International Taxation Practice Group (ITPG)

UK Reform of Controlled Foreign Companies

By Graham Busch

The UK Government wants to create "the most competitive tax system in the G20". As part of ongoing reform, proposed changes have been published to the Controlled Foreign Company (CFC) regime, which attempts to stop profits made in the UK from being artificially diverted abroad. CFC rules were first introduced in the UK in 1984, and have since been largely criticised as making the country less attractive to large multinational businesses, as was an attempt to change them as part of a larger tax reform programme in 2007. The Government has taken into account many of the criticisms, and now plans to introduce a modernised CFC scheme which recognises the fact that most CFCs are held for genuine commercial reasons.

CFC Reform in brief

- UK Government to create "the most competitive tax system in the G20"
- Regime will protect UK profits while allowing greater business flexibility
- CFCs with profits less than £200,000 exempt from charges
- Charges will not apply to profits from genuine overseas business activity.
- Several multi-national groups declare their intention to re-locate to the UK on basis of these reforms.

The proposals are designed to create a stable CFC regime that, unlike the current system, does not require constant changes to address new avoidance risks.

The stated objectives of the CFC reforms are:

- To prevent diversion of profits from the UK;
- To comply with EU law;
- To reflect the way international business is carried out today; and
- To be part of an attractive, and competitive, UK tax system.

The new rules will only apply to the proportion of profits that have actually been diverted from the UK. If a CFC charge is applied, then genuine foreign profits will be outside the scope of the regime.

CFC charges will apply when business activity has been set up in a country where the rate of company tax is less than 75% of the rate in the UK. From 2014, when the UK corporation tax rate is being lowered to 23%, this means that the CFC regime will be used if any overseas company profits are taxed at less than 17.75%.

There are several exemptions that have been proposed:

- Low profits exemption – designed to remove CFCs that make a low level of profits. There are three possible options, the most attractive being an exemption for CFCs with profits less than £200,000.
- Territorial business exemption – designed to remove genuine overseas profits from the regime. A CFC would be exempt if its profits did not exceed 10% of its operating expenses. This exemption also applies to CFCs that carry on manufacturing or commercial activities.
- Finance company rules – designed to apply to overseas financing, it will give an effective UK corporation tax rate on profits from overseas intra-group financing of 5.75% by 2014.
- General purpose exemption – designed for when other exemptions don't apply. Ensuring that only profits artificially diverted from the UK for tax reasons are charged under the CFC regime, there will be no automatic assumption that profits would have arisen in the UK.

The proposals have been widely praised. Will Morris, Chair of the Confederation of British Industry's Tax Committee, said: "This consultation will make a serious

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contribution to the government's pledge to create the most competitive tax system in the G20. The government is rightly continuing to protect the UK's tax base, while allowing companies owned here much more flexibility when conducting business overseas. There remains much work to be done in the coming months to ensure the details of the government's proposals match up to its aspirations."

With the consultation period for the reforms having ended on the 22nd September, the Government hopes to publish draft legislation in the autumn.

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