UK Controlled Foreign Companies Rules – and Certain Exemptions that can Reduce or Remove the Obligation to Pay UK Tax

By **Paul Webb**, 11th August 2017

The UK updated its foreign company ("CFC") rules on 1 January 2013. A number of exemptions apply that can reduce or remove the obligation to pay UK tax.

Background

A CFC is a non-UK resident company controlled by persons in the UK. Typically a CFC is a foreign subsidiary of a UK group, although corporate control is not required for a company to be a CFC.

The rules, which are essentially anti-avoidance rules designed to prevent a company artificially moving its profits abroad to a country with more favourable tax rates, came into effect for accounting periods beginning on or after 1 January 2013.

Where the CFC rules apply some or all of the CFC's profits will be allocated to the UK company that controls it and the UK company will be taxed on this amount.

Exemption from CFC Rules

Certain types of company and income are exempt from the CFC rules.

"Entity Level Exemptions" – these are a series of exemptions. Where a CFC qualifies under one of these exemptions the entire income of the CFC will be outside the scope of the CFC rules, and the group need not concern itself with CFC provisions.

"Gateway Provisions" – these examine the activities of the CFC and essentially leave only those profits that have been artificially diverted from the UK (those within the gateway) under the scope of the CFC rules, and therefore liable to UK tax.

Entity Level Exemptions

The following are full entity level exemptions:

- Exempt period exemption – this exemption applies for the first 12 months after a non-resident company has come under UK control. There will be no CFC charge, provided that any necessary restructuring is undertaken to ensure that no future CFC charges will arise in subsequent time periods.

- Excluded territories exemption – CFCs resident in specified territories (generally territories with a headline tax rate of more than 75% of the UK tax rate) will be exempt, provided that their total income within certain designated categories does not exceed 10% of the company's pre-tax profit for the accounting period, or £50,000 if greater. This exemption is not available where significant IP has been transferred to the CFC from the UK during the accounting period or during the previous six years.

- Low profit exemption – a CFC will be exempt if its accounting profit does not exceed £50,000 in an accounting period, or if its accounting profit does not exceed £500,000 and its non-trading income does not exceed £50,000.

- Low profit margin exemption – a CFC will be exempt provided its accounting profit does not exceed 10% of the relevant operating expenditure.

- Low level of tax exemption – a CFC that has paid local tax of at least 75% of the amount it would have paid as a UK resident company is exempt.

Gateway Provisions

If the entity level provisions above do not apply, then the gateway provisions need to be considered to determine if profit passes through the CFC gateways and should therefore be subject to UK taxation.

There are a number of gateways specified in the various chapters of the legislation and for each gateway it is necessary to establish whether the applicable test applies, and, if so, which profits pass through the gateway.

The CFC charge gateway tests are as follows:

- Chapter 4: Profit attributable to UK activities
- Chapter 5: Non-trading finance profit
- Chapter 6: Trading finance profit
- Chapter 7: Captive insurance business
- Chapter 8: Solo consideration

Chapter 4 – Profit Attributable to UK Activities

Chapter 4 will apply if the CFC has business profit (other than property business profit and non-trading finance profit), where the CFC is unable to satisfy at least one of the following tests:

- the CFC does not hold assets or risks under an arrangement to avoid tax;
- the CFC does not have any UK managed assets or bear any UK controlled risks; and
- the CFC could operate effectively if its UK managed assets or UK controlled risks were managed/controlled other than from the UK.

Chapter 4 includes a number of exclusions which prevent a CFC's profits passing through this gateway, for example; where those profits arise mainly from non-UK activities or where they relate to arrangements entered into with group companies where those arrangements could have been entered into with independent organisations.

Chapters 5 to 8 Gateway Tests

Chapters 5, 6, 7 and 8 gateway tests are specifically designed for CFCs with certain non trading finance profit, trading finance profit, insurance companies and CFCs consolidated with regulated UK financial companies. Unless the CFC falls into one of these categories, it will only be the Chapter 4 gateway that will need to be considered.

Chapter 5 – Non-Trading Finance Profit

Non-trading finance profit, which is incidental to business profit, will not pass through the gateway. Full or partial (75%) exemption may apply with regard to non-trading finance profit from qualifying loan relationships.

Chapter 6 – Trading Finance Profit

Only trading finance profit which derives from UK connected capital contributions will pass through this gateway. The profits of a group treasury company are treated as non-trading finance profit and therefore do not fall within this category. This enables such a company to access the full or partial (75%) finance company exemption.

Chapter 7 – Captive Insurance Business

Profits from captive insurance business will pass through the gateway where the contract of insurance is entered into with:

- a UK resident person connected with the CFC; or

- a non-UK resident person connected with the CFC acting through a UK permanent establishment; or

- a UK resident person where the contract is linked to the provision of services or goods to the UK resident person.

Chapter 8 – Solo Consideration

Solo consideration applies where the CFC is controlled by a UK resident bank.

Summary

It is important that UK CFC rules are clearly understood by all non-UK resident companies controlled by persons in the UK. Due to the exemptions and the various gateways there may be legitimate opportunities to reduce the UK tax payable. Dixcart can provide advice in relation to UK CFCs and the exemptions that are available.

Additional Information

If you require any additional information please speak to Paul Webb or to your usual Dixcart contact.