Given that the formal controlled foreign companies (CFC) reform process began more than five years ago it has been more marathon than sprint. Perhaps steeplechase is more appropriate given the apparent obstacles that have at times strewn the course.

With the enactment in July of Finance Act 2012, some understandable fatigue is offset by the realisation that, from 1 January 2013, a wholly new set of rules will apply and there will be an impact for all UK companies that have foreign subsidiaries. This article gives an overview of the changes and discusses how companies may seek to respond.

OVERVIEW OF THE CHANGES
The CFC rules charge additional UK tax where UK companies generate profits in low-taxed offshore subsidiaries. Under the current rules there is an additional tax charge in the UK shareholder company based on the CFC’s profits, unless one of a number of statutory exemptions applies.

The new rules are no longer an all-or-nothing regime but instead focus on certain types of profits earned offshore, specifically those that are ‘artificially diverted’ from the UK.

Those responsible for the tax affairs of UK companies with overseas subsidiaries will need to develop an overall understanding of the new rules to make informed decisions about how to respond and to identify the opportunities and risks relating to future transactions. Responses to the new rules could be considered under three key themes: opportunities, risk areas and compliance.

EXPLORE OPPORTUNITIES
Although the new rules remain fundamentally an anti-avoidance measure, they are designed to better reflect modern business structures and there are areas where UK companies will have greater flexibility to structure their international investments.

The most widely publicised change is the introduction of a new partial exemption for intra-group financing income. Where a low-taxed CFC has interest income receivable from another foreign group company, any CFC liability will be based on only a quarter of the related profits, and in some limited circumstances there may be a full exemption. This is a major shift from the current regime which may well impose a CFC charge on the full amount.

The government sees this as a pragmatic acknowledgement that multinationals frequently wish to centralise certain funding operations in a single company which may be outside the UK.

The commercial objectives around treasury management and repatriation of profits, as well as local tax rules in the territories of the borrowing companies, will be paramount but clearly there will be more flexibility from a UK tax perspective to use tax-efficient intra-group funding.

For example, a group may be able to deploy funds to overseas operations through a central treasury company and obtain interest deductions in the local operations while suffering a low tax burden on the interest income.

Another area where there is increased flexibility is captive insurance. Under the new law, there will be greater opportunities to benefit from centralising certain group risks in a single subsidiary. Provided that the significant people activity in relation to the business is not undertaken in the UK, and the subsidiary is not overcapitalised, it should be possible for the profits from insurance of other foreign group companies to fall outside the gateway (see below) and thus not subject to a CFC liability, even if the subsidiary suffers a low rate of local tax.

www.accountancylive.com
Finally, because the new rules focus on whether activity is done in the UK, there is more scope for groups to structure their foreign business operations. Regional financing, leasing, intellectual property, shared service or ‘hub’ companies dealing with non-UK operations that may be difficult under the current CFC rules will become more feasible under the new rules.

**FOCUS ON HIGH RISK AREAS**

Situations which are likely to give rise to a CFC liability will be confined to those where an overseas subsidiary suffers a local tax liability lower than three-quarters of the hypothetical corresponding UK tax liability (as otherwise the High Tax exemption would apply – see below). Sometimes this will be easy to identify – eg, subsidiaries based in tax havens that pay no tax on their profits. But in other cases it may not be a simple task – eg, where local tax consolidation rules mean that a subsidiary’s tax position depends on that of other local companies, or where there are differences in the way that the local territory measures taxable income compared to the UK.

In practice, the main areas of potential CFC liability are likely to be:

- Low-taxed subsidiaries that have substantial finance income, where the funds used to generate the income originated from the UK, or there is significant UK input in managing the funds, or the income is from loans to other UK companies (albeit note the partial exemption for intra-group financing described above); and
- Low-taxed subsidiaries whose business involves significant UK people input, provided under arrangements that would not be found between unconnected parties. An example might be a subsidiary that generates profits from valuable intellectual property, but where all the development and strategic decision making in relation to the intellectual property is done by people in the UK. No doubt there will be more borderline cases, especially where businesses are run on a divisional basis and the UK has an important role in a particular division.

Another consequence of the focus on UK activity is likely to be that HMRC will have a renewed interest in transfer pricing arrangements and the remuneration that UK companies receive for their role in the global supply chain.
REVISIT COMPLIANCE
While the vast majority of overseas subsidiaries will not give rise to any actual CFC liability, there are of course self-assessment obligations to consider.

Under the new law, all foreign subsidiaries of a UK parent company are in principle CFCs. To conclude that such a subsidiary does not give rise to a CFC tax liability, the UK parent company must determine that one of the entity level exemptions applies, or that the subsidiary has no profits that pass through the gateway.

The entity level exemption concept will be familiar to those who deal with the current UK CFC regime. If certain conditions are satisfied then the CFC is entirely exempt from the charge. The exemptions are low profits, low profit margin, high tax, excluded territories and exempt period. It should be noted that two of the main exemptions in the current law are not replicated under the new regime: the exempt activities test and the motive test. Accordingly, those who currently take the view that foreign subsidiaries are exempt from the CFC charge under these provisions will need to carefully revisit the position. The new excluded territories exemption has a ‘white list’ of territories much like the current excluded countries regulations, but the accompanying conditions seem clearer and easier to apply than the current version (and there is a significant relaxation for CFCs resident in Australia, Canada, France, Germany, Japan and the US) so this exemption will be very valuable.

The gateway mechanism is a new feature of the CFC rules and is an attempt to define the types of profits that the UK may wish to tax (ie, those that are artificially diverted from the UK). Very broadly, it includes income of a CFC’s business where the significant people activity that drives the profits is undertaken in the UK, even though the CFC may legally own the

EXEMPTIONS
There are five separate entity-level exemptions. If any of these applies, there is no CFC liability. Even if they do not, the CFC charge will only apply to those profits that pass through the CFC gateway.

The new rules are no longer an all-or-nothing regime but focus on certain types of profits earned offshore, specifically those ‘artificially diverted’ from the UK.

HMRC DRAFT GUIDANCE

Is there a chargeable company?
Are none of the CFC exemptions applicable?
Does the CFC have any chargeable profits?
Calculate the CFC’s creditable tax
Apply the CFC charge to the chargeable companies
related assets and bear the related risks. It also includes certain types of finance income.

UK parent companies will need to refine their current processes so that they can gather the detailed local financial and tax information necessary to support a conclusion that an entity level exemption applies or that no profits pass through the gateway. Which of these is easier in any particular case really depends on the facts: where a CFC has a complex business that does involve some input from the UK, the gateway analysis could become quite difficult and so the entity level exemptions may be the best starting point. On the other hand, for highly autonomous local trading subsidiaries it may be possible to conclude quite easily that no profits pass through the gateway with the result that no CFC liability arises.

**CONCLUSIONS**

In December 2011 the government stated that it wanted 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 new rules certainly target the CFC charge on a narrower set of circumstances and there is greater flexibility to structure operations without risk of a CFC liability, or with a liability at a much reduced level in the case of intra-group financing.

These policy decisions have already led to increased interest in the UK as a holding company location, both for multinational corporate groups and in private equity backed acquisitions. The price paid is probably the complexity; there are a number of new concepts and as these are applied to real scenarios it seems inevitable that there will be some significant uncertainties. HMRC has thus far indicated that it is amenable to early stage discussions with companies to help them avoid unexpected exposures; hopefully, this will go some way to addressing the issue. Overall, the changes are welcome.

**CFC CHARGE**

There is a CFC charge if (and only if):

- The CFC has ‘chargeable profits’;
- None of the entity-level exemptions apply; and
- There is a UK ‘interest holder’ that is not exempt and that (together with connected companies) holds an interest of at least 25%.

The new rules certainly target the CFC charge on a narrower set of circumstances and there is greater flexibility to structure operations without risk of a CFC liability, or with a liability at a much reduced level in the case of intra-group financing.

These policy decisions have already led to increased interest in the UK as a holding company location, both for multinational corporate groups and in private equity backed acquisitions. The price paid is probably the complexity; there are a number of new concepts and as these are applied to real scenarios it seems inevitable that there will be some significant uncertainties. HMRC has thus far indicated that it is amenable to early stage discussions with companies to help them avoid unexpected exposures; hopefully, this will go some way to addressing the issue. Overall, the changes are welcome.

**CONCLUSIONS**

In December 2011 the government stated that it wanted 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 new rules certainly target the CFC charge on a narrower set of circumstances and there is greater flexibility to structure operations without risk of a CFC liability, or with a liability at a much reduced level in the case of intra-group financing.

These policy decisions have already led to increased interest in the UK as a holding company location, both for multinational corporate groups and in private equity backed acquisitions. The price paid is probably the complexity; there are a number of new concepts and as these are applied to real scenarios it seems inevitable that there will be some significant uncertainties. HMRC has thus far indicated that it is amenable to early stage discussions with companies to help them avoid unexpected exposures; hopefully, this will go some way to addressing the issue. Overall, the changes are welcome.

**Ed Wright**

ACA, CTA

Director in international tax, Deloitte LLP.

edwright@deloitte.co.uk.

www.deloitte.co.uk