More change on the cards?
Corporate tax reform: what does the future hold?
On 29 November 2010, HM Revenue & Customs (HMRC) and HM Treasury published a consultation document called *Corporate Tax Reform: delivering a more competitive system*. The document contained many welcome announcements and outlined elements of the Government’s vision for achieving a simpler, more stable and more competitive UK tax system.

This was followed by a written ministerial statement, released on 6 December 2010, which contained various new anti-avoidance rules, and on 9 December 2010, the publication of draft legislation for Finance Bill 2011.

Here we review the draft legislation covering:

- the interim controlled foreign company (CFC) and foreign branch exemption legislation issued in draft today
- the draft legislation intended to enact the anti-avoidance rules in the 6 December statement.

Our previously released publication, *More change on the cards? Corporate tax reform*, provides an overall perspective on the area of corporate tax (CT) reform. The initial reform proposals, published on 29 November covered the following measures and were broadly welcomed:

- controlled foreign company (CFC) interim measures;
- a foreign branch exemption regime for inclusion in Finance Bill 2011;
- full CFC reform measures for Finance Bill 2012;
- proposals for the taxation of intellectual property; and
- a statement confirming that the Government is no longer pursuing changes to the rules on the deductibility of interest.

The interim CFC measures and the branch exemption regime included in the draft Finance Bill 2011 are consistent with the published proposals but narrow in terms of their application. The anti-avoidance measures announced 6 December 2010, and the anticipated targeted anti-avoidance rules (TAAR) expected in the full CFC reform indicate that there is a continued need for dialogue with HMRC. Whilst the tax system is moving in the right direction the inclusion of complex anti-avoidance rules may prevent the new proposals delivering a truly competitive system.

**Draft legislation relating to the CT reform proposals in Finance Bill 2011**

**CFC interim improvements**

The interim improvements provide a set of welcome measures for UK business. It is proposed that the rules are effective for accounting periods beginning on or after 1 April 2011 however this is open to consultation.

The extension to the transitional period for holding companies, increase in de minimis limit and widening and extension to the motive test period of grace should help relieve the compliance burden for UK groups in certain situations. Although the motive test has been widened for certain circumstances the anti-avoidance may be problematic as it restricts the ability to meet the test where either the overseas company or assets were previously under the control of the UK.
The foreign to foreign intra group trading exemption, and the narrower exemption for intellectual property (IP), where there is minimal or no connection with the UK are designed to allow UK multinationals to manage overseas operations more efficiently than is possible under the current rules and should provide groups with new opportunities to structure operations without causing CFC concerns.

Under the intra-group trading exemption, provided UK income or expenses are under 10% of the total amounts of income or expense of the CFC, the exemption should be available. As promised by the CT reform document, a ‘safe harbour’ is provided to ease the burden of the UK connection condition. Where the ‘safe harbour’ substance conditions are satisfied a company which has UK-related gross income or business expenses in excess of 10% of the total gross income or business expenses, but not more than 50%, will not be considered to have a significant connection with the UK and may avail itself of the full exemption. The ‘safe harbour’ substance conditions were expected to include an effective management requirement plus a mechanical test. The legislation clarifies that the mechanical element of this test will require relevant profits to be 10% or less of the relevant staff costs for the period (in respect of staff resident in the same territory as the CFC). If the ‘safe harbour’ conditions are not met, there may be the opportunity, in certain circumstances to apply for a reduction in CFC apportionment. This partial exemption may be available provided the combined finance and IP income of the CFC exceeds 5% of gross income but the relevant IP income of the CFC does not exceed 5% of gross income.

For the IP exemption where financing income exceeds 5% of gross income full exemption will not be available. However a partial exemption may be available by application to the Commissioners to reduce the relevant chargeable profits such that only the excess finance income (over 5% total gross income) is apportioned.

A number of areas of uncertainty arise through the use of the phrase ‘substantial’ throughout the draft legislation for the two new exemptions. In the consultation document, it was suggested (in respect of the extent of non-trading activities in a company seeking to rely on the new intra-group trading exemption) that the threshold would be set at 10% but no definition, or figure, has been included within the legislation to define this phrase.

Foreign branch taxation

The foreign branch exemption regime will allow a UK company to make an election for all its foreign branches to be exempt from UK corporation tax on its ‘relevant profits’. The exemption is available for profits including gains, with profits / gains defined by reference to the relevant double tax treaty, in territories with a treaty in place and the Organisation for Economic Development and Cooperation (OECD) model treaty in all other cases. However, it is worth noting that there are certain qualifications in respect of exempting gains and a number of complex transitional rules for branches with brought forward losses.

As stated in the CT reform proposals the branches will be subject to anti-diversion of profits provisions similar to those currently in place for CFCs. This draft legislation (which is expected to only apply until amended to mirror full CFC reform in Finance Act 2012) proposes that where an overseas branch pays a lower level of tax (similar to the test in place for CFCs), unless the branch meets the specified de minimis (referred to the ‘entry limit’) or motive tests, the exemption will not be available. Depending on HMRC’s approach to the motive test, these anti-diversion rules have the potential to be broadly applied.

The proposals will have effect for accounting periods beginning on or after a specified date in 2011 however the specific date is still open to consultation.

The regime should make branches more viable for doing business as they will broadly be taxed on the same footing as companies. Situations where branches may be preferred include:

- intellectual property management strategies, where using a company may create an immediate exit charge
- establishing businesses in territories where there’s a positive rate of withholding tax on distributions but not on branch remittances
• establishing businesses in territories where there are significant incremental corporate law requirements (e.g. statutory audit, board of director requirements etc)
• establishing businesses in territories where there are incremental regulatory requirements e.g. exchange control
• establishing businesses in territories where there are incremental commercial issues (e.g. the need for a local sponsor to hold shares) and establishing businesses in territories where there are other hurdles (e.g. works councils, statutory profit share etc).

The written ministerial statement proposals in more detail

Group mismatch schemes (GMS)
There are two changes here. Both were expected although the inclusion of CFCs in the TAAR would seem to be out of step with CT reform.

Firstly, changes have been introduced with effect from 6 December 2010 to counter planning using convertible loans. The planning in question generated tax deductions in the borrower which exceeded the corresponding taxable income in the lending company. Broadly, the impact of the legislation is to deem additional income in the lender to match the expense in the borrower.

Secondly, a new principle based TAAR targeting GMS is to be included in Finance Bill 2011. The rules are intended to apply from the date of Royal Assent (anticipated to be mid-2011). The legislation takes a generic/principles based approach as seen in other recent TAARs (e.g. disguised interest rules introduced in 2009). The GMS rules are widely drafted and complex. The key messages are that the GMS rules:

• aim to prevent the development of further GMS arrangements
• apply to CFCs that are required to compute chargeable profits
• only apply where there is a mismatch under UK legislation between the treatment of loans or derivatives within a group (i.e. they will not apply simply because there is a difference between the UK and foreign treatment of an item) and
• don’t grandfather existing arrangements (unlike the disguised interest rules).

Where the GMS rules apply only debits and credits relating to the mismatch are adjusted.

Derecognition
These changes seek to generically counter arrangements which rely on accounting derecognition to create a tax advantage.

The broad basis of the loan relationships and derivative contracts regime is to tax debits and credits as they arise in the accounts. In certain circumstances, the accounts may not recognise a loan relationship or derivative contract so there are no credits arising. With effect from 6 December 2010, the anti-avoidance rules applying to derecognition based planning have been widened to prevent such schemes being effective. As before, it is to be achieved by overriding accounting derecognition for tax purposes as it applies to loan relationship and derivative contracts where the company is party to tax avoidance arrangements. However, the trigger for such an override is only where derecognition arises as a result of avoidance arrangements so commercial non-avoidance transactions should be unaffected.

Debt Cap
The legislation in Part 7, TIOPA 2010, almost universally known as the debt cap regime became effective for accounting periods of worldwide groups commencing on / after 1 January 2010. The complexity of the regime has led to the potential for mismatches to arise in a number of circumstances. Regulations were anticipated to be released before the end of the year to deal with these mismatches.
with effect from 1 January 2010. The only regulation published today addresses some of the issues but many remain. In addition, these changes are only effective for periods beginning on or after 1 January 2011. We anticipate further regulations may be laid before the end of 2010 to address the remaining anomalies but, as it stands, companies may still be facing adverse unintended consequences of the debt cap rules.

**Functional currency of UK resident investment companies**

The draft clauses for Finance Bill 2011 include provisions to counter tax avoidance involving changing the functional currency of an investment company. These are designed to ensure that in a period when a UK resident investment company changes its functional currency, no foreign exchange gains or losses arising from loan relationships or derivative contracts will be brought into account. The legislation will take effect for accounting periods beginning on or after 1 April 2011.

However there is also a rule which allow investment companies to elect for a functional currency to be used for tax purposes that is different to the currency used in the company’s accounts. The key features of the legislation are that:

- Any election can only be made prospectively (the legislation provides that an election can be made at any time after 9 December – i.e. before the legislation comes into force!)
- The elected currency must meet one of two tests at the time the election is made. It is either:
  - the currency in which a “significant proportion” of the “assets and liabilities” of the company are denominated or
  - the functional currency of another company in the consolidated accounting group.
- Once an election has been made it is effective until:
  - the company makes another election or
  - neither of the conditions for originally making the election are satisfied.

This new rule intends to make hedging foreign currency exposures for tax purposes more straightforward for many companies, however, complexities may arise on transition.

**General anti-avoidance rule (GAAR)**

In the June 2010 Budget, HM Treasury published ‘Tax Policy Making: A New Approach’. This document included a commitment to consult informally on whether a GAAR is appropriate for the UK. Following the informal consultation process held over the summer, HM Treasury now proposes a study programme to establish whether a GAAR could be framed within the Government’s stated objectives of providing fairness, certainty, and an attractive tax regime for business which minimises compliance costs. This study should report back by 31 October 2011. There will then be a period of formal public consultation on any proposed measures. So the earliest any GAAR might be introduced is likely to be Finance Bill 2013.
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