Linklaters

1 December 2010

UK Tax Alert.
Best Laid Plans.

The Corporate Tax Road Map and Associated Consultations

Although it had been billed as a move away from the Pre-Budget Reports of recent years, the Chancellor of the Exchequer, George Osborne, still used his Autumn Statement on 29 November 2010 as a platform to launch a number of Government consultations on taxation. These were all published as part of a single document entitled "Corporate Tax Reform: Delivering a More Competitive System" which is intended to form a comprehensive "road-map" of how the Government sees the corporate tax system developing over the next few years (indeed the Government confirms that it does not intend any other significant corporate tax reforms until 2013 other than those discussed in this document).

Set out below is a summary of some of the key aspects of the consultations, which relate to the reform of the tax rules on controlled foreign companies, foreign branches and intellectual property. If you have any queries on these or any other taxation issues, please contact Michael Hardwick tel: (+44) 020 7456 5658, Mark Kingstone tel: (+44) 020 7456 5714, Dominic Winter tel: (+44) 020 7456 5683 or your usual Linklaters LLP contact.

Contents

General

There is a great emphasis throughout all the consultations on promoting the competitiveness of the UK as a place for business, and on achieving a simpler and more stable tax system. Whilst this is an admirable aim, it is difficult to assess whether it is likely to be achieved as in many respects the consultations are surprisingly light on detail, and draft legislation is yet to be published. Nevertheless, the Government's willingness to set out its thinking at an early stage is very welcome.

"in many respects the consultations are surprisingly light on detail, and draft legislation is yet to be published"

Controlled Foreign Company Reform

The Government notes that CFC reform is a key priority for multinational businesses, and recognises the role that the current rules have had in prompting recent corporate emigrations (although unsurprisingly there is no acknowledgement that many of the difficulties actually stem from the way HMRC has applied the motive test and the way it has chosen to interpret the ECJ's judgment in Case C-196/04 *Cadbury Schweppes*). In the light of this, there seems to be a real sense of urgency to get reform underway, and therefore (as already announced) it will be taken forward in two stages.

Interim Improvements

The Government has been consulting on the detail of interim improvements to the CFC regime since July 2010. This consultation provides an update on the Government's latest thinking. It will be followed by the publication of draft legislation on 9 December 2010 (presumably in the draft Finance Bill 2011, which is also scheduled for publication on that date), and ultimately enactment in Finance Act 2011. The interim improvements proposed are as follows:

> A new exemption for "foreign to foreign" trading transactions, which (unlike the trading company test which forms part of the current exempt activities exclusion) will not be limited by reference to transactions between connected parties. Essentially a CFC which carries on mainly trading activities (with only a minimal amount of finance income or income from IP) with mainly non-UK income/expenses (90% or more) will be able to benefit from the new exemption. Where the proportion of UK income/expenses of the CFC is between 10% and 50%, a CFC charge may arise unless the CFC falls within the "safe harbour" by having an appropriate level of effective management and by its profits falling within a set return.

> There will also be a new exemption for, broadly, a CFC with a main business of IP exploitation (with only a minimal amount of finance income), where both the IP and the CFC have a minimal UK connection.

> The existing "grace period" for foreign subsidiaries that come within the scope of the CFC rules for the first time as a result of an acquisition or reorganisation will be extended from one year following the end of the accounting period in which the acquisition or reorganisation took place, to two years (unless there is a relevant change in the business of the CFC during that period).

> The *de minimis* exemption will be increased for groups which include "large" enterprises from £50,000 per CFC per 12 month accounting period to £200,000, and the relevant measure of profits will be based on the CFC's accounts drawn up in accordance with GAAP and adjusted for capital gains and transfer pricing, rather than its "chargeable profits" (i.e. profits computed under the UK tax rules).

> The transitional exemptions for superior and non local holding companies will be maintained until 2012 (when full CFC reform is implemented).

> A mechanism will be introduced to allow, in certain circumstances, HMRC to agree a partial CFC exemption for entities which do not meet the conditions outlined above for full exemption.

Although these improvements are modest, they represent a useful first step pending full reform of the CFC rules in 2012. Comments on the interim improvements are invited by 9 February 2011.

Full CFC Reform

Full reform of the CFC rules is still scheduled for Finance Act 2012. However, somewhat disappointingly, it seems that a significant amount of work remains outstanding. The overall intention is that the rules should be more territorial and focused. To achieve this, the Government intends to introduce a mainly entity based system that will only apply to profits artificially diverted from the UK. There will be a number of exemptions to "minimise compliance burdens and focus attention on higher risk entities", and specific rules for sectors such as banking, insurance and property. Unfortunately there is little further detail on the general regime at this time.

"the Government intends to introduce a mainly entity based system that will only apply to profits artificially diverted from the UK"

Greater progress has been made in two specific areas, namely monetary assets (e.g. cash, cash equivalents, debt and debt equivalents) and IP. These are regarded by the Government as particularly difficult and as posing particular risks to the UK tax base, and therefore have been singled out for special treatment.

In relation to monetary assets, it is proposed that a "partial finance company exemption" will be introduced. This will require a finance company's debt:equity ratio to be compared. To the extent that the company has "excess equity" (i.e. above a specified ratio, possibly 1:2), a proportional CFC charge will arise. This is a pragmatic solution to the Government's concern that a UK company may divert profits from the UK by the "thick capitalisation" of an offshore subsidiary, i.e. by using more than an arm's length amount of equity to fund a low tax offshore investment. The exemption will also be available in respect of any "excess cash" held in trading companies (incidental or ancillary interest income arising in trading companies will simply be exempted). As seems to be inevitable nowadays, the exemption will be accompanied by a targeted anti-avoidance rule. Further discussions will be required in relation to entities which carry on treasury operations alongside higher risk financing activities.

"it is proposed that a "partial finance company exemption" will be introduced"

In relation to CFCs with IP related profits, foreign IP with a minimal UK connection will (broadly) be exempted from the CFC rules under the interim improvements outlined above. However, the Government intends that ultimately the CFC rules should be more closely targeted and only apply to "high risk" entities holding IP with a substantial UK connection (e.g. IP that has been transferred from the UK within the last 10 years, IP where a significant amount of UK activity is undertaken to maintain or generate the IP value, or IP held as an offshore investment). In the first two examples, the Government then suggests that it will be necessary to assess whether such a "high risk" entity has "excessive profits" (e.g. falling outside a safe harbour based on the return earned, and failing a subjective "proper allocation" test), some of which represent "artificially diverted" UK profits. If so, a CFC charge will arise on such profits. Where IP is held as an offshore investment which is

"the CFC rules should be more closely targeted and only apply to "high risk" entities holding IP with a substantial UK connection"

equity funded from the UK, a CFC charge may apply to the proportion of profits that represents a return on that investment.

It seems clear from this that foreign funded IP with no UK connection should be outside the scope of the new regime, so that foreign funded foreign IP holding structures should not be prejudiced by the new regime. Where IP has a UK connection, the position is less clear and the new regime could be complex.

Overall, the direction of travel is becoming clearer and the new CFC regime should be an improvement on the old, leaving intact non-UK financing and foreign IP holding structures that are not equity financed from the UK. Yet it remains to be seen whether the new rules will be enough to dissuade groups from redomiciling out of the UK, particularly when a country like Ireland has no CFC rules at all.

Comments on these proposals are invited by 22 February 2011. Further details on full CFC reform will be published in Spring 2011, and draft legislation in Autumn 2011.

Interest Deductibility

Changes to interest deductibility (i.e. denying interest deductions in the UK where the debt on which the interest is paid is used to fund offshore investments), which were suggested by some as an alternative to the CFC regime, will not be pursued. The Government considers that changes to UK's current interest rules would be disruptive, could undermine the Government's commitment to stability and growth, would be difficult to implement and would remove the competitive advantage they currently provide to business. This will come as a welcome relief to UK multinationals and the private equity industry.

Foreign Branches

Another key area for reform, on which the Government has been consulting since July 2010, is the taxation of foreign branches. The broad intention is to simplify the current rules under which UK companies are subject to UK corporation tax on the profits of their foreign branches, with credit given for foreign tax paid on the same profits and, to some extent, align the taxation of foreign branches with the taxation of foreign subsidiaries (noting that a UK parent company can now benefit from the distribution exemption when repatriating the profits of a foreign subsidiary).

Legislation will be published "shortly" for inclusion in Finance Bill 2011, however in the meantime the Government has used this consultation document to set out its detailed proposals.

"An opt-in exemption regime will be introduced, under which a company may make an irrevocable election for all of the trading profits, investment income and capital gains connected with its foreign branches to be permanently exempt from UK corporation tax."

An opt-in exemption regime will be introduced, under which a company may make an irrevocable election for all of the trading profits, investment income and capital gains connected with its foreign branches to be permanently exempt from UK corporation tax. The election will apply to branches in both treaty and non-treaty jurisdictions (except in relation to small companies). If a company makes such an election, it will not receive relief in respect of foreign branch losses. (It remains to be seen whether an EU law overlay will be added in the light of the ECJ's judgment in C-446/03 *Marks & Spencer*, allowing loss relief in the UK where there is "no possibility" of the losses being used elsewhere.) Exempt profits/gains will be defined by reference to the relevant double tax treaty, or if there is no treaty by reference to the OECD model treaty.

There will be a transitional rule, so that the exemption will only apply once the aggregate tax losses of a company's foreign branches in the preceding six years have been matched by foreign branch profits (except in the case of very large losses (it is suggested this may mean over £50 million), when the tax losses will need to be matched in full).

A modified version of the CFC rules will apply to foreign branches until 2012, and the new CFC regime from 2012 will apply to foreign branches as well as to subsidiaries.

Comments are invited by 9 February 2011.

Intellectual Property

In addition to the specific CFC rules proposed for IP held offshore, the Government is also suggesting significant domestic reform.

As first announced in the pre-Budget Report 2009, an optional "Patent Box" regime will be introduced from 1 April 2013, allowing for a 10% tax rate on the net profits arising from patents (which will encompass both royalty income and "embedded income" included in the price of patented products). The regime will be available for patents first commercialised after 29 November 2010. Further details will be published in Spring 2011, draft legislation in Autumn 2011, and the final legislation included in Finance Bill 2012. The intention is that this regime will incentivise companies to retain IP in the UK during commercialisation.

"An optional "Patent Box" regime will be introduced from 1 April 2013, allowing for a 10% tax rate on the net profits arising from patents"

The Government has also announced that it is reviewing research and development tax credits more generally, however it remains unclear what changes, if any, will be made.

Comments are invited by 22 February 2011.

Linklaters

Contacts

For further information please contact:

Michael Hardwick
Consultant

(+44) 020 7456 5658

michael.hardwick@linklaters.com

Mark Kingstone
Partner

(+44) 020 7456 5714

mark.kingstone@linklaters.com

Dominic Winter
Partner

(+44) 020 7456 5683

dominic.winter@linklaters.com

Clare Bouwer
Managing PSL

(+44) 020 7456 5727

clare.bouwer@linklaters.com

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com

Author: Michael Hardwick/Clare Bouwer