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Update on the Reform of the UK's CFC Tax Regime

On November 9th HM Treasury and HM Revenue & Customs held a joint meeting with industry stakeholders to provide an update on the progress of the proposed reform of the UK's controlled foreign company ("CFC") regime.

It is now becoming clear that the extent of reform is unlikely to be radical, due to fiscal constraints, which is disappointing. The main hopes for affected businesses must now be that the existing uncertainties can be put aside as quickly as possible, and that the new regime will be simpler from a compliance perspective.

The new regime is reported to be on schedule to be legislated in Finance Act 2011.

TIMING AND PROCESS

The release of a further discussion document is expected some time after the Pre-Budget Report (anticipated for early December), but hopefully before the end of the year (although that can't be guaranteed). The further document is unlikely to contain any surprises for those who have been following the progress of the CFC consultation to date. HM Treasury officials are not then expecting significant progress before the next general election, which must occur by 3rd June 2010 at the latest. Once the new government has been formed, progress is then expected to continue, with legislation being made in Finance Act 2011.

FRAMEWORK OF NEW REGIME

No decisions have been made, but the likely general shape of the reform is now becoming clearer. The probable outcome is thought to be as follows:

- There is no possibility of the CFC regime being abolished, due to current fiscal constraints.

- The new regime will apply on an entity-by-entity basis, to entities owned or controlled by UK resident corporates, where subject to a lower level of tax. (A simpler test for a "lower level of tax" than that in the current CFC regime is hoped for. A "black list" of jurisdictions is possible.)

- The application of the regime to an entity may not require all its current income to be taxed in the UK. Certain kinds of income of the entity could be excluded even if others are taxed.

- A series of objective tests will be featured, designed to enable determination of CFC status for many entities without reference to subjective factors. It is hoped that the scope of these tests will provide increased certainty for taxpayers in comparison to the current regime, where reliance on the difficult current motive test exemption is thought to be rising.

- A further subjective test will apply ("business purpose test"), relating to the artificial diversion of profits from the UK. The meaning of this phrase is yet to be determined, but the authorities hope that a consensus on the meaning of the term "artificial" can be reached which all parties are reasonably comfortable is compliant with EU law. One possible approach could be to ask whether the objective of a transaction is "not to avoid UK tax but to pursue non-tax related commercial objectives."

- The existing exemptions appear likely to be retained, in an amended form.

- There will be a single regime for both EU and non-EU entities.

SPECIFIC CONCERNS - IP AND TREASURY COMPANIES

The authorities are clearly concerned that the exportation of intellectual property ("IP") from the UK represents a serious threat to the UK tax base. IP companies in low tax jurisdictions appear likely to be caught by the new regime unless they can show that they actively manage their businesses and that the IP held has (and has had) no connection to the UK.

More positively, there appears to be a growing recognition of the valid commercial reasons for which group treasury companies can be established, and even that the "management of global tax rates" could be considered a valid reason. It is possible an exception for such entities will be legislated.

SUMMARY

No final decisions have yet been made, and the detail of the new regime is yet to be drafted, so it is far too early to draw conclusions on the impact it may have. However, although it does now appear that radical reform will not occur, the hope remains that a new regime will emerge which puts a lower compliance burden, if not a lower tax burden, on affected taxpayers.

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