Exodus averted

CHANGES TO THE TAX RULES FOR CONTROLLED FOREIGN COMPANIES ARE LIKELY TO TAKE PLACE AS EARLY AS APRIL. **ANDREW ROYCROFT** EXPLAINS WHAT TREASURERS SHOULD EXPECT.

The last few years have seen a major departure in the UK's approach to taxing foreign profits earned by UK companies. In part, the changes have been prompted by European Court of Justice (ECJ) decisions casting doubt on the compatibility of the UK's rules with EU law. However, the pressure for reform developed increasing momentum as the perception grew that the UK's tax regime is falling behind other "more competitive" tax regimes. A number of high-profile redomiciliations to Ireland, the Netherlands and Switzerland seemed to illustrate the concern about the UK's ability to retain its major multinationals.

Significant steps have therefore been taken to improve the UK tax regime. An exemption for foreign dividends was introduced in 2009, and later during the course of this year an exemption for foreign branch profits should be introduced.

Not surprisingly, HM Treasury and HM Revenue and Customs (HMRC) have insisted that these exemptions be accompanied by measures to prevent significant loss of tax revenue. The concern is that the new exemptions could allow businesses to use techniques (such as upstream loans, and borrowing in the UK to equity-fund non-UK subsidiaries) to reduce corporation tax on their UK-sourced profits. Part of the protection against this risk of behavioural change took the form of the debt-cap rules, which place further restrictions on the amount of funding costs that qualify for tax relief.

Another reform concerns the UK's controlled foreign company (CFC) rules. Having rejected the option of imposing yet more restrictions on tax relief for funding costs, the government has refocused the CFC rules on countering artificial diversion of profits from the UK. Defining what constitutes an artificial diversion has proved difficult, which explains why these reforms were deferred to give HM Treasury and HMRC time for further consultation with the large corporates that are most affected.

That consultation has resulted in a set of interim reforms to the CFC rules, which will likely take effect from 1 April 2011. Full reform is promised for 2012.

THE CFC RULES AND THE NEED FOR REFORM The CFC rules require UK companies to pay corporation tax on the retained profits of certain overseas companies which they control. The profits of all controlled companies located in low-tax jurisdictions are caught unless one of a number of exemptions applies, such as CFCs with profits under £500,000, certain specified activities, and whether the CFC was set up for non-tax reasons (the motive test). These exemptions are not always easy to apply; for example, the exempt activities test is intended to exclude certain genuine trading operations from the scope of the CFC rules, but over the years it has become increasingly complex (largely in response to perceived abuses).

As a low-tax jurisdiction is defined as one which charges corporation tax at less than 75% of that payable in the UK, the worldwide trend towards lower rates of corporation tax has seen more jurisdictions fall below this threshold. This potentially brings subsidiaries located in those jurisdictions within the scope of the CFC rules. And even if the CFC rules do not apply, it can still be time-consuming (and costly) to be satisfied that this is the case; some groups expressly cited the complexity of the CFC rules as a reason for their recent redomiciles.

The CFC rules pose particular difficulties for finance companies and treasury companies. It is not unusual for such companies to be located in jurisdictions such as Ireland, where corporate taxes are significantly lower than 75% of that charged in the UK. Although there may be genuine non-tax reasons for this choice of location – e.g. the presence of suitably qualified staff, attractive labour laws and lower operating costs – this is arguably not sufficient to bring such companies within the exempt activities test.

In response to the ECJ decision in the Cadbury Schweppes CFC case, legislation was introduced which permits a UK company to claim a reduction in the amount of its CFC's profits that are taxed under the CFC rules. Although this can result in all of a CFC's profits being excluded from the CFC charge, there are limits to how useful this facility is. A claim can be made only for CFCs in the EEA*, and the UK parent must demonstrate that the CFC creates "net economic value" for the group. Furthermore, that net economic value must be created by individuals working for the CFC in the EEA territory in which the CFC has its business establishment. Considerable doubt also remains as to whether the new legislation has made the UK CFC regime compliant with the EU rules.

THE INTERIM REFORMS The initial reforms to the CFC rules will likely take effect from April 2011, and have three main elements.

First, the £50,000 "de minimis" profits exemption will be increased to £200,000, but only for large groups. Although this increase is welcome, it is questionable whether it will take many group finance functions outside the scope of the CFC rules; groups that are large enough to benefit from establishing a finance company may find that their profits will exceed even this threshold.

Two new exemptions will also be introduced, one for certain "trading" CFCs and the other for CFCs which exploit intellectual property outside the UK. However, neither exemption will be available for a CFC whose finance income exceeds 5% of its gross income. Accordingly, these exemptions will not be available for group finance companies, unless the proposals are changed before the March Budget.

Furthermore, as the investment of funds for other group companies is considered to be an investment activity, these exemptions provide no comfort for group treasury companies that are currently CFCs. The lack of an exemption for finance or treasury companies is not surprising because monetary assets are one of the two most difficult areas for CFC reform (the other being intangible assets).

Finally, a statutory period of grace will be introduced. This will prevent a UK company from incurring a CFC charge for a recently acquired CFC. This extends an existing practice which benefits groups that have completed a merger or acquisition. It will provide a period of up to three years in which to restructure before any low-tax non-UK companies that are acquired are taxed as CFCs.

However, there are limits to this exemption. Even a three-year period may not be long enough to reorganise a problematic CFC, and certain changes (e.g. increased loans by the CFC to the UK) will terminate the period of grace. As the period of grace applies only to non-UK companies not previously under UK control, it will not apply to acquisitions of companies that are currently CFCs. Although the period of grace potentially applies to groups that are themselves redomiciling, or transferring subgroups, to the UK, this is not a trend that has been apparent in recent years.

WHAT NEXT? The full CFC reform will offer exemptions for both non-UK finance and treasury companies, although only limited detail about the extent of the reform is available as consultation is ongoing. Helpfully, there is an acknowledgement that they can be conducted offshore legitimately without necessarily leading to a CFC charge.

Accordingly, there will be an exemption from the CFC rules for "appropriately funded" finance companies – i.e. those which are not overcapitalised. A debt to equity ratio of at least 1:2 is the proposed test. Where a finance company is more heavily capitalised (i.e. its equity is more than twice its debt), its UK parent will incur only a proportionate CFC charge and a fraction of the CFC's finance income will be taxed; the precise charge will depend on how far below the 1:2 debt-equity ratio the CFC's ratio falls. For a finance company that is entirely capitalised by equity, this will produce an effective rate of UK corporation tax of 8-9% of its finance income, as one third of its finance income will be taxed at the standard rate of corporation tax.

This should enable UK-headquartered groups to manage their finance function with less concern about the CFC rules. However, the proposed exemption will be accompanied by a targeted anti-avoidance rule, which can only add to complexity and costs.

Although the use of a debt-equity ratio should simplify the CFC rules, there will inevitably be anomalies. For example, because the new regime will operate by bringing a fraction of the finance income into charge to UK tax (e.g. one third of the income of a fully equity-capitalised finance company) and taxing it at standard UK rates, the UK tax payable might not be fully covered by foreign tax credits even if foreign tax has been paid on the income at a rate in excess of the 9% maximum effective UK rate.

In theory, the position of treasury companies should be even simpler. The government wants to exempt such activities from the CFC rules entirely, on the basis that they should make only a small turn on the funds that they manage. However, it may be difficult to define such a treasury company; in particular, how will the rules address CFCs that combine treasury with finance and other functions?

Many gaps remain to be filled in; for example, how the new CFC regime will deal with banks, insurance companies and the property sector. Businesses and advisers alike await the detail with interest.

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** The European Economic Area (EEA) consists of the member states of the European Union plus Iceland, Liechtenstein and Norway.*

Moving out

One treasurer of a company that had moved overseas for tax purposes told The Treasurer: "HMRC's latest proposals are constructive and go a long way to addressing the issues faced by overseas finance companies of UK-parented groups. If the proposals implemented are not overly complex, they will significantly reduce the benefits of redomiciling and may persuade companies from taking this step. However, companies which have already redomiciled would continue to pay less tax as compared to UK-parented groups, which, coupled with significant transaction costs associated with returning to the UK, make it unlikely that any would return in the near future."

Corporates that have made the tax switch are careful about what they say. But over the years a significant number have voted with their feet and not many look likely to return. For instance, in 2008 event and publishing company UBM reorganised its corporate structure to create a new holding company which is UK-listed but incorporated in Jersey and with tax residency in Ireland. At the time UBM said the move would mean no change to the operating businesses; although the board has to meet outside the UK, that was happening anyway.

Advertising and marketing giant WPP likewise moved its tax base to Ireland in 2008 amid a row over tighter anti-avoidance rules for foreign profits. Chief executive Sir Martin Sorrell said the uncertainty surrounding the issue was the main factor in driving his company and others abroad. Before last year's general election WPP announced it would consider moving back to Britain if a new government reformed the taxation of overseas profits. However, the point of dispute for WPP is the taxation of overseas profit rather than the absolute rate of corporation tax and key for the company is certainty over the medium to long term, which makes a move back to the UK look unlikely at the moment.

In 2009 Lloyd's of London insurer Brit Insurance became the latest British company to leave the UK and establish its tax domicile overseas, shifting its British headquarters to the Netherlands. Dane Douetil, chief executive, said the move was prompted by lack of clarity over HM Treasury's proposed reforms of the way it taxes foreign profits. When asked by The Treasurer whether the company had any plans to relocate back to the UK, it declined to comment; such a move is seen as highly unlikely.

Pharmaceutical company Shire incorporated in Jersey and became tax-resident in Ireland in 2008. It said at the time that the introduction of a new holding company with Irish tax residency was designed to protect Shire's tax position. It declined to comment further on the issue.

Additional reporting by Peter Williams.