UK Government Publishes Road Map for Corporate Tax Reform

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The Government of the United Kingdom has published the Corporate Tax Road Map which sets out how it proposes to enhance the competitiveness of the UK's corporate tax system, with particular focus on controlled foreign company reforms, a new Patent Box regime, and exemptions to the UK corporation tax for foreign branches.

On 29 November 2010, the Government published the Corporate Tax Road Map setting out how it intends to enhance the competitiveness of the UK's corporate tax system. This Road Map provides a summary of the consultations on controlled foreign company (CFC) reforms (both interim and comprehensive packages), the new Patent Box regime and Foreign Branch taxation. The interim CFC improvements and the changes to Foreign Branch taxation will be legislated for in the Finance Bill 2011, whilst the comprehensive CFC reform and Patent Box are scheduled for the Finance Bill 2012.

Overview

The Foreword to the Road Map states that the UK's tax system "was once viewed as an asset" and that "it needs to be an asset again". The primary purpose of the Road Map is to set out in more detail what the Government proposes to do to achieve this objective.

To the practitioner, however, it provides just as valuable an insight into what the Government does not wish to do: and in particular, its decision not to bring in any further restrictions on the deductibility of interest payments. The UK regime is considered relatively generous in allowing relief for interest payments, and the Government appears to have concluded that this represented a competitive advantage that was worth preserving, particularly as any restriction of relief would necessarily introduce complexity and uncertainty into this area of the tax system.

Proposed Reforms to the CFC rules

The Road Map sets out in more detail the Government's thinking on the reform of the UK's CFC rules. These have been effectively under review since 2006, during which time a number of different proposals have been floated. The ongoing uncertainty has proved to be something of a running sore for the UK's corporate tax system, being cited by a number of major corporates as a reason for locating holding companies outside the UK and thus outside the scope of the CFC rules.

The Road Map confirmed the Government's previously announced intention to reform the CFC rules in two stages, with interim improvements being introduced in Spring 2011 and more thoroughgoing reforms being legislated a year later. The aim of both stages is twofold: to ensure that the rules are more targeted at profits artificially diverted out of the UK tax net, and that the rules are more certain in their operation by providing clear, objective exemptions that can easily be applied and assessed by taxpayer companies without having to resort to the existing "motive test" exemption, which is subjective and necessarily lacks clarity.

Interim changes

The main interim change is the introduction of a new exemption from the CFC rules for foreign subsidiaries of the UK parent company engaged in intra-group transactions with other foreign subsidiaries where there is no risk of profits being artificially diverted out of the UK. This is intended in particular to assist companies forming part of a supply chain and which cannot easily establish a CFC rule exemption under the existing rules.

The exemption will apply to trading companies with a business establishment in their territory of residence and which receive no more than an incidental amount of finance or intellectual property (IP) income (defined as 5 per cent of the company's total income). Such a company's income will be outside the CFC rules if no more than 10 per cent of its income or expenses are UK income or UK expenses (*i.e.,* they derive from transactions with the UK). Where the proportion is between 10 per cent and 50 per cent, the company will fall outside the CFC rules if it has an appropriate level of effective management and its profits fall below a set return on operating costs and assets: a safe harbour for low-profit foreign companies.

Companies not meeting the safe harbour criteria will fall within the CFC rules but may agree to a reduced CFC charge which excludes profits commensurate with the CFC's economic activity from charge in the UK.

A separate exemption will be introduced for companies exploiting IP with limited UK connection because it has not been held or developed in the UK. The exemption will only apply if the company itself has a minimal business connection to the UK, which will be tested by reference to the source of the company's funding and income, and has minimal finance income. If the company has more than a minimal amount of finance income, only the excess will be apportioned to the UK.

Other interim amendments include a temporary 36-month exemption from the rules for newly acquired foreign subsidiaries that were not previously UK CFCs. This is effectively a period of grace to allow post-acquisition restructuring to take place. It will extend and clarify the existing practice of HMRC, which was to accept that acquired companies were exempt by virtue of the motive test for the first 12 months following an acquisition. The upper limit for the *de minimis* exemption for CFCs with small profits will be raised from £50,000 to £200,000 and will be measured in future by reference to accounting profits rather than taxable profits. Additionally, the implementation of changes to the rules exempting certain intermediate holding companies from being CFCs will be postponed for 12 months until the full reforms have been completed.

Full CFC reforms

The 2012 CFC reforms will address the areas that have proved most problematic during the reform process: monetary and IP assets held by overseas subsidiaries of UK companies.

In relation to monetary assets, the Government has adopted its predecessor's favoured approach of exempting from the CFC rules treasury companies concerned with day-to-day management of monetary assets. Finance companies (those that provide structural finance or manage cash on a longer-term basis) will be exempted provided they maintain a debt:equity ratio of at least 1:2. Otherwise, a proportional CFC charge will be imposed. The effect of this would be that one third of the finance company's overseas income would be taxed in the UK at an effective tax rate of 8 per cent once the corporation tax rate falls to 24 per cent, as is proposed to take place by 2014. Anti-avoidance rules will prevent companies from obtaining a tax advantage by recycling money back to the UK or diverting profits from the UK into finance companies.

To prevent finance income being "swamped" within trading companies, the debt:equity measure will also be applied to cash held alongside trading operations in low tax jurisdictions.

In relation to IP, the Government has decided to adopt a markedly different approach from its predecessor. In particular, it has rejected the idea of an "earn-out" charge on IP transferred out of the UK and of a broad exemption for actively managed IP. Instead, an exemption will be granted for all IP except for that with a substantial UK connection, which is defined as IP that has been transferred out of the UK within the last ten years or where its value is maintained or generated by work done in the UK. A safe-harbour test will be applied so that CFCs making a sufficiently small return will not see their IP income apportioned to the UK. Entities that do not satisfy the safe harbour will still be able to exempt from apportionment those profits that are properly attributable to the activities carried out offshore, a test that has yet to be fully worked out.

The Government is also concerned about IP held as an offshore investment, and proposes to apply the same debt:equity test as will apply to finance companies, thus resulting in an effective UK tax rate of 8 per cent on income from such IP by 2014.

Patent Box

The Government recognises that the UK's tax regime for IP has become uncompetitive in contrast to other jurisdictions such as Luxembourg and Switzerland, which offer low effective tax rates on income from patents and other IP.

In order to combat the trend for businesses to transfer patents offshore prior to the full realisation of their value, and to encourage more high-tech R&D and manufacturing activity to take place in the UK, the Government intends to introduce a 10 per cent tax rate for patent income. The Government intends for the Patent Box to apply to net patent income after associated expenses, including pre-commercialisation expenses, rather than to allow deductions for expenses at the main rate of corporation tax.

The Patent Box will be an elective regime, and patents eligible for inclusion in the regime are those first commercialised after 29 November 2010. It is also intended that the Patent Box should be available to both discrete royalty income and royalty income which may be "embedded" in the price of patented products. Embedded income will be identified and quantified using a formulaic approach in the interests of providing greater certainty and ease of administration.

The Government does not wish to incentivise purely passive holding of IP, or to encourage artificial tax avoidance behaviours. Potential solutions such as linking the amount of income which can be attributed to the Patent Box to the level of ongoing R&D or associated manufacturing activity are under consideration.

Although the R&D tax credit regime is intended to be retained, it is likely to undergo changes in order to "refocus" the relief more effectively on "genuinely innovative activity". The potential changes include making the eligibility for credits more prescriptive, providing statutory definitions for concepts previously reliant on HMRC guidance, as well as improving the administration of the regime.

Foreign Branches

Under the present rules, the profits of foreign branches are subject to UK tax, but with credit given for foreign tax paid on the same profits. If the foreign tax paid is less than the UK tax chargeable, then the company must pay a "top up" of UK tax. In keeping with the new territorial approach to UK taxation, the Government proposes to introduce an exemption from UK corporation tax for foreign branches. These reforms would in effect put branches and subsidiaries on an equal footing as far as their UK tax position goes.

Companies will be able to opt into exemption regime for foreign branch taxation, but such elections are irrevocable and apply to all foreign branches of the company. If an election for exemption has been made, the company will not receive relief in respect of the foreign branch losses.

The exempted profits of the foreign branch will be the trading profits and investment income that is effectively connected to the branch. A treaty basis will apply for the purposes of attributing profits to a branch. If the territory of the branch has no treaty with the UK, the measure of exempt profits will be determined by the Organisation for Economic Cooperation and Development (OECD) model treaty.

Large and medium companies may exempt profits of foreign branches in all countries and territories, including those with which the UK has no tax treaty. Small companies will not be able to elect for exemption in relation to non-treaty territory branches due to the perceived risk of loss of tax through diversion of personal income.

The exemption will also apply to chargeable gains which are in accordance with the relevant treaty or the model treaty taxable in the host state.

A transitional rule to allow claw-back of relief already given for foreign branch losses will also be introduced. When a company opts into exemption, the company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding six years have been matched by profits. This is subject to a carve out for losses of £50 million or more.

In order to prevent artificial diversion of profits to branches, there will also be "CFC"-type rules, breach of which would result in some or all of the profits of a branch being subject to UK tax for the year in question. These rules will not be as detailed as the CFC rules given the ongoing reforms to the CFC rules themselves and the difficulties in applying an entity-based regime to branches.

Conclusion

The Road Map will undoubtedly be regarded by many companies as a positive development, as it seeks to address a number of long-standing concerns about the corporate tax system, and it also shows a greater sense of purpose and direction than had previously been apparent. That said, a considerable amount of uncertainty still remains in relation to the precise scope of the CFC reforms and the patent box. We believe that companies considering substantial investments into the UK (and equally, companies considering relocating functions out of the UK) should await greater clarity in this area before committing themselves to a particular course of action.