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UK government publishes additional draft CFC legislation

On January 31, the UK government published an update and draft legislation as part of UK controlled foreign corporation ("CFC") reform. The documents provide additional proposals for the finance company exemption, the temporary period exemption, the application of the CFC rules to exempt foreign branches, and the commencement provisions. These proposals are in addition to the draft legislation published on December 6, 2011.

The proposed CFC rules are still within a consultation period which will end on February 10, 2012.

Finance company exemption

The draft legislation published in December 2011 included a partial exemption for CFCs that finance non-UK group companies. When this exemption applies 75% of the CFC's finance income is exempt from CFC apportionment. This may result in an effective UK tax rate of 5.75% (by 2014) for overseas finance structures.

In addition, the draft legislation published on January 31, 2012, exempts 100% of the finance income in two specific circumstances:

1) When loans made from the overseas finance company are funded from 'qualifying resources'. 'Qualifying resources' include lender profits from lending to group companies in the territory of the ultimate borrower, and cash received from a rights' issue; and,

2) When the overseas finance income inclusion would cause the group's UK financing income to exceed its finance expense ('matched interest'). The matched interest provision limits the apportionment of overseas finance companies' profits, in line with the aggregate UK net borrowing costs.

Temporary period exemption

The current CFC rules include an exemption for overseas companies that become controlled by UK persons for the first time. The current exemption applies for two years after the end of the accounting period in which the overseas company becomes a CFC.

The UK government proposes a similar exemption in the new CFC rules. The new exemption would apply for 12 months from the date on which the company falls within the CFC rules, but will only apply if the CFC undertakes restructuring to become CFC compliant during that 12 month period. The proposed rules provide for an extension of the 12 month period if the CFC is unable to restructure and become compliant for reasons beyond its control.

A transitional provision will apply to CFCs that satisfy the current temporary period exemption before the commencement date of the new CFC rules (expected to be January 1, 2013). The transitional provision allows those companies to rely on the current exemption.

Application to exempt foreign branches

UK companies can elect to exempt their overseas trading branch profits from UK corporation tax. These provisions are currently subject to an anti-diversion rule that, in broad terms, restricts the exemption's availability when the overseas branch was formed to reduce UK tax. The proposal would repeal the anti-diversion rule and replace it with rules similar to the new CFC rules.

The branch exemption will still not apply to pure overseas finance branches. Therefore, the above finance company exemption will not apply to foreign branches of UK companies.

Commencement and next steps

The new CFC rules are currently due to apply to accounting periods that commence on or after January 1, 2013. The accounting period in this context will be the CFC's accounting period rather than the group's accounting period. Thus, groups with fiscal year ends could fall within the rules earlier or later by changing the accounting period of their overseas companies.

All groups with CFCs under the UK should evaluate the impact of these rules and, where possible, participate in the consultation, which ends on February 10, 2012.

While the temporary period exemption reduction to 12 months is disappointing, the additional CFC changes may provide an effective exemption from UK tax unless profits have been artificially diverted from the United Kingdom. For investors, these changes, when combined with other features of the UK tax regime, make the United Kingdom an attractive location for business.

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