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# *European Tax Newsalert*

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## *UK Draft Finance Bill 2012 includes CFC Reform*

On December 6, 2011, the UK government published draft legislation which proposes to fully reform the UK's controlled foreign companies ("CFC") regime. The proposals will transform the UK tax landscape. Both UK multinational companies and inward investors should welcome this package.

A period of consultation has begun and will close on February 10, 2012. Various details are still under consideration, so further improvements may occur before the final changes are enacted. Please consider the proposals now so that you can participate in this consultation and prepare for the changes ahead.

### *Overall assessment*

These proposals contain positive new elements and deal with some of the shortcomings of previous proposals. Most significantly, an entirely new concept, a gateway test, would remove many companies from the CFC regime entirely. The proposals also introduce safe harbors, which offer taxpayers a more straightforward exemption where the gateway test does not apply.

The government also reaffirmed its intent to introduce a new low rate finance company exemption (FCPE), and will continue consulting on potential further improvements.



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In addition, the proposals update the remaining exemptions and clarify their role within the CFC regime.

The proposal brings good news for banks and insurance groups, as they can now benefit from the FCPE. They will also receive updated exemptions on sector-specific issues. This should boost the competitiveness of the UK's financial sector.

## *Definition of a CFC and control*

The tests to determine if a foreign company is a CFC under the new regime are based on control and residence. The existing definition of control in the CFC rules has broadly been imported into the new rules, including the 40% test. Companies will also be regarded as controlled under an accounting-based test and anti-avoidance rules will apply where the main purpose of entering into an arrangement has been to circumvent the control test.

## *Finance company rules*

The draft legislation exempts 75% of a company's finance profits (including any foreign exchange differences) resulting in a 5.75% effective tax rate by 2014. A corresponding amount of double tax relief will be available. A company does not have to be a pure finance company to benefit from this exemption, nor does it need to have local management.

To qualify, the UK company must submit a claim to HM Revenue & Customs ("HMRC"), rather than simply self assessing a reduced apportionment.

The government is considering full exemption for intra-group financing income and is also considering an apportionment cap based on the UK group's net borrowing costs. Furthermore, the proposal extends the exemption to banking and insurance groups; additional details will follow.

### **Initial reactions**

This new exemption benefits UK-based businesses by mitigating the tax impact on their overseas lending for the first time.

## *Gateway test*

The most significant new proposal is the optional gateway test. Profits meeting the gateway test requirements will be exempt from tax. CFCs whose activities do not create a risk of artificially diverting profits from the UK may use the test. This fundamental shift in the CFC rules reinforces the move to a more territorial regime.

The gateway test defines the scope of profits within the CFC regime such that foreign profits not covered are exempt. The government believes this will allow many groups to self assess whether their foreign activities are outside the scope of the new CFC rules, thereby reducing their compliance burden.

Finance profits are dealt with separately under the finance company rules.

Under the gateway test, only profits failing all three of the following conditions represent amounts that have been artificially diverted from the United Kingdom and thus fall within the CFC regime's scope.

- **The artificiality condition:** a majority of the profits from the CFC's assets or risks are connected with UK activities by reference to significant people functions ("SPFs").
- **The non tax value condition:** the separation of assets or risks from activity noted above does not give rise to substantial value over and above the tax saving.
- **The independent companies' arrangements condition:** unconnected persons would not have entered into the arrangement creating the separation.

### **Initial reaction**

The introduction of a gateway test is welcomed and significantly improves on previous proposals. We anticipate that this gateway test will attract many businesses since it potentially reduces the CFC compliance burden.

However, the draft gateway test legislation is complex. A key component is an understanding of relevant SPFs. This concept will be new for many and there is little practical guidance currently. Businesses should therefore evaluate the benefits as they learn these new rules.

## *The gateway safe harbors*

In addition to the broader gateway test, a number of mechanical safe harbors exclude certain profit categories from the CFC rules.

### **Commercial activities safe harbor**

This exclusion only applies to trading income and not to broader commercial profits and contains a number of detailed requirements. These requirements include the need for a business establishment in the foreign territory; a restriction when intellectual property ("IP") of significant value has been transferred from the United Kingdom within the previous six years; and various limits on the level of UK connection and management. There is also a targeted anti-avoidance rule ("TAAR").

### **Incidental finance income safe harbor**

The proposal exempts incidental finance income up to the greater of 5% of business profits (before interest and tax) and a foreign company's interest income earned on funds retained for business purposes.

### **Insurance and banking**

Insurance and banking activities will also be dealt with via a safe harbor exclusion. The full details are subject to further consultation.

### **Initial reaction**

The safe harbor rules offer businesses greater flexibility in evaluating whether foreign profits are subject to the CFC regime.

## *Entity level exemptions*

Where neither the gateway test nor safe harbor rules apply, or where businesses prefer not to use them, profits may instead be exempt via an entity level exemption.

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### **The low tax exemption**

The 'not subject to a lower level of tax' test will now form one of the entity level exemptions. The proposal bases this exemption on the 'less than 75%' test as in the current regime.

### **The low profits exemption ("LPE")**

The government has adopted a simple approach to the LPE. The current threshold of £200K provided in Finance Act 2011's interim changes has been increased to £500K. This threshold is based on an accounting profits measure and will include a £50K limit on investment income and an anti-abuse measure, similar to that in the interim de minimis exemption.

### **The excluded territories exemption ("ETE")**

The ETE is similar to the existing excluded countries regulations ("ECR"). The government has opted for a list of excluded territories with anti-avoidance provisions applying alongside an income based requirement.

### **The low profits margin exemption ("LPME")**

This exempts foreign companies which earn low profit margins compared to their cost base. The proposed 10% mark up applies to a cost base that includes the cost of goods sold for resale, provided the goods are actually delivered into the territory of residence. However, related party business expenditure is excluded from the relevant cost base.

### **Initial reaction**

These mechanical exemptions are narrower in scope than the current rules. This is not surprising given the new gateway and safe harbor proposals. However, the omission of a motive test alongside mechanical exemptions may concern some businesses.

## ***Other developments***

In direct response to comments made during consultation the proposals would generally be available to leasing businesses. Property income will be outside the new CFC regime's scope as will captive insurance companies in certain circumstances.

## ***Areas of additional consideration:***

The government is considering the following points; any draft legislation on these matters will be published in January 2012:

- Commencement and transitional provisions - the proposal would apply the new rules to accounting periods beginning on or after Royal Assent to Finance Bill 2012. The government is considering whether to include transitional rules between the current regime and the new one.
- Interaction with foreign branch exemption - the government intends to include exempt foreign branches within the scope of the new CFC rules, effectively replacing the existing foreign branch exemption anti-diversion rule.
- Temporary period exemption - the government intends to include a time-limited exemption similar to that introduced in Finance Act 2011.

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- Application of the new rules to investment funds.

## *Next steps and engagement*

All groups with CFCs under the UK should evaluate the impact of these rules and participate in the ongoing consultation. The government is listening to business so changes are possible.

If you are a UK based multinational, consider reviewing your tax strategy. The FCPE is also a great catalyst for reviewing and potentially improving your financing strategy. For inward 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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