



HM TREASURY



HM Revenue  
& Customs

# Proposals for controlled foreign companies (CFC) reform:

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discussion document

**January** 2010





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# Basic information

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<b>Subject of this consultation:</b>	This document sets out proposals for reforming the UK tax treatment of controlled foreign companies (CFCs) in a way that enhances the competitiveness of the UK whilst providing adequate protection of the UK tax base.
<b>Scope of this consultation:</b>	This discussion document sets out principles and proposals for modernising the CFC rules.
<b>Impact Assessment:</b>	An impact assessment has not been prepared for policy options at this stage. Responses received to the questions set out in this discussion document will assist the Government in preparing an impact assessment for the next stage of consultation.
<b>Who should read this:</b>	The Government would like to hear the views of business, as well as the views of representative bodies and tax advisers, on the options outlined in this discussion document, in order to develop more detailed proposals.
<b>Duration:</b>	The consultation period for this discussion document runs from 26 January 2010 to 20 April 2010.
<b>Responses and enquiries:</b>	Responses and enquiries should be sent to:  Jennifer Payne or Hannah Mitchell Room 2/E1 HM Treasury 1 Horse Guards Road London, SW1A 2HQ  Alternatively, please email: <a href="mailto:Jennifer.Payne@hmtreasury.gsi.gov.uk">Jennifer.Payne@hmtreasury.gsi.gov.uk</a> or <a href="mailto:Hannah.Mitchell@hmtreasury.gsi.gov.uk">Hannah.Mitchell@hmtreasury.gsi.gov.uk</a> Telephone enquiries (switchboard): 020 7270 5000
<b>Additional ways to become involved:</b>	The Government intends to hold a stakeholder event towards the end of February 2010 to outline and clarify policy proposals. Further details on this event will be released shortly.
<b>After the consultation:</b>	The responses the Government receives to this document will assist in the development of more detailed proposals. The Government aims to release a further document on the proposals along with draft legislation later in 2010, with a view to legislating in Finance Bill 2011.
<b>Getting to this stage:</b>	Since the publication of a document setting out the policy principles underpinning the CFC review and analysis of stakeholder responses to a questionnaire on the CFC regime, the Government has been listening to the views of business through productive dialogue with representative bodies, individual businesses, working groups and advisors. The aim of these initial discussions has been to identify concerns with the current rules and options for reform. These published documents are available on the HMT website at <a href="http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm">http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm</a> .



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# 1

## Introduction

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### Background

**1.1** The Government is committed to making the UK an increasingly attractive place in which to invest and do business. Over recent years the Government has announced a number of reforms to modernise the corporation tax system. The taxation of foreign profits has been identified as a priority area for reform.

**1.2** Foreign profits reform has been separated into two parts. The first part was introduced in Finance Act 2009 and included a wide-ranging exemption for foreign dividends repatriated to the UK. Dividend exemption represents a significant change to the taxation of foreign profits for corporate groups and has been welcomed by business. To support the exemption, a limited interest restriction measure (the worldwide debt cap) was also introduced.

**1.3** Given the complexity and importance of the Controlled Foreign Company (CFC) rules, the Government recognised that it would take more time to ensure that any new rules meet the needs of both Government and business. The review of these rules was therefore separated from the 2009 package to form the second part of the reform.

### Document aim

**1.4** Following extensive consultation with business, this document sets out proposals for a new CFC regime. It concentrates on the overall shape of the rules and specifically addresses how the two most difficult areas of money and intellectual property might be addressed.

**1.5** This document is for discussion with business and other interested parties. The Government welcomes views on these proposals and encourages continued stakeholder engagement.

**1.6** The Government aims to publish more detailed proposals and draft legislation for consultation later in 2010, and to legislate in Finance Bill 2011.

### History

**1.7** The Financial Secretary reiterated the Government's commitment to reform the CFC rules at the 2008 Pre Budget Report by publishing an open letter on the future direction of travel for the taxation of foreign profits. The Government committed to move towards a more territorial approach to the taxation of UK groups - firstly by introducing an exemption for foreign dividends and secondly by committing to modernise the CFC rules.

**1.8** The Government published a *Policy Principles Document* in July 2009 that outlined the policy drivers, objectives and principles to support the CFC reform. A copy of this document is included as Annex A. To achieve the policy objectives identified, the proposals in this document have in some areas, adopted a pragmatic approach to applying the underlying policy principles.

### **Box 1.A: Key points from *Policy Principles Document***

- There is a continuing need for CFC rules to protect the UK tax base from erosion through the artificial diversion of profits from the UK which is not countered through other measures.
- The new rules will be targeted on artificial diversion of UK profit and not on taxing profits that are genuinely earned in overseas subsidiaries.
- An essential part of adapting a more territorial approach to the new rules will be moving from the current default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location.
- UK ownership and control are the most suitable basis for bringing artificially diverted profits within the scope of the UK tax base. This recognises the benefit gained from the rights and protections that residence in a state offers, such as the broader legal framework, and offers the most appropriate mechanism for applying the rules.
- Reform should aim to modernise the CFC rules in a way to reflect modern business practice with an aim of enhancing UK competitiveness, while providing adequate protection of the UK tax base.
- The new regime should, as far as possible, minimise compliance costs and seek to provide taxpayers with certainty. To achieve this a balance will need to be struck between the overarching principles and operational simplicity.
- The new regime is not intended to increase the scope of the current CFC rules and any new regime must be compliant with EU law

**1.9** Consultation to date has demonstrated that it is difficult to articulate an all purpose definition of artificial diversion that is capable of practical application to cover all situations that the Government has been asked to consider. The alternative approach taken in this document has been to identify specific arrangements and transactions that the Government considers may provide opportunities for artificial diversion.

## **Consultation process**

**1.10** The Government is committed to facilitating an open and transparent approach throughout the reform of the CFC rules. To date the Government has placed a high priority on consultation with business to ensure that the reform takes account of views from a cross-section of stakeholders and to build a strong evidence base upon which to develop these proposals.

### **Process to date**

**1.11** Consultation with stakeholders during 2009 has been informative and constructive. As well as forming working groups and issuing an open questionnaire, officials have met with a wide range of interested parties including individual businesses, advisors, academics and representative bodies.

**1.12** To facilitate the wider consultation and to provide initial constructive challenge to policy proposals, the Government established a Liaison Committee in Spring 2009. The Committee is formed of six industry representatives. To date five formal meetings have been held, as well as informal discussions, providing officials with helpful insights. Further details and records of the meetings can be found on the HMT webpage\*.

**1.13** The Government published the *Reform of Controlled Foreign Companies: Stakeholder Engagement Strategy* in Summer 2009. This document set out the way in which officials would engage with business to gain representative views from them.

## Questionnaire

**1.14** A key component of this strategy was the publication of the *CFC Reform Questionnaire*. This enabled a wide range of stakeholders to provide input into policy development at a relatively early stage, helping to identify the key issues that needed to be addressed. The questionnaire gave respondents the opportunity to:

- provide views on the existing regime;
- contribute to the conceptual framework of a new regime; and
- comment on possible approaches for a new regime.

**1.15** Seventy questionnaires were completed by a cross-section of industries and representatives and the results were presented during a stakeholder event in November 2009. Slides from this event can be found on the HMT webpage.<sup>1</sup> The Government has drawn on this evidence in formulating the proposals and options in this document. Key findings included preferences to:

- target the new regime at 'artificial arrangements' intended to avoid UK tax; and
- use an entity or hybrid approach as opposed to an income basis as the overarching framework for the regime.

## Working groups

**1.16** A further important component of the stakeholder engagement strategy was the establishment of working groups. These facilitated detailed discussion on the issues and potential solutions for monetary assets, treasury functions and intellectual property. They were held in September 2009 and a record of these meetings can be found on the HMT webpage. The outcomes from these discussions have informed policy development.

## Consultation on this document

**1.17** The Government is keen to engage with a wide range of stakeholders on this document. A stakeholder event will be held in late February to clarify the proposals and to hear views on the document. For further details on how to respond to this document please refer to section 5, should you want to discuss the proposals set out in this document further please contact Hannah Mitchell or Jennifer Payne.

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<sup>1</sup> [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm)



# 2

## Overarching framework

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### Proposed mechanism

**2.1** To meet the policy objectives identified in the *Policy Principles Document* the Government proposes that the new rules will operate on an entity basis. To minimise the compliance burden it is proposed that a number of objective tests will be designed to exclude subsidiaries from the regime where there is a low risk of artificial diversion of UK profits. This methodology should be familiar to business, will reduce transitional costs and will provide the necessary flexibility for a modernised, more focused controlled foreign company (CFC) regime.

**2.2** The Government recognises that in some cases rules based on the profits and activity of an entity as a whole could create a liability to UK tax for income streams that do not represent artificial diversion and are not the target of the rules. In cases where this would give a disproportionate result, the Government aims to tax only the profits within those subsidiaries that represent an artificial diversion of UK profit.

### Alternative bases

**2.3** The Government considered a number of alternative bases to identify which would provide the best option to meet the policy objectives and to most effectively target those profits that represent a significant risk to the UK tax base. Summarised below are key findings and reasons for why these approaches were rejected.

#### Income stream approach

**2.4** Many other countries' CFC rules work on the basis of taxing specific foreign income streams. Under this approach, certain income streams are identified as included or excluded from the rules. This basis allows fiscal authorities to target closely those income streams of concern and, in principle, offers a more targeted approach than an entity basis. However, given the implied complexity and compliance burden for business, the Government does not favour this approach. Many businesses noted that they would need to make costly changes to their current accounting systems to provide the necessary information to comply with streaming rules.

#### Single purpose test approach

**2.5** A second alternative is to consider the purpose of every foreign company and transaction so as to determine whether there has been an artificial diversion of UK profits. All activities and income streams would be included, irrespective of the type of industry or activity undertaken. Given the degree of subjectivity involved in this approach, Government and working groups consider that it would create unmanageable uncertainty, result in protracted negotiations with HMRC and could give rise to inconsistencies in tax treatment.

#### Exemption v inclusion

**2.6** The approach taken in this document is to propose that the new regime is drafted on an exemption basis, so that CFCs meeting specified criteria are exempted from the regime. Compared to an inclusive basis (i.e. a regime specifying only the type of companies that should

be included) this approach appears to provide the most certainty and be less complicated for both HMRC and business to apply. Once detailed criteria have been developed to determine the activities and income that should be within the scope of the regime, the Government may reconsider this position.

## Scope of regime

**2.7** The proposals apply to foreign controlled companies, most typically those with a single UK parent. The Government recognises the importance of appropriately targeted rules for determining control.

**2.8** It is proposed that capital gains will continue to be excluded from the scope of the regime, subject to existing anti-avoidance provisions.

**2.9** The risk of artificial diversion and erosion of the UK tax base is low where subsidiaries operate in tax jurisdictions comparable to the UK. Businesses have made it clear that the lower level of tax test is seen as overly complex and time consuming to apply. The Government is therefore considering whether a new test could be designed that would exclude companies from the rules that operate in jurisdictions with (a) similar statutory rates and (b) similar tax bases to the UK. In order for this test to be effective, it would need to be easy to comply with. The Government is exploring whether a short list of factors could be compiled that would act as proxies for an UK type tax base. Adopting this approach could be used instead of a lower level of tax test and could also remove the requirement for a white list.

Question 2A: The Government welcomes views from business on how such an approach would work and whether it would be preferable to having a lower level of tax test and white list.

**2.10** The Government recognises that the majority of CFCs do not exist for the artificial diversion of profit from the UK but to undertake genuine trading activities. As far as possible, the aim is to design objective tests to exempt these activities from the new regime.

**2.11** Trading activities may include transactions with other group members. Under the current regime there are significant restrictions on intra-group transactions. To the extent that such intra-group transactions do not pose a risk to the UK tax base, it is proposed that the profits arising would be exempt from a CFC charge under the new regime. These transactions can present opportunities for tax avoidance, therefore designing rules in this area will require careful consideration and benefit from full discussion with business.

Question 2B: The Government would like to discuss with business the level and type of intra group transactions undertaken to ensure that the new regime targets the artificial diversion of UK profits with minimum impact on commercial transactions.

**2.12** Chapters 3 and 4 set out proposals for improving the trading company exemption by extending the definition of trading activities to include genuine offshore group treasury operations and the active management of intellectual property. The Government also proposes in Para 3.16 to 3.20, that non-trading income generated by a trading company that is incidental or ancillary to the trade would have the same tax treatment as the trading profits (so that typically a trading entity would be wholly exempt). Although the present regime defines trading activities more narrowly than is now being proposed, it is currently possible for a company to artificially locate unrelated non-trading profits (typically intra-group interest income) alongside

trading profits in order to shelter that income from a CFC charge. It is envisaged that this practice would no longer be possible.

**2.13** The Government recognises that the current regime may bring certain activities within the scope of the rules in circumstances where these activities do not constitute artificial diversion of profits from the UK. For example:

- *Reinsurance subsidiaries.* An insurance group may hold an overseas reinsurance subsidiary that is managing non-UK risks in circumstances where there is no erosion of the UK tax base assuming that the company is holding an appropriate level of capital.
- *Property subsidiaries.* Where a group holds an overseas property subsidiary that is managing non-UK properties, assuming that the company is appropriately funded (see section 3.6) there is unlikely to be erosion of the UK tax base.

Question 2C: The Government is considering whether it would be possible to specifically exempt these and similar activities from the new regime, and would like to discuss this with stakeholders to see how such exemptions might be defined.

**2.14** The current CFC rules include a de-minimis test whereby companies with profits beneath £50,000 are exempt from the CFC regime. The Government continues to see the need for a similar test to reduce the number of companies that need to comply with the rules and to simplify the CFC system by focusing on subsidiaries that pose a significant risk of artificial diversion of UK profits. The existing limit was introduced in 1998 and needs updating. The Government proposes to increase the de-minimis limit in the new regime and a range of options proposed by questionnaire respondents are being considered to determine the most appropriate approach.

### **Motive test**

**2.15** Although the proposals set out in this document use a similar mechanism to the current regime, they represent a significant change with targeted exemptions that are intended to improve competitiveness and more closely reflect modern business practice. It is unlikely, however, to be possible to design specific exemptions that will accommodate every genuinely commercial subsidiary or situation where no artificial diversion of UK profit is involved. The Government therefore proposes two further tests for circumstances where other exemptions are not available.

**2.16** Where exemption requirements are narrowly missed or where one-off commercial transactions result in a test being failed, it is proposed to explore how flexibility could be included in the rules to exempt or partially exempt those subsidiaries.

**2.17** The Government also proposes that a reformed regime will include a new motive test for situations where other exemptions are not available. The policy principles document set out the Government's intention to move away from the default assumption that all activities that could have been undertaken in the UK would have been undertaken here, were it not for the tax advantage afforded to them in the overseas territory. This objective should be met through a re-designed motive test that would cover situations where a subsidiary that is properly established overseas is not engaged in activities intended to artificially divert UK profit. The test would provide an opportunity for such an overseas subsidiary to demonstrate the non-tax related commercial rationale for any specified transaction and/or its role or purpose as a member of the group as a whole.

## Practical application

**2.18** The proposed rules aim to provide as much certainty as possible to business, recognising that group companies have to self-assess their CFC position. Given that all businesses operate differently, there is a balance to be struck between certainty and flexibility in framing the rules. To help reduce uncertainty in situations where CFC exposure may arise, the Government will continue to welcome responses from business, including views about the role of discussions with Customer Relationship Managers and HMRC's clearance procedures.

**2.19** In general, the commercial acquisition from a third party of a new sub-group which has had no previous connection, through ownership or material transactions, with the UK may not present a significant risk of artificial diversion. Recognising this, application of the new rules could be suspended for a period of time. This approach would build on and potentially extend the current "period of grace" motive clearance arrangements. The case for specific anti-avoidance rules would need to be considered, as would the nature and extent of any clearance procedure.

Question 2D: The Government would welcome views from business on whether this approach should be included in statute rather than guidance, and what would be an appropriate time period.

# 3

## Monetary assets

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**3.1** This section outlines possible approaches to the treatment of monetary assets. The overall aim of reform is to allow groups to manage their monetary assets in a way that best supports overall competitiveness while providing appropriate protection of the UK tax base.

**3.2** Monetary assets are instruments that give rise to interest like returns and include cash, cash equivalents, debt and debt equivalents. Discussions with business to date have focused on trading groups outside the financial services sector. The Government accepts that banking and insurance groups will probably need their own specific rules, given the different role played by monetary assets in financial concerns. The Government will engage with the financial sector separately to ensure that the proposals recognise this difference.

### Issues and solutions

**3.3** Discussions with business highlighted that a distinction can be made between traditional treasury operations and finance companies. The former involve day-to-day management of groups' monetary assets, where profits consist of a small interest turn on the funds managed on behalf of the group and are essentially fully debt funded. The latter can encompass all other financial transactions including long-term structural debt advanced to group companies. In some cases groups separate these functions into different companies but in others these two functions exist together in a combined finance and treasury company.

**3.4** The management of monetary assets requires a certain level of expertise; it will include significant decision makers acting under delegated authority who are likely to make substantial decisions. Examples of activities undertaken in the management of monetary assets could be: managing regional cash balances; initiating and refinancing inter-group loans; managing foreign exchange exposure and setting and enforcing terms and conditions of loan agreements.

### Treasury operations

**3.5** Profits of group treasury companies generally arise from the interest rate differential on short term amounts borrowed and lent on to other group companies (and related foreign exchange movements), and from the provision of treasury services including cash pooling. These activities are unlikely to pose a risk to the UK tax base and the Government proposes that the new regime could provide an exemption for such companies.

Question 3A: The Government invites comments on the necessary scope of a potential exemption for treasury operation companies and views on the level of substance required.

### Finance companies

**3.6** The Government recognises that in many groups, finance companies are an integral part of their structure and would like to minimise the impact of a new controlled foreign company (CFC) regime on business decisions about the location and operation of financing companies by more closely targeting the rules.

**3.7** A risk of artificial diversion of UK profits exists where finance companies are funded through UK capital on which the UK does not earn a return. The clearest example is where the finance company is funded through equity and either (i) that equity is paid for out of UK borrowings by the parent company (the corresponding interest costs being claimed as a UK tax deduction) or (ii) the group's accumulated UK funds (including excess cash – see below) are used to pay for the equity in the finance company so they are unavailable for use elsewhere.

**3.8** It might be argued that the position is different where all the cash exchanged for the finance company's equity is newly raised from shareholders with this express intention, for example through a rights issue.

**3.9** One possible approach that would protect the UK's tax base and recognise this distinction would be to use tracing rules to determine how the UK has funded the finance company, distinguishing between the source, or perhaps the tax treatment, of the amounts invested. The Government is not keen to pursue this option given the inherent complexity of tracing rules and the significant difficulties groups would face in complying with them.

**3.10** A second option would be to review the mix of debt and equity advanced to the financing company and to exempt financing companies that are funded on an appropriate basis (in terms of the mix of debt and equity). The UK would also need to ensure that this proposal did not encourage artificial diversion of profit from the UK (see paragraph 3.13). Inappropriate funding arrangements would trigger the imputation of a taxable return to the UK by reference to the excess equity funding. This would be a simpler and more pragmatic approach than tracing.

Question 3B: The Government welcomes views on this approach, especially whether this strikes the right balance between operational simplicity and the ability for a group to manage its monetary assets in a way that supports overall competitiveness.

### Level of equity funding

**3.11** If the proposal to review the mix of debt and equity is adopted, it would still be necessary to decide how to determine whether a financing company is funded on an appropriate basis. One approach would be to compare the debt:equity ratio of a financing company with a specified ratio. Any equity in excess of that level would be deemed to be debt for the purpose of the test. The deemed debt would be treated as interest bearing, applying a suitable interest rate. The deemed interest would be taxable as part of the UK parent's profits. There are a number of options available to set an appropriate ratio for a test of this sort. It could, for example, be based upon the external debt:equity ratio of the group, or specified safe harbour rates which would seek to take account of all relevant factors.

**3.12** The Government recognises that the value at which the debt:equity ratio is set will be seen as an important factor in determining the role of a financing company exemption in a more competitive CFC regime. Discussions with business on the proposed exemption will allow this aspect, together with the other design issues, to be explored further.

**3.13** The risk of artificial diversion of profit from the UK is arguably greatest where an exempt finance company lends money to a UK group member. The finance company proposal will only be feasible so long as the UK tax base can be protected. Although this will be partly safeguarded by the debt cap it is likely that further protection will be required. This suggests that a financing company exemption would require either that the company make no loans to the UK or that any interest received by the finance company from the UK would not be eligible for exemption. Options to prevent such activity include focusing the exemption on interest received from exempted trading CFCs, or a targeted anti-avoidance rule.

**3.14** The Government recognises that in some situations it may not be possible to comply with a safe harbour test, for example where local legal requirements specify minimum equity funding of those companies. Provision would be made for such cases, with one option being a motive test.

Question 3C: The Government would welcome views on these proposals, options for setting a suitable safe harbour ratio, along with appropriate comparables and views on the level of substance required.

### Combined Finance and Treasury Companies

**3.15** The Government considers that companies that combine finance and treasury activities should benefit from the same exemptions as those carrying on either of the functions separately. However, given treasury operations are wholly or mainly debt funded and the highest risk of artificial diversion arises where those companies are equity funded, it is proposed that, for simplicity, the treatment of combined finance and treasury companies follows that of finance companies, so that their profits are exempted as long as the company is appropriately funded.

Question 3D: The Government welcomes views on the relative merits of the proposed options, including comments on any practical issues for combined treasury and finance companies

### Excess cash

**3.16** The finance and treasury company proposals set out above should enable a UK group to make commercial decisions as to where to manage monetary assets without being unnecessarily constrained by the CFC legislation. In order to produce a balanced package and to provide adequate protection of the UK tax base, the receipt of income from holding of un-commercial levels of cash within trading companies needs to be considered.

**3.17** The Government understands from discussions with business that cash is often viewed as belonging to the group as a whole rather than to separate subsidiaries. The point was also made that typically a group may centrally direct how that cash should best be used on a global or regional basis.

**3.18** While a group's primary aim will be to maximise its investment return, there are opportunities for cash to be located in low tax jurisdictions to avoid UK tax which represents a significant risk to the UK tax base.

**3.19** The Government recognises that the level of cash held in overseas trading subsidiaries will vary significantly dependent on business requirements. This approach proposes that an incidental or ancillary amount of interest can be earned within those trading companies without giving rise to a CFC exposure. In determining a level that is incidental or ancillary the activities of that trading company along with any local legal requirements will be considered.

**3.20** As set out in chapter 2, although the new regime proposes to operate on an entity basis, companies should not be unduly penalised if they fail the above test. It is therefore proposed that only interest income earned that is not incidental or ancillary to the company's trading activities should be treated as artificially diverted profits and so would be taxable in the UK and it is only that income that would be subject to a CFC charge under this proposal.

Question 3E: The Government would like to discuss with business whether making provision for incidental or ancillary non-trading income would offer a suitable balance of flexibility and protection, and to discuss whether numerical measures should be considered.

# 4

## Intellectual property

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**4.1** This section outlines possible approaches to reform the treatment of intellectual property with the aim of more effectively targeting situations where there is a risk of erosion of the UK tax base.

**4.2** Intellectual property (IP) encompasses certain intangible assets and associated rights and particularly includes:

- industrial, commercial or scientific information, knowledge or expertise;
- patents, trade marks, brands, copyrights, invention or design rights; and
- licences or other rights in respect of intellectual property.

### Issues and solutions

**4.3** These proposals refocus the rules on a more territorial approach by taxing those situations that represent an artificial diversion of profits from the UK.

**4.4** The current controlled foreign company (CFC) rules generally target income from IP on the grounds that it is passive income from a mobile asset. There is therefore a risk that UK tax can be avoided through the artificial movement of IP into a low tax jurisdiction. Business has emphasised that many offshore IP companies undertake genuine and effective management activity with the aim of maintaining or increasing the value of their IP, and that a new CFC regime should reflect the extent to which active management of IP takes place offshore. Exactly how IP should be held and managed is dependent on the needs of the business and the type of product to which the IP relates.

**4.5** The Government recognises that IP management can be a trading rather than an investment activity. One proposal for a new regime would be to identify companies that carry on sufficient IP management activity offshore and to exempt these companies from the CFC rules.

**4.6** CFC rules on IP interact with a number of other areas of corporation tax. As the design of the new CFC regime develops, one objective will be to ensure that any interaction with the UK's transfer pricing legislation is absolutely clear. The general approach also needs to be considered in the context of the 2009 Pre Budget Report announcement that the Government will introduce a Patent Box (a reduced rate of corporation tax applying to income from patents) from April 2013. The interaction between CFC reform and the Patent Box will be explored in further consultation with business.

### Transfer of IP from the UK

**4.7** There is a risk to the UK tax base where IP is developed in the UK and later transferred offshore. Activity conducted in the UK to develop the IP should be rewarded appropriately. Business recognises that there are issues with the current exit tax and transfer pricing rules, but argues that this risk should be addressed through these rules rather than by seeking a CFC charge.

**4.8** The Government remains concerned about the Exchequer impact and practical difficulties of relying on this approach. It will therefore continue to consider the extent to which exit taxes and transfer pricing can be used to deal with this issue.

**4.9** There is a specific concern over circumstances in which IP is transferred outside the UK at a point in its life cycle before its value can be accurately determined. These situations represent a risk to the UK tax base as the value recognised on exit may significantly undervalue the IP. Transfer pricing adjustments can be made to correct any under-reporting of income in the UK that results from transactions of this kind but this is a complex process that can take significant amounts of time and resource to resolve. One approach to the problem could be to apply an additional tax charge in limited circumstances for a finite period where the price at the date of transfer is difficult to calculate and the value of the IP has significantly increased following the transfer from the UK. This could bring these intra-group situations more in line with commercial 'earn out' arrangements that take place between third parties. The interaction between this approach and the transfer pricing legislation would need to be made absolutely clear.

Question 4A: The Government would like to discuss with business (a) how this approach could be applied to find a workable and commercially equivalent solution, and (b) how to limit such a charge to those situations that are of specific concern.

## **IP held outside the UK**

**4.10** One way in which the rules could be refocused would be to look at the extent to which an offshore company that owns IP undertakes active IP management similar to a trading activity.

**4.11** Where there is no or minimal UK involvement and the offshore company undertakes sufficient IP management activity, the company would be exempt. This approach could include a characteristics based test, identifying activities required for the IP to be actively managed offshore.

**4.12** When IP is held offshore and the associated activities and decisions relating to that asset in whole or in part are performed in the UK, it seems probable that active management of the IP would be conducted in the UK. A CFC charge would apply on the grounds that this represents an artificial diversion of profits from the UK. A partial exemption might be available for situations where some elements of the active management are conducted in the UK and others outside the UK.

**4.13** There may be some situations where the IP cannot be actively managed and conducted offshore. For example, a geographically sensitive brand with its integral value in the UK. In these cases a CFC charge could arise.

## **Active management of IP**

**4.14** This approach to IP would require a substance test that could apply primarily on the basis of expertise, rather than personnel numbers (although this would remain a relevant consideration).

**4.15** Box 4A offers a list of factors for discussion that might be considered when determining whether the IP is being actively managed. A selection of these characteristics might be relevant dependent on the type of IP. Recognising the way in which the organisation of IP rich businesses has changed significantly since the current CFC regime was introduced, it should not be necessary for all of these activities to be undertaken in the same territory as that in which the IP company was located. It is also recognised that the company should be able to contract-out some of the activities to a mix of third party and group members. While the general approach of

these proposals is entity based, it is understood that the management of IP in large groups is often undertaken on a regional basis, rather than strictly allocated to one specific entity. The approach to what constitutes active management of IP would need to take this into account.

#### **Box 4.A: Active management of IP: Characteristics to consider**

- Development of IP through R&D or other activities by scientists, engineers, brand managers, marketing directors or other specialist employees –
- Obtaining legal protection for IP in each relevant jurisdiction
- Evaluation and analysis of IP for potential acquisition
- Forecasting analysis of value of IP and future plans to develop
- Negotiating and entering into IP licensing agreements
- Setting, directing and monitoring brand advertising and marketing strategy
- Taking risks for failure/infringement.
- Protecting intellectual property rights from infringement by third parties
- Expenses relating to development of IP incurred offshore (not in UK).
- Quality control where IP licensed

**4.16** One option to determine whether the company had the necessary expertise would be to assess whether the IP company is capable of controlling and managing all aspects of its business - including controlling and managing any elements of its business which it did not carry out itself. One way of testing this would be to consider whether all parts of the business that it did not carry on itself could be successfully contracted out to third parties. There is a difference between activities contracted out intra-group and those contracted out to third parties - primarily in relation to the level of control, knowledge and expertise required. If an IP entity did not have sufficient expertise to pass such a test, this could suggest that some of its profits were reliant on group support, rather than generated by the IP entity itself.

**4.17** The Government recognises that commercially it may be necessary to perform some activities in the local market, for example local marketing. Such activity should not determine whether the IP is being actively managed offshore.

**Question 4B: The Government would like to discuss with business whether:**

- (a) using active management of IP conducted offshore is a workable approach, and if so,
- (b) how best to measure and define the activities described, and
- (c) which of these characteristics above are the right ones to consider.

#### **IP that is not actively managed**

**4.18** Where there is insufficient active management, the profits could be considered to arise from the holding of IP as an investment. In line with a more territorial approach to taxing foreign subsidiaries, the UK would consider a more pragmatic approach to its taxing rights in these situations. This could be achieved by imposing a tax charge only where there has been artificial erosion of the UK tax base, for example, where there is equity funding of that IP investment financed by the UK.

**4.19** Where a company which is holding IP has no UK connection, either through management activity or funding, there is a case for exempting it from the new CFC regime. In considering management activity for this purpose, it would be reasonable to ignore minor or incidental transactions with the UK.

**4.20** IP held as an investment is broadly comparable to an interest bearing loan. Both investments yield a return, as royalties or interest respectively, and the acquisition of either investment must be financed by the group. Where the financing has a substantial equity component, the debt: equity approach for financing companies outlined in paragraphs 3.6 - 3.10 could be considered. This would exempt the underlying profits of the company and impute an interest like return to the UK parent if the company has not been appropriately funded. Such an approach would reflect the fact that the IP owning entity was primarily performing an investment rather than a trading function. A further consideration would be the extent to which the royalty receipts within the IP company are received from the UK.

Question 4C: The Government welcomes views from business on the proposals for IP investment companies and whether focusing on the funding of these companies is a way of dealing with IP offshore.

Question 4D: The Government also welcomes views on whether this approach could be used where it is difficult to distinguish between the profits derived from holding IP and those derived from managing it (removing the need to draw a distinction between the passive holding of IP and the active management of IP).

# 5

## Next steps

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**5.1** The Government welcomes views on this document, in particular:

- The overall approach of the proposed regime including whether the right balance is struck between protection of the UK tax base and competitiveness;
- The exemptions, in particular the proposals for dealing with monetary assets and intellectual property;
- The impact of these proposals on compliance costs;
- The detailed questions raised throughout the document.

The Government would also appreciate views on the impact and cost to business of the proposed rules including, the impact of the application of the rules for larger and small businesses.

### How to respond

**5.2** The Government welcomes comments on the proposals in this discussion paper. Any comments or technical queries should be addressed to Hannah Mitchell or Jennifer Payne:

CFC reform

Corporate tax team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Email: [Jennifer.Payne@hmtreasury.gsi.gov.uk](mailto:Jennifer.Payne@hmtreasury.gsi.gov.uk) or  
[Hannah.Mitchell@hmtreasury.gsi.gov.uk](mailto:Hannah.Mitchell@hmtreasury.gsi.gov.uk)

Telephone (treasury switchboard): 020 7270 5000

**5.3** Comments should be received by 20 April 2010.

### Confidentiality

**5.4** Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

**5.5** If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account

of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury (HMT) and HM Revenue and Customs (HMRC).

**5.6** HMT and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

# A

# Policy principles document

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## A. Aim

- 1 The aim of this document is to outline the current thinking on policy drivers, objectives and principles that will support the reform of the CFC rules. This will be used to facilitate discussion over the coming months.
- 2 Alongside this document, HM Treasury have also released a questionnaire (accessed at [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm)) and would encourage businesses, representative groups and advisors, to complete this. The questions focus firstly on the workings of the current CFC rules and secondly on options and considerations for a new regime. Sharing views at an early stage should help to identify the key issues that need to be addressed.

## B. Background

- 3 PBR 2008 announced significant changes to the taxation of foreign profits, including the introduction of an exemption from UK tax for foreign dividends repatriated to the UK. At the same time a commitment was made to consult on the modernisation of the CFC regime.
- 4 Since the introduction of the CFC rules in 1984 the business landscape has significantly changed and large groups, both in the UK and worldwide, have become more focused on globally integrated functions and overseas expansion. Alongside this they now often manage their business regionally and globally. Any new rules need to take account of these changes.
- 5 The Financial Secretary's open letter to business representative bodies dated 24 November 2008 ('open letter'), stated that a reformed CFC regime would reflect a more territorial approach to taxing foreign subsidiaries. An essential part of this approach will be moving away from a default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location.
- 6 The drivers and principles below set certain key parameters within which this consultation should take place. Whilst broader discussion is encouraged, focus needs to be on the scope and mechanics of a new regime in order to deliver a package of reform in the expected timeframe set out in the stakeholder engagement document.

## C. Policy drivers

- 7 There is a continuing need for rules to protect the UK tax base from erosion through the artificial diversion of profits not countered through other measures. However, we recognise that this protection must be balanced with the need to sustain UK competitiveness in a globalised economy. Therefore, the primary driving factors for reviewing the CFC rules are:

- Recognising and adapting to changes in the way that modern business operates globally.
- Making the rules consistent with the recent changes to the taxation of foreign profits.
- Targeting the rules as effectively as possible.

## **D. Policy objectives**

### **Competitiveness**

- 8 The UK is recognised as providing a competitive environment for ownership of multinational business and for location of business operations, where tax is one aspect of a much broader picture. The Government is committed to improving the competitiveness of the UK as a jurisdiction for businesses to locate and invest, as demonstrated by the introduction of a wide-ranging dividend exemption.
- 9 Reform must modernise the CFC rules in a way that enhances UK competitiveness, while providing adequate protection of the UK tax base. The CFC regime needs to avoid undue interference in groups' abilities to make decisions that best support their overall competitiveness in relation to the location and management of their business operations.

### **Protection**

- 10 Introducing dividend exemption represents an important move towards a more territorial system of taxing foreign subsidiaries. Nevertheless, dividend exemption itself increases the risk to the UK tax base, as it enables any diverted profits to be repatriated to the UK more easily without incurring a UK tax charge. Any CFC rules must take account of this additional risk.

### **Commerciality**

- 11 Business has raised concerns that the current rules are not always aligned with the reality of modern business. As a result commercial transactions can be hindered, delayed or unnecessarily complicated. To the extent that transactions do not represent an artificial diversion of UK profits, the reformed CFC rules should not obstruct them.

### **Simplicity and certainty**

- 12 Since the CFC rules were introduced in 1984, there have been many changes to the tax and regulatory architecture, including the introduction of self-assessment. Over the years a number of amendments have been made to the CFC rules to ensure that they continue to target avoidance activity. Business has expressed concern about the complexity and scope of the CFC rules as they currently stand and whether they target avoidance effectively.
- 13 The new regime should, as far as possible, be easy to comply with and seek to provide taxpayers with certainty. To achieve this it is likely that a balance will need to be struck between the overarching principles and operational simplicity.

### **Scope**

- 14 As set out in the open letter the new regime is not intended to increase the scope of the rules. Final decisions on the implementation of any revised CFC rules will

need to be taken in the normal way as part of the Budget process, which takes into account the economic position and wider Government finances.

## EU compliance

- 15 Any new regime must be compliant with EU law.

## E. Policy principles

- 16 The current CFC regime is based upon a worldwide basis of taxation. The open letter announced that a reformed CFC regime would reflect a **more territorial approach** to taxing foreign subsidiaries and should target the artificial diversion of profits from the UK.
- 17 This does not mean that the UK is proposing to move to a pure territorial system. Such a system would involve an exemption for foreign source income, alongside symmetrical restrictions on all expenses attributable to the earning of that income. This would make the UK tax system more complex, and would not meet the policy objectives for the reform.
- 18 There is a continuing need for protection of the UK tax base from erosion, but the protection required cannot be provided through reliance on **transfer pricing rules** as tax avoidance is not their primary focus. These rules are concerned with the arm's length nature of transactions and allocation of profits.
- 19 Transfer pricing rules work where the issue is determining the price. But where the terms and conditions are fundamentally not those that would have arisen at arm's length, and the issue goes beyond pricing, complexities can arise in applying transfer pricing rules to prevent diversion of profits from the UK.
- 20 So, for example, the creation of a fully capitalised money box on arm's length terms cannot be challenged by transfer pricing rules even though it may result in the artificial diversion of profits from the UK. Building on this, the money box company could lend money, again on arm's length terms, to a UK subsidiary which would then use that money to acquire a new subsidiary from a third party. The resulting UK interest deduction would not be balanced by a UK interest receipt. These examples illustrate that the transfer pricing rules alone are not always sufficient to protect the UK tax base from the diversion of profits.
- 21 Similarly reliance on exit taxes does not necessarily offer the protection required because of, for example, the potential for long term or indefinite deferral.
- 22 Without additional protection rules there would be excessive pressure on the transfer pricing and exit tax rules, resulting in increased uncertainty and administrative burdens for both business and Government. In turn this could result in significantly longer and more difficult tax negotiations.
- 23 It has been suggested that adequate protection might instead be provided by an **anti diversion rule** that would apply equally to UK and foreign-headed groups. This would apply in principle to all UK profits where there was a risk of diversion.
- 24 In designing an anti-diversion rule it would be necessary to consider disallowing deductions in respect of payments made directly or indirectly to non-UK subsidiaries, or taxing some or all of the income received by non-UK subsidiaries. This would typically require complex tracing rules that would apply equally to non-UK and UK headed groups. As well as complexity and uncertainty, this would add an additional area of compliance that would impact adversely on the UK's relative

attractiveness as a location for investment. Difficulties would also arise in respect of the UK's treaty obligations.

- 25 Although there are countries with anti-diversion rules, it is difficult to see these as a model for the UK. For example the rule applicable in Hong Kong, which is driven by the tax authority's subjective view of each transaction, operates in the context of a territorial system with low tax rates and very limited interest deductibility.
- 26 As explained, the transfer pricing rules and exit taxes do not deal fully with artificial diversion and there are significant policy and design difficulties with an anti-diversion rule. In contrast, there remain good reasons for retaining UK **ownership** and control as the principal determining factor in bringing an overseas company and activities within the scope of the UK tax base, so allowing diversion of profits from the UK to be targeted.
- 27 Adopting the ownership and control principle is simple. It also recognises the benefit gained from the rights and protections that residence in a state offers such as the broader legal framework. That is why it is not only the starting point for the current UK CFC rules, but also for CFC regimes in most other countries.
- 28 Beginning with ownership should allow practical rules to be developed that provide adequate protection of the UK tax base, whilst offering the flexibility to meet the wider policy objectives. This appears to be the right starting point for any new rules and should allow significant reform to take place.
- 29 **A move towards a more territorial approach, whilst retaining ownership as an underlying principle appears to be the optimal solution. This can be achieved by refocusing the CFC rules on artificial diversion of profits from the UK, moving away from a default presumption that all activities that could have been undertaken in the UK would have been carried on here, had it not been for the tax advantages of the overseas location. A CFC regime developed along these lines should achieve the policy objectives, set out above.**

## F. Areas for discussion

- 30 Having set out the principles, the next question is how the proposed refocusing of the CFC regime could be achieved in practice.
- 31 Central to this will be the criteria applied to distinguish between profit genuinely earned and that which represents an artificial diversion from the UK. Given the extent of integrated activities in multinational businesses and the various contributions of activities from different locations, it may not be possible to precisely reflect this distinction in every circumstance.
- 32 The attribution of profits to those 'genuinely earned' in the UK may have to be based on rules that represent simplified approximations of those principles. These rules may depend not only on the specific circumstances but also on quantitative practical tests that provide sufficient certainty to business while minimising the administrative burdens and complexity involved.
- 33 In developing the criteria and tests, the more difficult issues are likely to arise in dealing with highly mobile, income generating assets and activities that require relatively little substance in terms of associated physical activity and employees. These pose the highest risk to the UK Exchequer in terms of artificial diversion of profits and include, but are not limited to, intellectual property and monetary assets.

- 34 It seems sensible to concentrate on money and intellectual property in the first instance, before turning to consider the treatment of other activities, for example intra group services. **Initial work will therefore focus on what the criteria should be in relation to offshore businesses whose level of profits is sufficiently different to their physical substance requirements**, although the amount of substance required varies for different activities and will require discussion.
- 35 The way that multinational groups manage their money and monetary assets will clearly raise particular difficulties in distinguishing between income genuinely earned and artificially diverted income.
- 36 A number of approaches are possible. In the context of financing group business, a treasury company exclusion could be revisited. Alternatively a broader alternative approach could be adopted, for example by seeking to identify excess capital allocated to overseas entities by the group. One approach would be to say that:
- 37 there should be no automatic presumption that income from cash held by overseas operations should be taxed in the UK; but
- 38 where that income is a return on capital in excess of the capital required for those operations, then CFC rules would apply.
- 39 This example is for illustrative purposes only - all approaches remain open for discussion.
- 40 Initial work should focus on the fundamental issues of monetary assets and intellectual property. The outcome of these discussions will help frame the approach for other areas.



# B

# The Government's Code of Practice on consultation

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## About the consultation process

This consultation is being conducted in accordance with the Government's Code of Practice on Consultation. If you wish to access the full version of the Code, you can obtain it online at:

<http://www.berr.gov.uk/files/file47158.pdf>

## The consultation criteria

- 1 When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.
- 2 Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- 3 Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- 4 Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- 5 The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- 6 Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- 7 Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Better Regulation Unit

020 7147 0062 or [richard.bowyer@hmrc.gsi.gov.uk](mailto:richard.bowyer@hmrc.gsi.gov.uk)



## HM Treasury contacts

This document can be found in full on our website at:  
[hm-treasury.gov.uk](http://hm-treasury.gov.uk)

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