Controlled Foreign Companies

Supplementary guidance on an additional exclusion from the definition of "qualifying loan relationship" in section 371IH (9A) – (9E) TIOPA 2010.

Guidance on the Finance Act 2014 additions to the CFC Rules at section 371IH(9A) to (9E) of Part 9A TIOPA 2010 was published on 17 April 2014 when the proposed legislation was still subject to Parliamentary scrutiny. The legislation was enacted without amendment and HMRC's policy and view on the application of the law has not changed since the publication of that guidance, which should now be read disregarding the words "draft", "proposed", etc.

However that guidance did not address the impact of the OECD/G20 base erosion profit shifting (BEPS) project, or potential changes in US tax laws, on businesses with existing tower structures. Since publication of the guidance, HMRC has received a significant number of clearance applications from groups that have cited concerns over the future effectiveness of tower structures as a motivation for proposed arrangements involving CFC finance companies. Guidance relevant to groups in this position is set out below.

Where a group looks to unwind a tower structure and put in place a CFC finance company, Section 371IH(9A) to (9E) will need to be considered since the arrangement will involve transferring existing intra-group lending out of the UK. In a Tower structure, a UK company lends out its capital to generate a taxable source of income which is sheltered by a debit arising on a second loan to another UK company. The group may now want the UK company to invest the same capital in the equity of a CFC so the CFC can lend it to the US sub-group in order to preserve a US tax deduction in the US but eliminate the possibility that profits from the loan become taxable in the UK. In this situation subsections 9A to 9E are intended to switch off the finance company exemption for that loan to ensure that the profits from the loan are subject to UK tax.

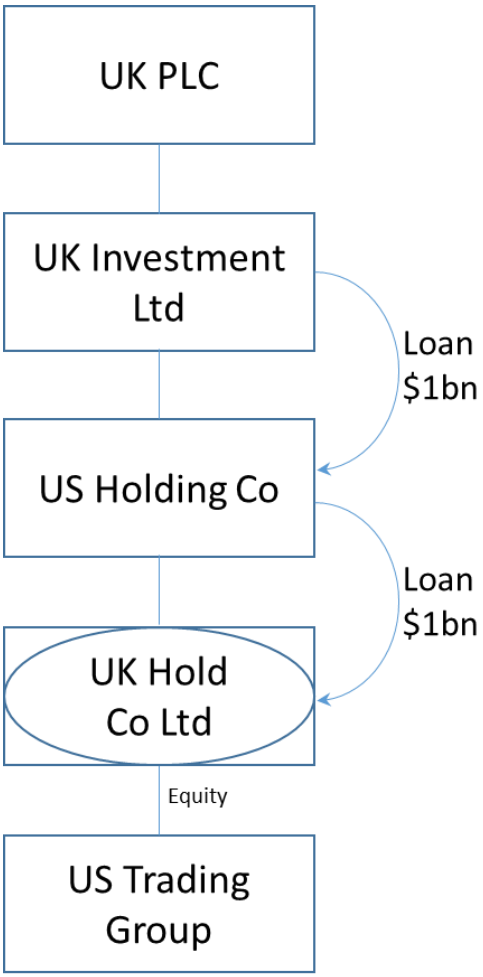
The legislation achieves that effect as follows. In a situation where a group unwinds an existing tower structure with a main purpose of eliminating the risk that future intra-group profits from this lending become taxable in the UK, this main purpose will typically involve, as an essential element, a reduction in UK loan relationship credits. The purpose test in section 371IH(9A)(c)(i) is therefore failed, and section 371IH(9B) will deny partial or full exemption.

Example 1a – Move from a Tower where there are concerns about the future effectiveness of the structure.

This example illustrates the operation of subsections 371IH 9A – 9E when a group's proposed move from a tower structure to a CFC financing structure is motivated by the group's concerns about tower structures becoming ineffective in the future.

A group has a tower structure which is often said to be "flat" for UK corporation tax purposes i.e. the UK tax analysis in the example of a Tower given on page 3 of the guidance applies. The group's tower structure is shown below. The group decides to unwind its tower structure and replace it with a CFC finance company structure.

Current structure

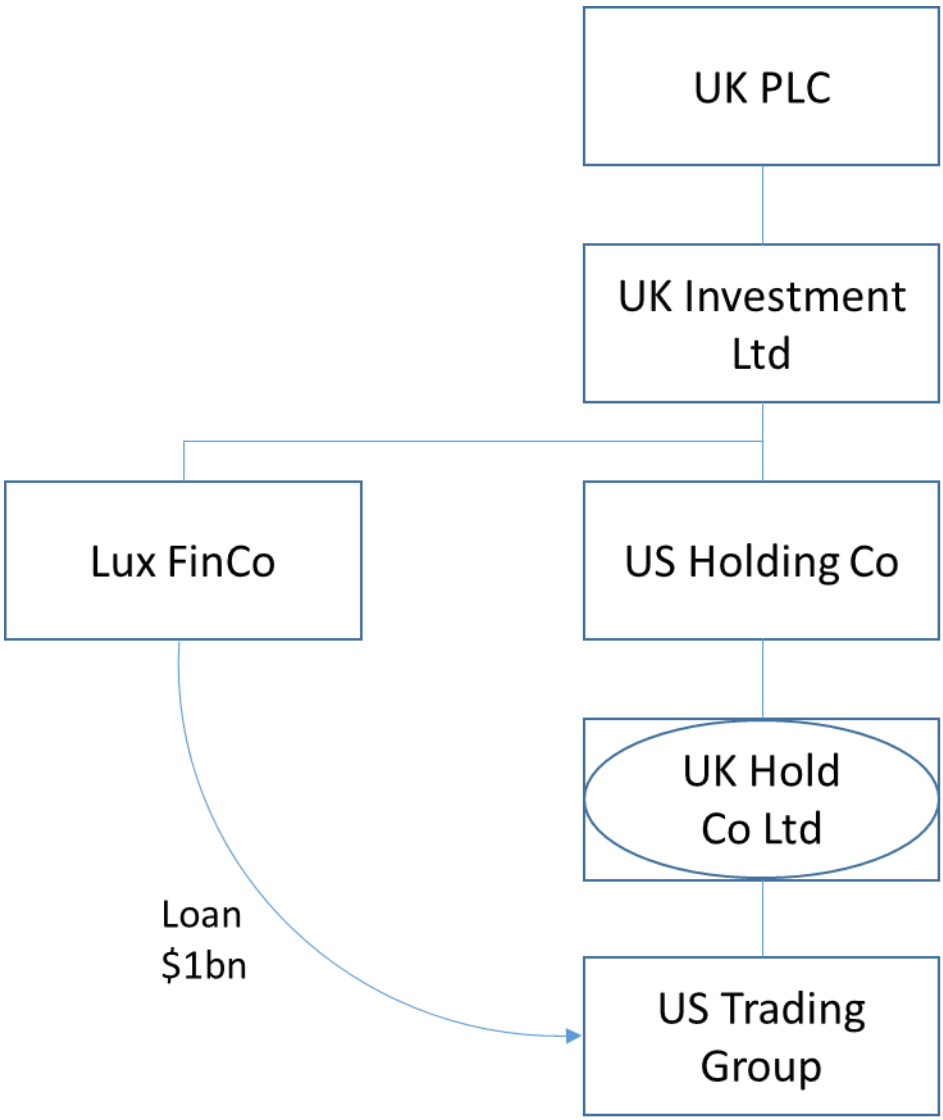


The restructuring is achieved as follows –

- UK Investment Ltd takes out a daylight loan of US$1bn.
- A CFC finance company (Lux FinCo) is incorporated in Luxembourg.
- UK.Investment Ltd capitalises Lux FinCo with $1bn.
- Lux FinCo make a $1bn loan to US Trading Group
- US Trading Group uses the $1bn to fund a dividend to UK Hold Co Ltd.
- UK Hold Co Ltd repays its $1bn loan to US Holding Co.
- US Holding Co repays its $1bn loan to UK Investment Ltd.
- UK Investment Ltd repays its daylight loan of $1bn.

The intended final structure is shown below.

Intended structure



It is established as a matter of fact that one of the main purposes of the proposed restructuring was to address the concern that tower structures, as well as presenting an increasing reputational risk could, in future, become ineffective from a group-level tax perspective due either to changes to tax rules arising from the OECD Base Erosion and Profit Shifting (BEPS) initiative or to possible US tax reforms targeting the use of hybrid entities in debt financing. The specific transactions designed to carry out this purpose by removing the loans giving rise to a hybrid mismatch involve, as an essential element, the elimination of taxable credits which hitherto arose on the loan from UK Investment Ltd to US Holding Co. The reduction in relevant UK credits is therefore an aspect of the main purpose, so the purpose test at subsection 371IH(9A)(c)(i) is failed.

Applying subsection 9A to this example:-

1. There is a UK creditor relationship. This is the loan relationship between UK Investment Ltd and US Holding Co.
2. A relevant arrangement is made. This is all the steps needed to achieve the refinancing using a structure involving lending from Lux FinCo.
3. One of the main purposes of the arrangement was to secure that the relevant credits of a UK connected company (UK Investment Ltd) were lower than they would have been had the UK creditor relationship continued unchanged.

Therefore, the conditions in subsections 9A (a), (b) and (c)(i) are met so subsection 9B applies and Lux FinCo's creditor relationship with US Trading Group is prevented from being a qualifying loan relationship.