United Kingdom

U.K. Treasury Unveils Proposals to Shake Up Controlled Foreign Company, Patent Regimes

LONDON—Draft clauses published Dec. 6 by the United Kingdom treasury for inclusion in the Finance Bill 2012 confirm that the government will press ahead with a major rewrite of controlled foreign company rules.

Changes to the rules will take effect from April 1, 2012.

Also included in the Finance Bill 2012 is a new patent box regime, which takes effect from April 1, 2013.

Leading tax advisers who spoke to BNA Dec. 7 about the changes to the CFC rules, while broadly welcoming them, also warned that the new rules are complex and will require close scrutiny—in draft form and also once implemented.

Other corporate tax measures included in the bill are:

- confirmation that the government will reduce the main rate of corporation tax to 24 percent with effect from 2013,
- new provisions for a low-tax offshore finance company,
- amendments to the capital allowances rules, and
- a major re-write of the tax legislation governing life insurance companies.

Commenting on the changes to the CFC rules Dec. 7, Sandy Bhogal, a leading commentator on U.K. corporate tax reform, said, ''The draft legislation and response to consultation show certain changes to the original approach taken by the Government on CFCs.

''The use of a gateway test is a welcome move in principle but it will be important that any such gateway is not overly complex, otherwise the desire for greater simplicity in the new rules (and thereby reduced compliance cost) will not materialise.''

Bhogal, a London-based tax partner with attorneys Mayer Brown International LLP, warned of the possibility of further changes to the proposals before they pass into law.

Much Debate Likely Before Passage. ''It is also interesting to note that the government has not ruled out a full exemption on passive finance income in certain circumstances,'' he said. ''Together with the continuing uncertainty as to whether the proposed rules are fully EU law compliant, this means that there will likely be considerable debate and amendment before the legislation is finalised.''

On the issue of complexity, Chris Morgan, the U.K. head of tax policy with advisers KPMG, told BNA, ''Sixty pages of legislation seek to cover every way in which a taxpayer could conceivably misuse the rules to divert profits from the UK.

''The reader is often instructed to follow a number of steps to determine if a certain type of income is caught or not. The steps incorporate definitions which refer to other definitions and sometimes are modified by a final anti-avoidance provision.''

'Gateway' Conditions for New CFC Regime. Under the new proposals, the government is planning to exempt the business profits of a foreign subsidiary from the scope of the new CFC regime unless they meet the conditions set out in a ''gateway.''

These conditions set out to define profits that have been artificially diverted from the U.K. In addition, the new rules establish ''safe harbors'' that will potentially place some or all of a foreign subsidiary's profits outside the scope of the regime.

Commenting on the gateway, Adam Blakemore, a corporate tax attorney with Cadwalader Wickersham & Taft LLP in London, told BNA that he was struck by its complexity.

''The ideal form of the U.K. CFC rules would be to have a single 'gateway' to exempt most trading operations and treasury companies from tax liabilities under the CFC rules, supplemented by other safe harbours and entity-level exemptions.

''Greater scrutiny would therefore only be required where a company failed to pass through the gateway exemption.

''A number of signals in November 2011 were strongly suggestive that both the treasury and HMRC were receptive to the presence of such a gateway in the draft legislation for the rewritten CFC rules to be introduced in the 2012 Finance Bill.''

But, he said, having scrutinized the proposals in detail, it is hard to avoid the conclusion that the gateway exemption ''is probably both over-complex and over-engineered.''

Blakemore added, ''Even allowing for a different—and longer—style of drafting tax legislation than within the currently existing CFC rules, the rewritten provisions appear to be less easy to navigate through than the existing ones.

More Complex Than Rules for Other EU Countries. ''Comparisons between the proposed U.K. CFC regime and comparable—but simpler and more limited—CFC regimes in competitor EU jurisdictions, such as The Netherlands, look to be pronounced.''

In conclusion, warned Blakemore, ''If the draft legislation was to be enacted in its current form, U.K. based groups and foreign corporate inward investors would need to approach the detail of the rules with great care, particularly in the early years following enactment while HMRC guidance becomes amplified through practical experience.''

Exemptions to CFC Regime Set Out. In addition, as an alternative to the gateway approach, the new regime will also provide certain exemptions for CFCs.

These exemptions, as currently set out, will apply to the CFC as a whole and include both an excluded-territory exemption and a low-profits exemption. The government has proposed that the existing lower-level-of-tax test will function as an exemption in the new regime

The existing CFC regime imposes a tax charge on the profits of certain foreign subsidiaries in which U.K.-based companies have an interest. A CFC is an overseas company, controlled by U.K. residents, that pays less than three-quarters of the tax that it would have paid on its income had it been resident in the U.K.

Accordingly, the purpose of the CFC rules is to snare companies that artificially reduce their U.K. tax bill by diverting profits to more favorable overseas jurisdictions.

Globalization Necessitating CFC Changes. Today's CFC regime was brought in by a Conservative government headed by Margaret Thatcher in 1984. In the ensuing three decades, however, globalization has seen companies increasingly operate across national borders.

At the same time, the ownership of U.K. businesses has become more internationally diverse. Both factors have left the CFC regime struggling to keep pace.

In a June 2011 consultation document (128 DTR I-3, 7/5/11), the government signaled it wanted to bring in a "modernized CFC regime in 2012 that better reflects the way that businesses operate in a globalised economy."

In recent years, controversy over corporate taxation has led to certain high-profile companies, among them pharmaceutical concern Shire plc, to depart the U.K. for what commentators have argued might be more business-friendly jurisdictions (2 DTR I-1, 1/6/09); 76 DTR I-2, 4/21/08).

In an impact assessment on the new measures, the government acknowledged that the CFC regime "is frequently identified by U.K. multinational businesses as a key priority in improving the U.K.'s tax competitiveness."

The measures unveiled Dec. 6 build on early changes to the treatment of foreign branches and dividend income. In 2009, the U.K. government moved to exempt dividend income from foreign subsidiaries from corporation tax.

More recently, legislation in the Finance Act 2011 brought the treatment of foreign branches in line with the treatment of foreign subsidiaries.

Among other measures of interest to corporate taxpayers announced Dec. 6 are:

- provisions for a low-taxed offshore finance company,
- potentially onerous changes to the capital allowances rules, and
- a major re-write of the tax legislation affecting life insurance companies.

Interested parties have until Feb. 10, 2012, to comment on the proposals.

By Stephen Bouvier

Text of the measures is at http://www.hm-treasury.gov.uk/finance_bill_2012_consultation.htm.

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