents felt that, where finance income was attributable to a branch, FCPE should be available for branches to achieve the policy aim of closer alignment of the tax treatment of branches and subsidiaries.

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?

A.67 Respondents did not feel this restriction was necessary.

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?

A.68 Respondents felt that the overall compliance burden would be reduced but did not feel that the proposed restrictions were necessary to protect the UK tax base.

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?

A.69 Respondents agreed that the profits rate safe harbour or commercial activities TBE would exempt management service companies which do not have profits artificially diverted from the UK.

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.

A.70 Respondents agreed that this was the case.

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

A.71 Some respondents felt that low value leasing should also be eligible for this safe harbour.

A.72 For compliance purposes, it was requested that the £10m minimum cost be based on original cost. A number of issues were raised with the proposed UK connection limits. Respondents felt that the income condition should not apply where income is the subject of an Advance Pricing Agreement or where the group as a whole has less than 20 per cent income from the UK.

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?

A.73 Respondents felt that management outside the UK would fit better with the aims of the regime and business practices in this sector.

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

A.74 It was suggested that the long funding lease asset definition may be appropriate.

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?

A.75 No respondents considered the 80 per cent requirement would cause any problems in practice. Responses were mainly focussed on the most appropriate definition to use for an insurance group.

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

A.76 Most respondents believed that there should be no restrictions on reinsurance within insurance groups. All issues of artificial diversion of profits should be dealt with by means of transfer pricing. Respondents felt that a fixed limit on reinsurance inhibited their ability to manage capital and would be a disincentive to undertaking activity in the UK.

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?

A.77 The main concern was that the capitalisation test should apply to as few companies as possible and should be simple to operate.

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

A.78 The majority of respondents felt that the current exclusions are 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?

A.79 Some respondents felt that this definition would not be problematic but others suggested using the bank payroll tax or Bank Levy definition to ensure consistency or allowing this exemption to apply to all regulated entities carrying on banking business.

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

A.80 Business who responded suggested that this test should focus on the regulatory capital of the CFC and loans and guarantees from related parties should be excluded.

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.

A.81 The capital interest test as currently designed was felt by some to work quite well but improvements could be made by removing foreign transactions with no UK connection, excluding debt funding from the UK and raising the threshold.

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?

A.82 A number of specific suggestions of items to be excluded from the definition of capital were received, including focusing on equity investment from funds in the UK which is the key way in which profits can be diverted. Some respondents commented on the timing of the test, for example, suggesting that it is applied at the end of the relevant accounting period.

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?

A.83 No detailed responses were received on this issue.

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.

A.84 Respondents had mixed views on this issue with some noting the exemption of UK interest receipts as critical for offshore deposit takers and therefore claiming that this is more important than exempting overseas income. Others felt that "foreign-to-foreign" transactions should be excluded from the scope of the CFC rules specific to banks to give closer alignment to other areas of the regime.

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?

A.85 No detailed responses were received on these issues.

Annex H

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

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

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.

A.86 No detailed responses were received on these issues.

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.

A.87 Some respondents expressed concern that the proposed GPE would significantly increase compliance burdens due to the number of CFCs it was expected it would need to be applied to. Some respondents requested a form of motive test or changing the regime to become, 'all out' rather than 'all in', in order to limit compliance burdens.

Other issues

A.88 A number of respondents gave their views on Annex I or the compliance of the proposals with EU law.

B

Guide to the draft legislation

Contents

Introduction

B.1 The key elements of the new CFC regime are set out in Chapters 1-4 of the main document. This Guide to the draft legislation describes how the draft legislation for the regime as a whole is arranged. There are a few elements of the new regime which are not included in the draft legislation published on 6 December. The later part of this Guide provides details of these elements, which it is anticipated will be published as part of a further draft in January 2012.

B.2 Under the proposals set out in the draft legislation, a CFC charge can arise only if:

- a foreign company is controlled from the UK (i.e. a CFC);
- none of the entity level exemptions apply; and
- the CFC has "chargeable profits" as defined by the gateway.

B.3 The gateway for the new regime consists of a series of provisions which define a CFC's chargeable profits so as to limit the scope of the new regime to certain categories of profits. If a CFC's profits are not chargeable profits then those profits are outside the scope of the new regime. It follows that a CFC with no chargeable profits is itself outside the new regime. This requirement for positive inclusion of profits within the regime contrasts with the approach taken by the current CFC regime, and can, in broad terms, be described as "all out, unless brought in".

B.4 The gateway provisions deal with non-finance profits separately from finance profits. This note refers to non-finance profits as "business profits".

B.5 For business profits, there are a number of conditions or general exclusions, any of which, if met, exclude the business profits in question from being chargeable profits. In summary, the effect of these general exclusions is to ensure that business profits will only be chargeable profits where they are attributable to UK operations, arise in a CFC through arrangements lacking any substantial non-tax value and involve arrangements that would not have been entered into by independent companies. In addition to the general exclusions, there is a more mechanical exclusion or "safe harbour" for trade profits.

B.6 Non-trading finance profits are chargeable profits only if they fall within specified categories. Finance profits arising from intra-group lending to foreign companies may also qualify for partial exemption under separate rules. An incidental income exclusion will exclude finance profits if they arise on funds that are held for the purposes of a trade or property business which does not give rise to chargeable profits. There are "safe harbour" exclusions where the finance profits are no more than 5 per cent of the CFC's total assumed trading and assumed property income (excluding tax and interest), or where the finance profits are less than 5 per cent of the dividend income of a holding company. The amount of a CFC's total assumed profits is the amount of taxable profits calculated on the assumption that the CFC is a UK resident company.

B.7 In addition to exclusion of profits from the scope of the regime as described above, the draft legislation proposes a number of entity level exemptions that can apply to a CFC as a whole, thereby excluding all of its profits.

B.8 In designing these exemptions it is recognised that the wider and more flexible they are, the greater the risk that they might be used to produce unintended results. The new regime therefore includes some anti-avoidance rules to ensure that the exemptions can be framed as widely as possible.

Structure

B.9 The draft legislation inserts Part 9A TIOPA 2010 as the statutory location for the new CFC regime.

B.10 Chapter 1 of Part 9A provides an overview, defines control for the purposes of the new regime, and so defines what is a "Controlled Foreign Company" i.e. CFC.

B.11 Chapter 2 sets out the basis for the CFC charge and the steps to be taken to establish the charge (if any) for the relevant accounting period. In particular, subsection 371BA(1) of Chapter 2 provides that there will be no charge if either of the following two conditions is met:

- One or more of the entity level exemptions in Chapters 3 to 6 apply, or
- The CFC has no "chargeable profits" as established under the gateway provisions (Chapters 7 to 13).

B.12 It does not matter which of these conditions is considered first. Companies will be able to look to the exemptions or to the gateway to establish whether a CFC has profits that are subject to the charge for the relevant accounting period.

B.13 The exemptions in Chapters 3 to 6 are:

- the low profits exemption;
- the low profit margin exemption (previously the profits rate safe harbour);
- the excluded territories exemption; and
- the tax exemption (equivalent to the lower level of tax test in the current CFC regime).

B.14 Chapter 7 sets out how to determine the chargeable profits of a CFC for an accounting period. Chargeable profits are those falling within one or more of the categories of profits set out in Chapters 8 to 12 (i.e. the gateway provisions) unless they are to be left out of account because they fall within Chapter 13 (which, for example, excludes property income falling within Part 4 of CTA 2009).

B.15 Chapter 8 is the principal gateway category of profits. It includes profits within it only if they arise from an arrangement which would not be found between independent companies, lacks any substantial non-tax value, and in which assets or risks in a CFC give rise to profits that are mainly attributable to UK based functions ("SPFs"). In addition to exclusions based on these principles, there is a more mechanical "safe harbour" on which companies can rely as an alternative exclusion for trade profits.

B.16 Chapter 9 sets out three categories of non-trading finance profits that fall within the regime. The first category is finance profits from financial assets or risks where the profit is mainly attributable to UK based functions (based on the same principles as detailed in Chapter 8). The other two deal with finance profits which arise from the receipt of UK capital investment or the making of loans from the CFC to a related UK company ("upstream" loans). Non-trading finance profits are chargeable profits if they fall in any of these categories.

B.17 Chapter 10 applies to trading finance profits and provides a capitalisation test together with regulation making powers for capitalisation safe harbours for banks and insurance companies.

B.18 Chapter 11 provides rules for captive insurance companies while Chapter 12 applies to a CFC that is a regulated finance company and that is the subject of a solo consolidation waiver.

B.19 Chapter 13 provides for specified types of profit to be left out of account in calculating chargeable profits. These are property income, incidental non-trading finance profits and incidental finance profits for holding companies.

B.20 Chapters 14 to 16 provide the rules needed to calculate the amount of any CFC charge that arises. Chapter 14 defines what is meant by "relevant interests" in a CFC for the purpose of identifying those persons to whom any chargeable profits are to be apportioned. Chapter 15 sets out the rules for determining the amount of a CFC's creditable tax, essentially the amount of double taxation relief that can be set against any chargeable profits. Chapter 16 provides the rules for apportioning a CFC's chargeable profits and creditable tax among those with a relevant interest.

B.21 Chapter 17 provides the rules for the partial exemption for certain non-trading finance profits arising from qualifying intra-group lending. It applies by excluding three quarters of the company's profits from such qualifying lending except for any part that is earned on funds held for a trade or property business purpose. It requires a claim because it is an alternative to the gateway determination of chargeable non-trading finance profits under Chapter 9.

B.22 Chapter 18 provides the detailed rules needed to compute, in broad terms, the assumed profits that the CFC would have made if it had been resident in the UK. The Chapter also sets out the corporation tax assumptions on which the amount of assumed profits is based.

B.23 Chapter 19 provides rules for determining the residence of a CFC for the purposes of the new regime. Chapter 20 provides the collection and management provisions for the regime while Chapter 21 contains supplementary, consequential and commencement provisions.

The "Gateway"

B.24 Chapter 2 of the draft legislation sets the scope of profits that will be potentially subject to the CFC charge. Section 371BA(2) provides that the CFC's chargeable profits and creditable tax are to be determined and apportioned between UK interest holders in accordance with Chapters 7 to 17 and that where there are no such profits there can be no CFC charge.

B.25 By defining the chargeable profits of the regime, Chapters 7 to 13 provide the gateway provisions that can be used to identify the profits, if any, of foreign subsidiaries that are within the scope of the regime.

B.26 Chapter 7 contains section 371GA, the main charging provision. The general effect of this provision is to:

- limit the CFC's chargeable profits to amounts falling within Chapters 8 to 12, broadly to:
    - business profits attributable to UK operations, and arising in a CFC through arrangements lacking any substantial non-tax value or those that would have not been entered into by independent companies, and
    - finance profits within specified categories;
- take account of any profits that are to be left out of account under Chapter 13.

Business profits gateway

B.27 Chapter 8 of the draft legislation defines business profits that fall within the CFC charge, broadly because they are attributable to UK SPFs and do not meet any of the four further Chapter 8 exclusions. It is not necessary to consider non-trading finance profits within this Chapter, since Chapter 9 has a similar but broader scope for this type of profit.

B.28 Section 371HA gives a definition of Chapter 8 profits which is subject to the four exclusions in the following sections. It must be considered alongside these exclusions, which limit its scope to those cases where there is considered to have been a diversion of profit from the UK.

B.29 Section 371HA identifies profits that arise in a CFC because the CFC holds an asset or bears a risk for which SPFs are carried out in the UK. The SPFs must be sufficient that, if they were carried out by a permanent establishment ("PE") of the CFC in the UK, they would lead to the asset or risk being wholly or partly attributed to the PE for the purpose of calculating the PE's profit. The section therefore focuses on cases of mismatch between the location of profit and the location of SPFs that give rise to the profit.

B.30 The principles for the identification of SPFs relevant to the assumption and management of risk, or the economic ownership of assets within an enterprise are set out in the 2010 OECD Report on the Attribution of Profit to a Permanent Establishment ("the OECD Report"). In broad terms these are SPFs requiring active decision–making. SPFs in the CFC or any connected company are taken into account for the purposes of Section 371HA.

B.31 It does not matter where SPFs are undertaken outside the UK – it is only necessary to distinguish between UK SPFs and others. If the UK SPFs are such that an asset or risk would be wholly attributed to the UK, the CFC's profits are recalculated as if it did not bear that risk or own that asset. Conversely, if there are no UK SPFs, there are no chargeable profits. Where the assets or risks would be partly attributed to the UK, the corresponding part is treated as not being owned or borne by the CFC. The CFC's profits are then recalculated on this basis and the difference between the actual CFC profit and the recalculated profit is the CFC's "provisional Chapter 8 profit". It is provisional because it may be reduced, either in whole or part, by the four exclusions described below.

B.32 Under the principles of the OECD Report the attribution of tangible assets may often be based on use rather than a determination of SPFs, so Chapter 8 in its application to assets will generally be restricted to intangible or monetary assets.

B.33 SPFs are unlikely to be of a nature that could be subcontracted to an unconnected person without there being adequate controls in place – in which case these control functions would themselves be the SPFs. Therefore, if a CFC is obtaining services such as advice from group companies in a way that is subject to the same level of oversight as would be employed in the case of the same services provided by unconnected companies, it is reasonable to suppose that the services do not constitute SPFs.

B.34 This observation may be helpful in identifying circumstances in which profits do not fall within the CFC charge. We have considered including such a rule in legislation, but have concluded that the circumstances it identifies are already excluded by the terms of the business profits gateway. Since the profits are already excluded under the draft legislation, this may be a matter best dealt with in HMRC guidance.

B.35 Chapter 8 applies to financial traders as it does to other companies. In the OECD Report a financial trader's SPFs are referred to as KERT functions. Within the draft legislation "SPF" will include both "significant people functions" and "key entrepreneurial risk taking functions" as described within the OECD Report. The insurance KERT is the assumption of risk. For most insurance companies the KERT will be part of their underwriting activities, so it is unlikely that any Chapter 8 charge will arise.

First exclusion – minority of UK SPFs

B.36 If the above calculation gives half or less of the amount it would give if the asset or risk were wholly attributed to the UK, then the Chapter 8 profits are reduced to nil. This is the effect of the "artificiality" exclusion provided by section 371HB, which is the first of the exclusions that narrow the scope of Chapter 8. It ensures that only cases of major mismatch between profit and the SPFs that generate the profit are caught. In general, it means that the SPFs must be mainly in the UK in order for Chapter 8 to identify any profit that is chargeable under the regime.

B.37 This exclusion and section 371HA both apply to particular assets or risks, except that where it is not practicable to separate a bundle of assets or risks, they are treated as a single item. For example, brand IP will often constitute a bundle of intangible assets that would be considered together.

Second exclusion – substantial non-tax value

B.38 Under section 371HC, the substantial non-tax value exclusion, no CFC charge will arise as a result of the separation of risks or assets from SPFs if any non-tax value arising from the separation is a substantial part of the total value from the separation. In making this comparison any foreign tax value is wholly disregarded, so total value will consist of UK tax value and non-tax value.

B.39 The draft legislation does not prescribe how the value is to be calculated and any reasonable method may be used. Although this is an annual test, projections of reasonably foreseeable costs and benefits should be taken into account in this comparison. For example, if a net present value calculation was undertaken as part of the assessment by a group of a proposal that involves the separation of assets and risks from SPFs, the calculation is likely to be helpful in comparing tax and non-tax value from the proposal for the purposes of this exclusion.

B.40 The word "substantial" is not synonymous with any fixed percentage threshold, but in general HMRC would expect a non-tax value that amounts to at least 20 per cent of the total to be substantial.

Third exclusion – arrangements which independent companies would have entered into

B.41 Section 371HD provides the third exclusion, which considers the arrangement that leads to the separation between assets or risks in the CFC and UK SPFs in another company. If it is reasonable to suppose that the two companies would have entered into an identical arrangement if they had been independent of each other, then the separation will not lead to a CFC charge. It is in fact relatively unlikely that an SPF would arise in another company if the arrangements between the CFC and that other company would be found between independent companies, but this exclusion may in practice be a useful way to identify where profits should be excluded.

B.42 Where arrangements would not have been entered into between independent companies, Part 4 TIOPA (Transfer Pricing) would have been considered. However it does not necessarily follow that no CFC charge can arise, as the pricing may be based on the artificial and tax motivated separation of risks and assets from functions which the CFC rules seek to address.

Fourth exclusion – trading income safe harbour

B.43 Sections 371HE to 371HJ set out an alternative approach to determining the profits within Chapter 8 that does not require the identification of SPFs. It is intended as a "mechanical" identification of circumstances that will not give rise to a CFC charge. This safe harbour may be applied to the whole of a CFC, or to particular assets or risks.

B.44 As the safe harbour represents an approximation to the principles that the legislation is designed to implement, it includes some restrictions that are intended to limit the risk that it inappropriately excludes profits. Section 371HE sets out the conditions, all of which must be met if the safe harbour is to apply. The CFC must:

- have business premises;
- receive no more than 20 per cent of its gross income directly or indirectly from the UK, unless it is a bank when the limit is 10 per cent but excludes interest received from UK connected companies;
- meet the management expenditure condition, which is described below;
- not hold IP transferred from UK related parties within the previous 6 years, where that IP forms a significant part of the CFC's total IP or generates significant additional profits for the CFC; and
- not receive more than 20 per cent of its income from goods delivered from the UK unless the goods are exported to its territory of residence.

B.45 The management expenditure condition applies to the cost to the CFC or any connected company of management of the CFC's risks and assets. This condition approximates the test of attribution of the risk or asset with a test of the cost of management:

B.46 If no more than 20 per cent of the cost of management of the CFC's combined assets and risks is incurred in the UK, then the CFC has no profit within Chapter 8.

B.47 As an alternative, if no more than 50 per cent of the cost of management of a particular asset or risk (or bundle of assets or risks) is incurred in the UK then no Chapter 8 profit will arise in respect of that asset or risk.

B.48 A transfer of IP is a transaction that leads to the CFC acquiring IP and that also leads to a loss of value for the transferor.

B.49 An anti-avoidance rule will apply where a CFC has made arrangements to organise its business with a main purpose to secure exclusion of profits under the safe harbour. The effect of the rule is to deny use of the safe harbour, but a CFC charge will follow only if these profits are included in the regime under the gateway.

Non-trading finance profits gateway

B.50 Chapter 9 applies to non-trading finance profits and provides for chargeable profits to be limited to those that fall within one of three specified categories

UK SPFs

B.51 The first category (section 371IB) is based on the same concept of SPFs as provided by Chapter 8 for including business profits as chargeable profits. In this context the SPFs are referred to as key entrepreneurial risk-taking functions, or "KERT" functions, in the OECD Report. In cases where active decision-making regarding group funds is undertaken in the UK, the clear expectation is that this category will generally be of less value than the alternative rules for partial exemption of intra-group financing profits.

B.52 The KERT functions for a loan will generally be those which require active decision-making with regard to the acceptance of risk and the ongoing management of that risk. Intra-group loans may in fact require little ongoing management, in which case the KERT functions with regard to the initial assumption of risk are likely to have much greater relative importance in attributing "economic ownership" of the financial assets. To the extent that a group instigates and manages oversight of intra-group loans through a central division such as group treasury, the KERT functions are very likely to rest within that division.

UK capital investment

B.53 Under section 371IC non-trading finance profits are included in the CFC charge if they are derived from funds invested directly or indirectly from the UK. Funds invested include profits diverted from the UK, consisting either of profits previously subject to the CFC charge, or profits subject to a transfer pricing charge. In either case, although tax will have been charged in the UK, the profits themselves remained in the CFC and are considered here as capital invested in the CFC.

UK Loans

B.54 Loans made by a CFC to a connected UK resident company (i.e. upstream loans) are included in the CFC charge by virtue of section 371ID where it is reasonable to suppose that the main reason, or one of the main reasons, for making a loan rather than a distribution relates to the UK or non-UK tax consequences of doing so.

Trading finance profits gateway

B.55 There are a number of provisions in the draft legislation that are for companies carrying on financial trades which give rise to trading finance profits including some that are specific to those companies carrying on either banking or insurance business.

Over-capitalisation

B.56 Chapter 10 of the draft legislation has a scope that complements that of Chapter 9, which applies to profits that (if they arose in a UK resident company) would be charged to tax under Parts 5 or 9A of CTA 2009, including those that are within Part 5 by virtue of Parts 6 or 7 of that Act. Chapter 10 applies where profits could fall within those Parts, but are excluded from them because of the priority given to Part 3 CTA 2009 (trading income). Companies with this type of profit (referred to as "Chapter 10 profits") are those carrying on financial trades, including those carrying on insurance and/or banking business.

B.57 Chapter 10 profits are included in the CFC charge if they are attributable to excess capital and there has been an investment of capital directly or indirectly from a UK resident connected company.

B.58 A CFC carrying on insurance business has excess capital if it holds more "free assets" than it is reasonable to suppose would be held by an independent company carrying on the same business. "Free assets" here takes the same meaning as is already used for the purposes of Chapter 4 of Part 2 CTA 2009 – it is the company's excess of assets over liabilities.

B.59 A CFC carrying on banking business or other financial trade (excluding insurance business) has excess capital if the proportion of its funds that are provided by "free" capital (i.e. non-interest bearing instruments) is greater than it is reasonable to suppose would be the case for an independent company.

B.60 If a financial trader has excess capital and has capital investment from the UK, then so much of its relevant trading finance profits as it is reasonable to suppose are attributable to the excess capital fall within Chapter 10.

B.61 We will continue to work with the banking and insurance sectors to establish how the concepts set out above can be implemented so as to draw as fully as possible on information available as part of normal capital management processes.

B.62 The legislation contains powers at Sections 371JB and 371JC to make regulations for "safe harbours" applicable to those carrying on banking and insurance business. A CFC within the safe harbour conditions set out in the regulations would have no chargeable profits under Chapter 10.

Captive Insurance Business

B.63 Section 371KA (Chapter 11) makes specific provision to include profits from a captive insurance business. For a CFC that is resident in an EEA state, chargeable profits include any profits that arise from the CFC's insurance business, and which are derived (directly or indirectly) from insurance contracts with connected UK companies which the insured has no significant non-tax reason for entering into. For a CFC resident elsewhere, profits from all UK connected insurance contracts are chargeable.

Solo consolidation

B.64 A regulated financial company may apply for a "solo consolidation waiver" whereby one or more other companies are treated as a division of the regulated company for regulatory purposes, rather than as separate entities. Where a CFC is solo consolidated with a UK resident company, section 371BC and Chapter 12 will include within the CFC charge any profit arising in the CFC that exceeds the amount that would be attributed to the CFC if it were a foreign PE of the regulated company. This ensures consistency between the regulatory and tax positions of the two companies.

B.65 An anti-avoidance rule (section 371BC(3)) applies where, although there is no solo consolidation waiver between a CFC and a UK resident bank, the regulatory effect of holding shares in a connected company is wholly or mainly reduced through a hedging arrangement. Where the anti-avoidance rule applies the same consequences follow as for solo consolidation.

Financial Traders and KERT functions

B.66 Chapter 8 applies to financial traders as it does to other companies. In the OECD Report a financial trader's SPFs are referred to as KERT functions. Within the draft legislation "SPF" will include both "significant people functions" and "key entrepreneurial risk taking functions" as described within the OECD Report. The insurance KERT is the assumption of risk. For most insurance companies the KERT will be part of their underwriting activities, so it is unlikely that any Chapter 8 charge will arise.

Amounts to be left out of the CFC charge

B.67 Chapter 13 provides for profits from property business and incidental non-trading finance profits to be left out of a CFC's chargeable profits.

Profits from property business

B.68 Property income that would fall within Part 4 of CTA 2009 is to be left out of chargeable profits.

Incidental non-trading finance profits – 5 per cent rule

B.69 If the total of the non-trading finance profits included within the chargeable profits is no more than 5 per cent of the CFC's total assumed trading and assumed property income (excluding tax and interest), then the amount of the non-trading finance profits are disregarded. The amount of a CFC's total assumed profits is the amount of taxable profits calculated on the assumption that the CFC is a UK resident company.

Incidental non-trading finance profits – trade or property business

B.70 Incidental non-trading finance profits which do not meet the 5 per cent rule are in any case left out of account to the extent they arise from funds retained for the purposes of a trade or property business the profits of which are themselves exempt. Section 371MD contains a list of reasons for retaining funds that do not constitute trade or property business purposes. They include for example retaining funds for more than 12 months ahead of a distribution or property purchase and funds retained for contingencies or share purchases.

Incidental non-trading finance profits – holding companies

B.71 Non-trading finance profits are also exempt from Chapters 8 to 12 for a CFC with a substantial part of its business as a holding company, provided that the profits are no more than 5 per cent of its dividends received (provided that these dividends would be exempt under Part 9A CTA 2009).

B.72 For this purpose the non-trading finance profits of a holding company are combined with any such profits arising in a subsidiary holding company for which this exemption (i.e. the holding company part of the incidental finance exemption) applies. The holding company exemption is not affected by any trade or property business incidental income exemption claimed by a subsidiary company.

Partial exemption for finance profits

B.73 The partial exemption for finance profits is in Chapter 17. Section 371QB provides the basic rule and requires a claim to be made by the chargeable company. As a result of the claim, the CFC's chargeable profits are re-calculated on the basis that the contribution to the CFC's chargeable profits from the CFC's qualifying loan relationship profits is limited to 25 per cent of the amount of qualifying loan relationship profits that would otherwise be taken into account.

B.74 Qualifying loan relationship profits are defined at Section 371QC as broadly those that would be charged to tax under Part 5 CTA 2009 and that are derived from qualifying loans, which are those made to connected foreign companies other than banks or insurance companies or companies that may be exempt under Chapter 3, or subject to an apportionment under Chapters 8 to 12 of Part 9A TIOPA. Expenses are allocated as appropriate to the income, including a reasonable proportion of overhead expenses, and the balance of qualifying income over expense makes up the qualifying profit.

B.75 A CFC may have a mixture of qualifying and non-qualifying profits and profits from other activity such as a trade. In such cases it may be necessary to determine whether the incidental income exclusion applies to the qualifying or non-qualifying profits, and to apportion expenses between the various types of income.

B.76 These issues should be approached as questions of fact, with expenses that are not attributable to any particular activity apportioned on a just and reasonable basis.

Foreign exchange (forex) gains and losses

B.77 Forex is taken into account in the usual way to determine the profits arising in respect of both qualifying and non-qualifying loans. Gains or losses from any instrument that is used to hedge a forex risk arising on a qualifying loan are taken into account in calculating qualifying profits.

B.78 Pairs of loans or other combinations of other financial instruments may be used collectively as a hedge, in which case profits from such arrangements, to the extent that they serve a hedging purpose, are also taken into account in calculating qualifying profits. For example, a pair of back-to-back loans in different currencies may be used in this way.

Ultimate debtor

B.79 To determine whether a loan relationship is a qualifying or non-qualifying loan relationship, it is necessary to look to the ultimate debtor in a case where the purpose of the loan made by the CFC is to fund a loan made by the borrowing company, and so on until there is a purpose for the funds other than on-lending.

B.80 The effect of this rule, which is provided by Section 371QD, may be either to increase or to reduce the amount of qualifying profit. For example:

- A loan made to a UK resident company for the purpose of on-lending to a connected foreign company will be a qualifying loan because the connected foreign company is the ultimate debtor;
- A loan made to a connected foreign company is not a qualifying loan if its purpose is to provide funds for a bank deposit.

Partial exemption for financial traders

B.81 A CFC in an insurance or banking group may claim partial exemption provided it is not a carrying on banking or insurance business itself. Loans for which the ultimate debtor is a bank or insurance company do not qualify for partial exemption.

Anti-avoidance rule

B.82 There is an anti-avoidance rule included in the partial exemption rules, largely to act as a back-up to the ultimate debtor rule, for example in cases where equity investment is one step in an arrangement replacing a loan, but the combined effect of the arrangement is to provide funds for a company where a direct loan to the company would not be a qualifying loan.

Entity level exemptions

B.83 The June consultation document proposed a number of mechanical "territorial business exemptions" or TBEs. The gateway approach has altered the role of the TBEs and made some aspects unnecessary. However, reconfigured elements of the TBEs are included in the current draft legislation where appropriate:

- the profits rate TBE is represented by the low profit margin exemption in Chapter 4;
- the manufacturing and general commercial TBEs are combined in the trading income exclusion in Chapter 8 (the fourth exclusion – as set out above in paragraphs B.43 to B.49);
- the incidental finance income exclusion is included in Chapter 13;

- there are banking and insurance exclusions, but these deal with capitalisation. The conditions to be met for these exclusions will be set out in secondary legislation (regulations) following further work with those sectors;
- there are no specific rules included for leasing; and
- profits of a property business which would fall within Part 4 CTA 2009 are excluded from the CFC regime by Chapter 13.

B.84 The June Consultation document included proposals for three entity level exemptions which are represented in Chapters 3 to 5. Chapter 6 provides for the "tax exemption" which is essentially the lower level of tax test from the current CFC regime presented as a further entity exemption rather than as part of the definition of a CFC.

Low profits exemption

B.85 Chapter 3 provides for a low profits exemption which excludes a CFC from the CFC charge if:

- its accounting profits or its taxable total profits (see paragraph B.88 below) are not more than £500,000; and
- its non-trading profits are not more than £50,000.

B.86 A CFC also qualifies if its total chargeable profits are less than £50,000 (for example, if they are reduced by a trade loss) irrespective of the amount of investment income subject to anti avoidance provisions.

B.87 The general approach taken is similar to that in taken for the low profits exemption introduced as part of the interim improvements to the current CFC regime in FA2011.

B.88 Exempt dividends are excluded from the measure of profit relevant to the low profits exemption, so a holding company may be able to qualify under that exemption if its finance income is less than £50,000.

Accounting profits

B.89 The rules for determining the accounting profits are provided by 371CB to 371CD. Accounting profits are determined by reference to either local GAAP, UK GAAP or IAS. Where no financial statements have been prepared for the CFC the accounting profits are determined by reference to the accounting standards that are normally used to prepare financial statements for that CFC, or as a default using IAS.

B.90 Accounting profits are adjusted to exclude distributions that would be exempt under Part 9A CTA 2009 and capital gains or losses.

B.91 Accounting profits are also adjusted to include a fair and reasonable share of any value that accrues to a trust of which the CFC is a settlor or beneficiary, or to a partnership of which the CFC is a partner.

Assumed taxable total profits

B.92 The rules for the tax rules based measure of profits take the meaning of assumed taxable total profits from Chapter 18.

Anti-avoidance

B.93 Equivalent anti-avoidance rules exist for both the accounting profits and assumed taxable total profits measures for the low profits exemption. In each case there are four circumstances in which the anti-avoidance rule will prevent the low profits exemption from being given where:

- profits are artificially shifted from the CFC to another company;
- profits are shifted into the CFC (in order to "fill up" the low profits capacity);
- the group mismatch scheme has effect in relation to the CFC; or
- the CFC's main business is to provide the services of a UK resident person i.e. intermediary services.

Low profit margin exemption

B.94 Chapter 4 provides for a low profit margin exemption based upon the low profits rate safe harbour in Chapter 5 of the June 2011 consultation document. The exemption applies where the CFC's profit is no more than 10 per cent of relevant operating expenditure.

B.95 A significant change compared to that proposal is that the cost of goods for resale is included in the allowable cost base, provided that the goods are delivered to the CFC's territory of residence. Intra group expenditure (including cost of goods for resale) is however excluded from the cost base.

Excluded territories exemption

B.96 Chapter 5 provides for an extended territories exemption (ETE) which applies where:

- the CFC's territory of residence is included on a list of excluded territories specified in regulations (a draft of those regulations is included as part of the consultation);
- the CFC's income in four categories (A to D) is less than 10 per cent of its accounting profit (or £50,000 p.a. if greater);
- there has not been any transfer of IP to the CFC in the year or the preceding 6 years; and
- an anti-avoidance rule does not apply.

B.97 The list of excluded territories is included at the end of the document.

Category A income

B.98 Category A is defined by Sections 371EE to 371EF and consists of income that is brought into the CFC's accounts:

- that is exempt from tax in the CFC's territory of residence (other than company distributions);
- that is subject to a reduced rate as part of an investment incentive scheme; or
- for which the law of the territory provides for tax to be repaid to any person connected to the CFC or having an interest in the CFC.
- This category also includes any such income that is received by the PE of a CFC if that PE is established in an excluded territory.

Category B income

B.99 Category B is defined by Sections 371EG to 371EI and consists of income in the CFC's accounts that has a non-local source for which the tax paid in the territory of residence is less than 75 per cent of the UK tax that would be payable in respect of the same income.

Category C income

B.100 Category C income is any partnership or trust income that is not included in the company's accounts, but that is included in the definition of accounting profits for the purposes of the ETE because of the extensions to that definition explained in paragraph B.90 above.

Category D income

B.101 Category D includes accounts income:

- which is subject to a reduced rate of tax in the CFC's territory of residence by virtue of a ruling or other similar decision by a governmental authority in the territory; or
- where there is a unilateral reduction to the CFC's taxable profits in its territory of residence on the basis that it would have earned less profit if it had been an independent company.

IP Condition

B.102 The ETE will not apply if either a significant part of its total IP has been transferred to it from the UK in the period or the previous 6 years, or if a the transferred part gives rise to a significant part of its profits. As in the fourth exclusion (paragraphs B.43 to B.49 above), the term "transfer" is restricted to arrangements that lead to a significant loss of value for the transferor.

Anti-avoidance

B.103 The anti-avoidance rule in section 371EB prevents ETE from applying in any case where the CFC is involved in an arrangement that has a UK tax advantage as its main purpose or one of its main purposes.

Tax exemption

B.104 Chapter 6 provides for an exemption called "the tax exemption" which corresponds to the lower level of tax test in the current CFC regime, but because the scope of the new regime will effectively be determined by the gateway, the lower level of tax test is now recast as an exemption.

B.105 The tax exemption applies where the tax paid under the law of the CFC's territory of residence (see paragraph B.116 below) in respect of its profits is at least 75 per cent of the corresponding UK tax.

B.106 The exemption is denied if it would otherwise have been allowed as a result of "designer rate" provisions that effectively allow the CFC to determine its own tax charge.

Framework

B.107 For the most part, the "framework" in which a CFC charge is made is generally comparable to that of the current regime and so is not the main focus of this guide.

Control

B.108 A CFC is defined simply as any foreign company that is under UK control. "Control" is defined in Chapter 1. Control may be exercised by voting shares or other means approved by the company's articles of association. A person also controls a company whenever it has rights that confer entitlement to a majority of the company's income (as far as it is distributed) or capital.

B.109 A company will also be controlled by a person if, in accordance with accounting standards (FRS 2), that person is the company's "parent undertaking", whether or not the parent undertaking is required to prepare consolidated accounts.

B.110 The 40 per cent joint venture rule and the requirement to attribute rights and powers of connected companies and potential rights and powers are maintained from the existing regime.

B.111 An anti-avoidance rule will cause a company to be a CFC if it would have been a CFC but for a scheme or arrangement that had a main purpose of securing the result that it is not a CFC.

B.112 Identifiable and severable parts of a company, referred to as unincorporated cells, can be brought, by way of Regulations, into the CFC regime by 371UC to ensure that captive insurance business undertaken through protected cell companies and other similar entities is subject to the regime.

Assumptions for computing chargeable profits

B.113 Chapter 18 provides the rules for computing a CFC's profits on a basis which assumes that it is a UK resident company. Section 371RB provides that a CFC's "assumed taxable total profits" are the profits that would be its chargeable profits if it were UK resident and its "assumed total profits" are those as computed without reliefs. The CFC's chargeable profits are those which in accordance with the gateway are the subject of the CFC charge and that may be apportioned to UK interest holders.

B.114 To the extent that a CFC's profits are chargeable profits (i.e. the extent to which the gateway applies to its profits), they are computed as if the CFC were UK resident and with an assumption that beneficial reliefs and elections have been claimed. As with current legislation, a majority interest holder may vary the assumption about reliefs and elections and may make a functional currency election for the CFC. Creditable tax is also calculated specifically by reference to the chargeable profits.

B.115 Sections 371RL and s371RM ensure that anti-avoidance rules may be taken into account in computing a CFC's profits in the same way as they would be for a UK resident company. The double taxation relief anti-avoidance rule at section 82 TIOPA applies for this purpose without the need for a counteraction notice.

Losses and gross attributed tax

B.116 There is no provision for loss relief to be set against the gateway profits. This reflects the narrower scope of the regime and the difficulty in establishing a basis for loss relief that is consistent with the scope of the regime. Distribution exemption makes the gross attributed tax legislation redundant and so it has not been included.

Residence

B.117 Chapter 19 contains a comprehensive rule for determining a single territory of residence for a CFC. A company is resident where it is liable to pay tax by reason of domicile, residence or place of management. If there is no such location, the CFC's territory of incorporation determines management. Where there is more than one potential territory of residence, Chapter 19 provides a checklist of factors to determine which takes priority. If no other factors apply, a majority UK interest holder may make an election or HMRC may make a designation of the territory of residence.

Elements of the new regime not included in the draft legislation

B.118 Whilst the draft legislation for the new CFC regime published on 6 December is substantially complete, there are a small number of missing elements. The intention is to publish these elements in January 2012.

B.119 The main omissions are detailed below.

Commencement and transitional provisions

B.120 The June consultation document gave the Government's view that the earliest date from which the new rules could become effective is for accounting periods beginning on or after the date Finance Bill 2012 receives Royal Assent. This remains the preferred option. Consideration is still being given to the case for providing transitional rules in respect of non-finance profits which take account of the status of CFCs under the existing CFC rules.

Interaction with Foreign Branch Exemption

B.121 The draft legislation does not make any changes to the exemption for profits attributable to a foreign PE in Chapter 3A of Part 2 CTA 2009. The intention is that the PE exemption anti-diversion rule should be replaced with one that has the same scope in relation to a foreign PE as the scope of the CFC rules for a foreign subsidiary. One way that this might be achieved is through the following steps:

- If any of the entity level exemptions in Chapters 3 to 6 of the draft legislation apply to the PE, the PE anti-diversion rule will not apply.
- If not, determine whether the UK resident company with the PE has any profits falling within the gateway (Chapters 7 to 13 of the draft legislation). If not, the PE anti-diversion rule will not apply.
- If there are such profits, the anti-diversion rule will apply to the extent (if any) that the profits are included in a relevant profits amount for a foreign PE.

B.122 The opportunity will also be taken to include some necessary amendments to the foreign branch exemption rules introduced in FA 2011.

Temporary Period Exemption

B.123 It remains the Government's intention to offer a time limited exemption as part of the new CFC regime. The impact of the revised overall design for the new regime on the scope of this exemption is currently under consideration, particularly in the absence of a free-standing purpose or motive test.

Financing Companies

B.124 The Government is continuing to consider the case for full exemption for intra-group financing income in limited circumstances. Should such proposals be pursued, draft legislation will be provided.

B.125 Following the extension of the partial exemption for finance profits to the non banking and insurance members of banking and insurance groups, there is a risk that a bank or insurer might reduce the rate of tax on its trade receipts by receiving interest via a CFC that claims partial exemption. To counter this risk it is proposed that a dividend paid by a CFC that claims partial exemption is always treated as a trade receipt when it is paid directly or indirectly to a bank or insurance company.

Banking and Insurance Exclusions

B.126 The draft legislation provides regulation making powers for the capitalisation exclusions for companies carrying on banking and insurance business. Work will continue with business to inform the scope and content of these regulations.

Investment Funds

B.127 Further work is still to be done to ensure that the CFC rules apply in an appropriate manner to funds.

Other issues

B.128 We are giving further consideration to a number of other areas of detail, including whether further specific rules are needed for holding companies and leasing. A number of detailed suggestions were made in representations and these remain under consideration. List of excluded territories

B.129 The list of excluded territories will appear in regulations. The intention is to include all territories with a statutory rate greater than 75 per cent of the UK main rate of Corporation Tax.

Afghanistan
Algeria
Angola
Argentina
Armenia
Aruba
Australia
Austria
Azerbaijan
Bangladesh
Barbados
Belarus
Belgium
Belize
Benin
Bolivia
Botswana
Brazil
Brunei
Burundi
Cameroon
Canada
China
Colombia
Croatia
Cuba
Czech Republic
Democratic Republic of Congo
Denmark
Dominican Republic
Ecuador
Egypt
El Salvador
Estonia
Falkland Islands
Faroe Islands
Fiji Islands
Finland
France
Gabon
Gambia
Germany
Ghana
Greece
Guyana
Honduras
Iceland
India
Indonesia
Iran
Israel
Italy
Ivory Coast
Jamaica
Japan
Kenya
Korea
Lesotho
Libya
Luxembourg
Malawi
Malaysia
Malta
Mexico
Monaco
Morocco
Namibia
Netherlands
New Zealand
Nigeria
Norway
Pakistan
Panama
Papua New Guinea
Peru
Philippines
Poland
Portugal
Puerto Rico
Russia
Saudi Arabia
Senegal
Sierra Leone
Slovakia
Slovenia
Solomon Islands
South Africa
Spain
Sri Lanka
Swaziland
Sweden
Tanzania
Thailand
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Tunisia
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