The CFC Charge Gateway: Chapter 3

1. Chapter 3 sets out how to determine which, if any, of the remaining CFC Charge Gateway Chapters (from 4 to 8) apply.

2. Chapter 3 therefore represents an initial part of the charge gateway. Its purpose is to exclude CFCs that have no chargeable profits from the regime in a way that keeps the cost of administration of the CFC regime as low as possible.

3. The Chapter sets out conditions that must be met for each of Chapters 4 to 8 to apply. If the conditions for a particular chapter to apply are not met, then the CFC will have no chargeable profits arising from that chapter.

4. The different chapters cover different categories of profit, as follows:

   - Chapter 4 deals with any profit other than non-trading finance profit and profit arising from a property business.

   - Chapter 5 deals with non-trade finance profits.

   - Chapter 6 deals with trading finance profits.

   - Chapter 7 deals with captive insurance companies.

   - Chapter 8 deals with certain subsidiaries of regulated financial companies.

5. The conditions for each chapter are intended to be straightforward to self assess in most cases. We expect a risk based approach to be taken to self assessment under Chapter 3 – there are no special requirements for documentation (see paragraphs 12 to 14 below). Where Chapters 4 to 8 do not apply, we would not expect the company to consider those Chapters at all in making its self assessment.

Section 371CA – Does Chapter 4 apply?

6. Section 371CA provides that Chapter 4 will apply for a CFC's accounting period unless any one of four conditions (A-D) is met. Chapter 4 determines profits that are attributable to "significant people functions" carried out in the UK [see Chapter 4 guidance] for the purposes of the CFC charge, using terms that take the same meaning as they have in the Organisation for Economic Co-operation and Development (OECD) Report on the Attribution of Profits to Permanent Establishments. Although Chapter 3 does not generally use those terms, Conditions A-C focus in a similar way to Chapter 4 on the CFC's assets and the risks that it bears, from which it may derive profits that are regarded as having been artificially diverted from the UK.

7. The combined effect of these conditions is that Chapter 4 will apply to and bring overseas profits within the scope of the CFC charge in relatively unusual circumstances. These will be where there is a high likelihood that a CFC is being used to divert profits from the UK by means of a separation of assets and risks from the underlying activity that supports the group's holding of those assets, or that necessarily go with its bearing of risk. It is expected that most CFC's will satisfy at least one of the four conditions at section 371CA. However even if none of them are met the CFC may still have no profits that pass through the gateway to be charged as Chapter 4 profits. This will depend on

the application of the steps set out at Chapter 4 to the CFCs profits, including the possible application of the specific exemptions in that Chapter.

8. Transfer pricing legislation [see INTM430000] is our primary defence against inappropriate division of profit between companies within a group of companies. Chapter 4 engages only where transfer pricing cannot remedy such inappropriate division. This will be in situations where individual transactions are correctly priced but the circumstances are such that profit attaches to (foreign owned) assets or risks that, for the purposes of the CFC regime, seem to have been artificially separated from (UK) activity. In such cases it will also be important to consider whether the CFC has a permanent establishment (PE) in the UK [see INTM261000] before the application of the CFC legislation is considered. This may need to include consideration of whether the activities of another person in the UK on behalf of the CFC constitute those of a dependent agent.

9. The Conditions in section 371CA are designed to provide high level tests of whether any such separation between activity, assets and risks that would lead to an inappropriate allocation of profits away from the UK is to be regarded as having occurred. The arrangements leading to the CFC's holding of assets or its bearing of risks will be treated as giving rise to such a separation only where the management of the asset or risk is carried on to any significant extent in the UK ; where the CFC would be incapable of the effective management of its business without that intra-group support ; or where the arrangement is strongly tax motivated.

10. It follows that profits will not, under Chapter 4, pass through the Gateway and come within the scope of the CFC charge unless:

- the UK activity generates profit through the group's holding of assets or bearing of risks, but those assets and risks are held outside the UK, and
- that UK activity is not performed by a PE of the CFC through which the CFC carries on a trade, and
- a transfer pricing adjustment is not an available or appropriate remedy.

<u>HMRC Governance [note - this section outlines the spirit of what will need to be considered further within HMRC]</u>

11. If, having read this guidance, you believe that arrangements in relation to UK activity justify a challenge to a taxpayer's view on whether or the extent to which a CFC's profits pass through the gateway to be charged as Chapter 4 profits you must submit the case to [HMRC governance arrangement] before you proceed. As noted in the section above it is expected that the application of the transfer pricing legislation and the question of whether any UK activity is carried out by a PE of the CFC will have been considered. The submission should set out the relevant facts, explaining as far as possible:

- the assets and risks in the CFC and the nature of the UK activity in relation to them;
- why you consider that UK activity is under-rewarded;
- why a transfer pricing adjustment will not remedy any under-reward to the UK;

- why the UK activity does not lead to the CFC being treated as trading through a UK PE;

- why you consider that none of the section 371CA conditions are met;

- why the exclusions in Chapter 4 [see xxx] do not apply;

- the estimated tax at risk from the arrangements that are in place between UK companies and CFCs.

Documentation

12. INTM 433030 provides guidance on the content and form of the records that a business is expected to be able to make available to HMRC in order to demonstrate that transfer pricing rules have been applied appropriately. Similar principles apply in relation to a company's consideration of whether any of a CFC's profits pass through the CFC charge gateway and the quantification of any such profits

13. In particular HMRC does not want businesses to suffer disproportionate compliance costs. Companies should prepare and retain such documentation as is reasonable given the nature, size and complexity (or otherwise) of the CFC's business or of the relevant assets / risks and the arrangements under which they are held or borne.

14. As with evidence to demonstrate an "arm's length" result for transfer pricing rules, any such documentation would need to be made available to HMRC in response to a legitimate and reasonable request in relation to a tax return that had been made (cross ref to governance procedures). Although the business would need to base relevant figures in its tax return, or the conclusion that were no chargeable profits in respect of CFC's, on appropriate evidence the material recording that evidence would not necessarily exist at the time the return was made in a form that could be made available to HMRC. Indeed, if HMRC never made a request, the evidence might never exist in such a form.

Conditions A to D

15. If one or more of Conditions A to D are met by a CFC then Chapter 4 does not apply to the CFC and so the relevant profits will remain outside the scope of the CFC charge. The conditions are:

- Condition A which is a two part test of the purpose of the arrangements by which a CFC holds assets or bears risks;

- Condition B which asks whether the CFC has any assets or risks for which key management activities are in the UK;

- Condition C which applies if Condition B is not met and asks whether the CFC would have the capability to run its business effectively, on a stand alone basis or with third party support, without the UK management activity;

- Condition D which excludes companies that have only property business profits and/or non-trade finance profits.

Condition A

16. Condition A asks about the arrangements by which a CFC holds assets or bears risks. The condition at section 371CA (2) is that the CFC does not, at any time in the accounting period, hold assets or bear risks under an arrangement that has all the characteristics detailed at subsections (3) and (4). These are that:

- the main purpose, or one of the main purposes, of the arrangement is to reduce or eliminate any liability of any person to UK tax or duty;
- the consequence of the arrangement is that at any time the CFC expects its business to be more profitable (other than negligibly) than it would otherwise be; and
- the arrangement gives rise to an expectation that one or more persons will have liabilities to tax or duty imposed under the law of any territory reduced or eliminated and
- it is reasonable to suppose that the arrangement would not have been made if there was not that expectation.

17. 'Arrangement' has a wide meaning as defined at section 371VA. Looking at the last part of Condition A the other way round, it would be reasonable to suppose that an arrangement under which the CFC holds assets or bears risks would have been made if there is a clear objective expectation of commercial non-tax benefits of the arrangement, and that these benefits, on an objective calculation, are clearly sufficient on their own for the arrangement to have been adopted. The consideration of this point will often not be confined to the accounting period in question, for example if the commercial benefits of the arrangement would only be expected to materialise over time.

18. Although there must be a main purpose of a reduction or elimination of a liability of any person to UK tax or duty for Condition A to be failed, the test of whether the arrangement under which assets and risks are separated from the underlying activity would have been made without the expectation of a reduction or elimination of tax is with reference to tax or duty imposed in any territory. This is consistent with the way that the "economic value" exclusion at section 371DD in Chapter 4 [see xxx] works, excluding all tax effects from the consideration of the commercial rationale behind the arrangement.

Condition B

19. Section 371CA(5) requires that the CFC has no UK managed assets and bears no UK managed risks at any time during the accounting period. Subsection (9) provides that an asset or risk is UK managed if:

"(a) the acquisition, creation, development or exploitation of the asset, or (b) the taking on, or bearing of, the risk, is managed or controlled to any significant extent by way of relevant UK activities."
The meaning of relevant UK activities is given by subsection (10) as activities carried on in the UK either by the CFC itself (unless through a UK permanent establishment) or *"by companies connected with the CFC under arrangements which would not, it is reasonable to suppose, be entered into by companies not connected with each other."*

20. These will be activities specifically in relation to the CFC and its assets and risks rather than more generally in relation to the group or those carried out by a UK parent company in its role as shareholder. Activities carried out by the CFC through a UK PE (see definition at section 371 VA) are excluded by subsection (10)(a), consistent with their exclusion from the meaning of "UK SPF" at section 371DA(3)(g) in Chapter 4. This is because the determination of Chapter 4 profits follows the same principles of attribution of profits to PEs as would apply if the CFC performed the relevant functions in the UK as part of a trade carried on through a UK PE. The same result would be arrived at in a much more direct way. It is therefore important that the issues relevant to whether the CFC is itself chargeable to Corporation Tax under CTA09 section 5 CTA [cross ref to INTM262020] are fully considered before those relevant to the CFC charge gateway.

21. It would generally be reasonable to suppose that arrangements would be entered into by unconnected companies where there is evidence that similar arrangements actually exist between such companies. What subsection (10)(b) is aimed at is the sort of situation where the nature of services or degree of control / access to information required is not such that it would be reasonable to assume that such support and/or services could have been provided by or given to an unconnected person (ignoring for these purposes the possibility of a joint venture where the dynamics of the relationship may be different).

22. It will generally be reasonable to suppose that arrangements would not be entered into by unconnected companies where one company's financial risk or its prospect of profit is dependent upon decisions made in the other and where the first company is not able effectively to monitor and if necessary reverse decisions made by the other company.

23. But not all activities carried on in the UK under arrangements that would only be found between connected group companies will be activities caught by the meaning of "UK managed" at subsection (9). An example of this might be where a UK company sets parameters according to which the business, or some part of the business, of overseas group companies must be conducted. As long as active, day-to-day decision making in respect of the matters specified at subsection (9) does not take place in the UK, the fact that management is carried out within general parameters or guidelines set in the UK would not by itself be sufficient to justify a conclusion that the CFC's assets or risks are "UK managed".

24. So the meaning of "managed or controlled to any significant extent" requires a greater degree of involvement in active decision making in relation to assets and risks than the setting of general parameters, strategy or guidelines across group companies. Where guidance or advice on specific matters is given to a CFC from the UK it will be important to consider the skills and capacity of the CFC's staff to understand and evaluate this guidance and to make appropriate decisions that take account of it.

25. A UK company's overseas subsidiaries may also be required to follow a particular operating model or perhaps to adopt group branding. The provision to a CFC of the use of UK held intangible assets of this kind would not in itself constitute UK management of assets and risks, as long as the value of those assets to the UK holder is not reduced as a result [see paragraph 98 et seq of Chapter 4 guidance on transfers or other derivations as at sections 371DJ(2) or 371KJ(2)].

26. It should be noted that the words “managed or controlled” as used in subsection (9) are not intended to have the particular meaning of similar words in the test of “central management and control” for determining company residence (see INTM120060). The meaning of the words in that test has developed through case law specifically in the context of residence. Nor can their meaning be taken to be synonymous with that of “significant people functions” or “key entrepreneurial risk-taking functions” which are used in Chapter 4 [see paragraph 9 et seq of Chapter 4 guidance]. They should be read in the context of the purpose of Section 371CA which is to allow for easy identification of companies which would be self-supporting without the benefit of the UK activities, so that their profits will not pass through the gateway to be charged as Chapter 4 profits.

Condition C

27. If the CFC does have UK managed assets or risks, Condition C at section 371CA(6) may be satisfied, so that none of the CFC’s profits pass through the gateway to be charged as Chapter 4 profits, if the CFC has itself the capability throughout the accounting period to ensure that its business would be commercially effective if those assets and risks were no longer to be UK managed. This can be seen as a test of a CFC’s reliance or dependence on UK management or control – the assumption being either any support or services being provided from the UK that amount to “relevant UK activities” could just as easily be obtained by outsourcing with third parties under arrangements commonly available in the outside world.

28. Subsection (7) thus specifies that the reference in subsection (6) to the CFC’s capability includes the capability to select unconnected persons to provide it with goods and services and also the capability to manage its transactions with unconnected persons.

29. Subsection (8) requires assumptions to be made in determining whether Condition C is met at any time during the accounting period.

30. The first assumption is that the CFC would continue to carry on the same business as it is actually carrying on at that time. So condition C would not be met if the CFC could only be commercially effective if it made changes in the nature or scale of its business to adapt to the withdrawal of the UK management or control activities.

31. The second assumption to be made is that none of the relevant UK activities, by which any asset or risk was UK managed, would be replaced in any way that relies on any person connected with the CFC at any time. So Condition C would not be met where any of these relevant UK activities are of a type that could not be obtained on a commercial basis at arm’s length. However it is important to remember that the only relevant UK activities we are concerned with here are those by which assets and / or risks are managed in accordance with subsection (5).

32. If all the relevant UK activities we are concerned with are of a type that could be obtained on a commercial basis at arm’s length then Condition C could be met, as long as the CFC has the necessary capability to select appropriate providers and manage its transactions with them.

33. The term ‘commercially effective’ in subsection (6) includes the CFC being fully competitive, capable of exploiting all its assets efficiently and delivering an appropriate return on the resources invested in it. However Condition C does not require the CFC to be capable of being no less commercially effective without the UK management or control activities than it has been with them. It is recognised that some synergies or other advantages of working with other group companies would almost certainly be lost under the assumptions required by the test at Condition C. The loss of such advantages would not in itself mean that the CFC is necessarily dependent on the UK management or control activities in the sense of the test.

34. It should be noted that the test at Condition C is only in relation to UK activities by which the CFC’s assets and risks are managed. Where such activities are carried on elsewhere, for example by a non-UK group company, the non-UK support is not treated as withdrawn for the purposes of the test. As suggested above, Condition C can be seen as test of a CFC’s reliance or dependence on UK management or control (not of its complete self-sufficiency). This does not of course mean that the test can be satisfied by showing that the relevant UK activities could be carried out by a non-UK group company or any other person connected with the CFC. Although this might be considered a reasonable alternative, it is specifically precluded by S371CA(8)(b), as covered in paragraph 31 above.

Condition D

35. The condition at section 371CA (11) is that the CFC’s assumed total profits only consist of one or both of:

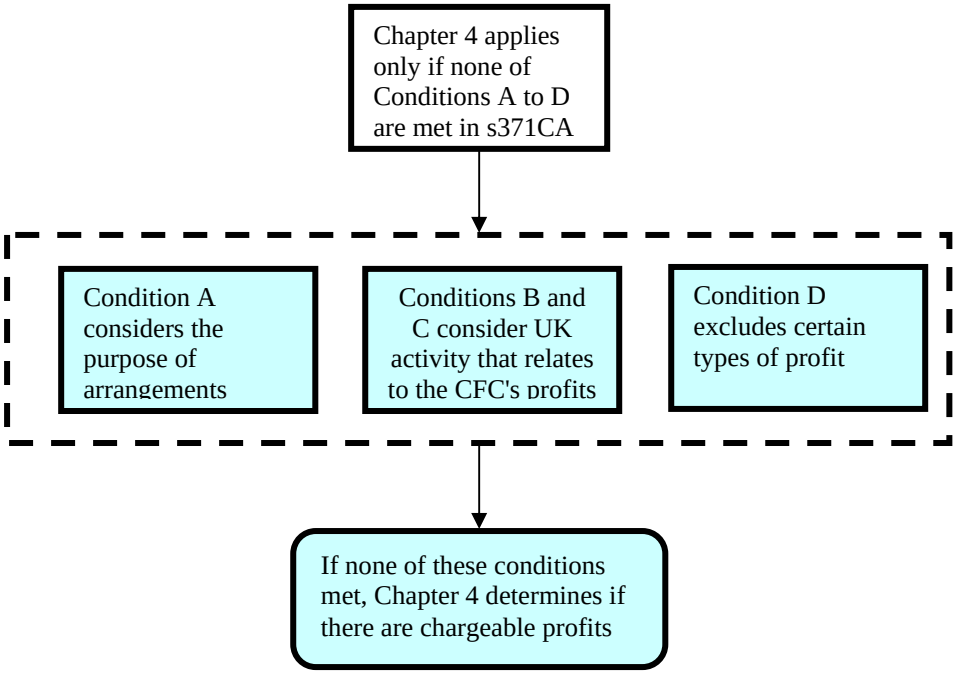
- non-trading finance profits;
- property business profits.

Any such profits are excluded from the CFC’s assumed total profits for the purposes of Chapter 4. Non-trading finance profits are dealt with in Chapter 5 and property business income is outside the scope of the CFC charge (see xxx). So Chapter 4 will not apply where a CFC has no profits of any other kind but these.

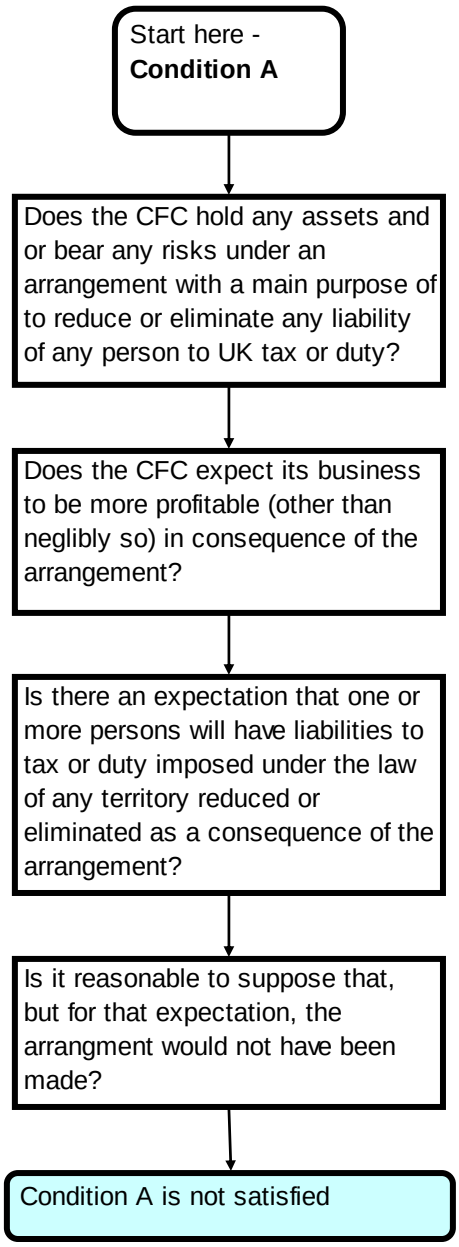
Flowchart

36. These flowcharts illustrates the operation of section 371CA

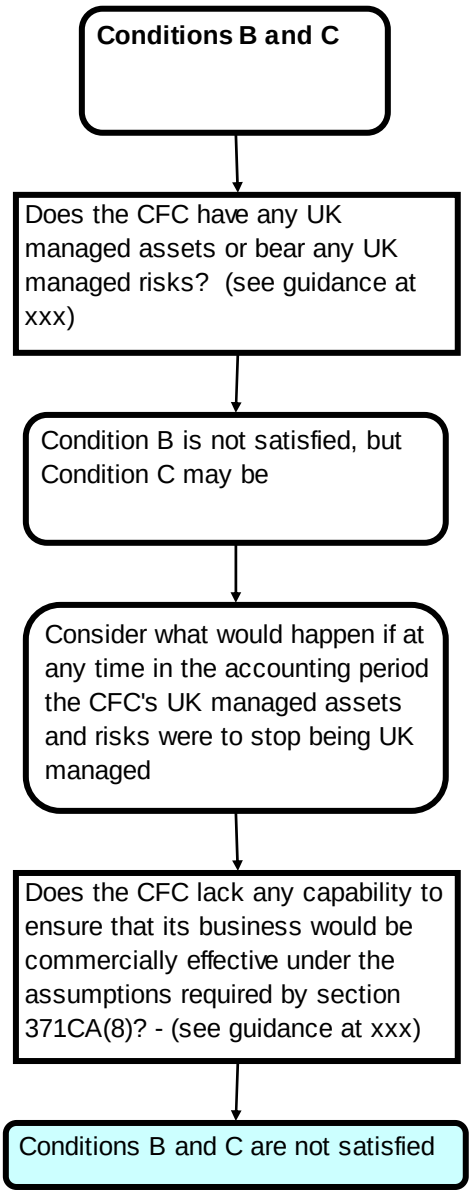
Overview


Chapter 4 applies only if none of Conditions A to D are met in s371CA
Condition A considers the purpose of arrangements
Conditions B and C consider UK activity that relates to the CFC's profits
Condition D excludes certain types of profit
If none of these conditions met, Chapter 4 determines if there are chargeable profits

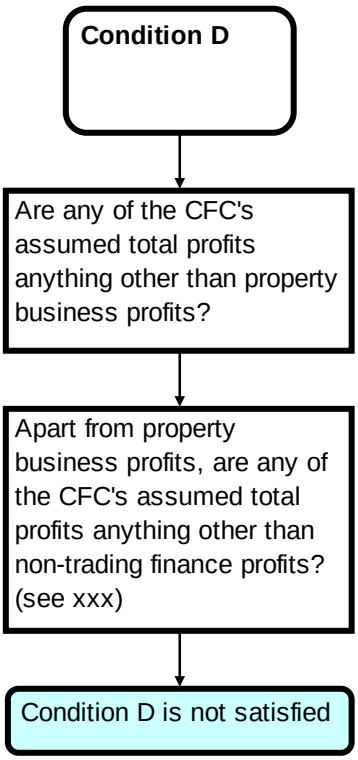
Condition A


Start here -
Condition A
Does the CFC hold any assets and or bear any risks under an arrangement with a main purpose of to reduce or eliminate any liability of any person to UK tax or duty?
Does the CFC expect its business to be more profitable (other than neglibly so) in consequence of the arrangement?
Is there an expectation that one or more persons will have liabilities to tax or duty imposed under the law of any territory reduced or eliminated as a consequence of the arrangement?
Is it reasonable to suppose that, but for that expectation, the arrangment would not have been made?
Condition A is not satisfied

Conditions B and C



Condition D


Condition D
Are any of the CFC's assumed total profits anything other than property business profits?
Apart from property business profits, are any of the CFC's assumed total profits anything other than non-trading finance profits? (see xxx)
Condition D is not satisfied

Section 371CA Examples:

37. A UK headed group holds intellectual property (IP) in two different companies, one resident in the UK (Company Y) and the other in a zero tax territory (Company Z). Company Y holds patents and related IP for products manufactured and marketed by the group around the world. Company Z holds software which is used by one of the group's businesses across Latin America and which is also licensed to third parties in Spanish and Portuguese speaking countries.

Example1

38. The group considers whether Chapter 4 will apply to company Z by first considering the conditions at section 371CA. Company Z is staffed adequately to manage its assets and risks and its people have developed a high level of experience and expertise in their field. It is a stand-alone operation and had no UK managed assets and did not bear any UK managed risks at any time during the accounting period. Condition B is met and there is no need to consider the application of Chapter 4 further. Company Z's profits (assuming it has no non-trading finance profits (see Chapter 5 guidance)) do not pass through the gateway and are outside the scope of the CFC charge.

Example 2

39. The facts are the same as in example 1 except that Company Z has become aware of a potential issue with a European company involving an infringement of its patents. It then learns that a similar issue had come up two years earlier when that same company had infringed patents belonging to another group company - Company Y in the UK. Company Y had successfully defended its IP rights and despite the differences between their businesses Company Z asks Company Y to look into the matter for them and to do some initial work under a service agreement made on arm's length terms.

40. In considering section 371CA for AP2, Company Y's activities under the service agreement are not seen as "relevant UK activities" as it is reasonable to suppose that unconnected companies would have entered into a similar arrangement. Again Condition B is met. Furthermore it is also considered that even if the provision of such advice from the UK constituted "relevant UK activities", the exploitation of the IP and bearing of the related risks could not be seen as "managed or controlled to any significant extent" by way of these activities. Company Z had to evaluate the advice it received against its specific circumstances and decide for itself how to proceed.

Example 3

41. The facts are the same as example 2, but company Z decides to send two members of its staff to the UK temporarily, in order to work with Company Y's staff to try to resolve the legal issues. Working together they negotiate the terms of a compromise agreement with the company that was accused of infringement. Company Z's two members of staff return to Company Z's territory of residence with the recommendation that these terms should be accepted and Company Z's Board of Directors subsequently authorises the settlement.

42. In considering Condition B it cannot be concluded that Company Y's activities were under arrangements that unconnected companies would have entered into. Furthermore Company Z's staff had themselves carried on relevant UK activities by which the IP asset and related risks had been managed to a significant extent.

43. However in considering Condition C it is concluded that Company Z at all times had the capability to select unconnected advisers to work with it on this issue and to achieve the same outcome. It had been convenient to work with Company Y on this, but not essential. Nor had it been essential that the two members of its staff had stayed in the UK. Again this had just been convenient in working with Company Y. Company Z's business would have been commercially effective if the assets and risks had stopped being UK managed at any time in the AP because Company Z could have substituted other European legal advisers for Company Y's staff. Of course something would have been lost in the process of instructing new advisers and not having access to shared group resources, but this does not prevent Condition C from being met in the circumstances.

Example 4

44. The facts are as in example 1 except that Company X, the UK parent of Companies Y and Z decides to acquire an African business that is quite similar to the group's Latin American operation. All the work in relation to this is done in the UK by Company X, which also makes the decisions on where in the group the newly acquired IP should be held and, within an outline business plan, sets out in general terms how its value might best be exploited. Ownership of the newly acquired software is transferred to Company Z as part of the acquisition process, and a number of patents are transferred to Company Y in the UK. Company Z needs to recruit some new staff locally to handle the increased work and its acquisition of the software is funded by additional equity from Company X.

45. In considering section 371CA, the fact that the exploitation and development of the software is within the parameters of the outline business plan does not of itself necessarily mean that the asset and risks are UK managed. Nonetheless it is concluded that Company X in the UK has managed or controlled the acquisition of assets and the taking on of risks to a significant extent by way of relevant UK activities (detailed planning, decision making, provision of equity funding), under arrangements that would not have been entered into by companies not connected with each other. So Condition B is not met.

46. Condition C requires that Company Z has the capability to ensure that its business would be commercially effective if its UK managed assets and risks were to stop being UK managed at any time during the AP. It is recognised that the acquisition could not have proceeded without Company X's involvement and the details of the additional funding and staffing were such that it cannot be concluded that Company Z could have carried on the same business in a commercially effective way without the relevant UK activities. So Condition C is not met.

47. Condition A will be met unless both subsections (3) and (4) of section 371CA apply. With regard to subsection (3), the possibility of either Company X or Y holding the software will have been considered in putting together the outline business plan as will the UK tax consequences of putting that arrangement in

place. As both tax and non-tax issues had to be taken into account in the decision to transfer the software IP to Company Z, subsection (3)(a) is likely to apply And as there was an expectation that Company Z's business would become more profitable by its owning the new IP, subsection (3)(b) also applies.

48. In relation to subsection (4), there is expected to be a reduction of the liabilities of at least one of the UK companies through holding the software in Company Z so subsection (4)(a) applies. This is on the assumption that, had the UK group simply acquired the third party intangibles and held on to them in the UK, this would have resulted in additional UK profits and tax. However it is not reasonable to suppose that the arrangement by which Company Z holds the software would not have been made but for that expectation. In this case, there were a number of sound commercial considerations involved in making the relevant arrangements, and sufficient evidence to conclude that the same decisions would have been made if the taxation consequences of all the options had been the same. So Condition A is met.

    It is important to note that whilst the facts of this example indicate significant UK involvement in relation to the acquisition, it will often be the case that an acquisition or commercial re-structuring has taken place during an earlier accounting period. It such cases, it may well be the case that the CFC no longer requires or indeed receives UK support for its ongoing activities. Clearly, in such cases, the analysis would be different. In particular, it may well be easier to demonstrate that the CFC could remain commercially effective without UK support. It should be easier for groups to demonstrate that Condition C is met in those later periods. The conditions have to be applied to each accounting period, based on the relevant facts during the accounting period under consideration.

Example 5

49. The facts are as in example 4 except that the acquisition managed by Company X is of a manufacturing business, not unlike that for which Company Y already holds patents, know how, etc and quite different from Company Z's other business. Only a small part of the value of the acquired IP is in software. Nevertheless the decision is to put all the IP into Company Z in the low tax jurisdiction, despite the fact that the group's experience with this IP and its decision making ability in relation to it resides primarily with Company Y in the UK. There is a considerable tax saving anticipated from this arrangement and contemporary evidence shows that tax was an important consideration

50. Conditions B and C are not met for the same reasons as in example 4 and because the ongoing work to exploit the newly acquired IP is undertaken primarily in the UK. Company Z has little real involvement with this line of business. As for Condition A, section 371CA (3) and (4)(a) apply as in example 4. However in these circumstances subsection (4)(b) also applies as it is reasonable to suppose that the arrangement under which Company Z holds the new assets and bears the associated risks would not have been made if it were not for the expected tax saving for the group. Company Z's assumed total profits do not consist only of the types of profit specified in Condition D, so none of the section 371CA conditions are met and Chapter 4 must be considered.

Section 371CB – Does Chapter 5 apply?

Overview

51. Chapter 3 poses the question, does Chapter 5, the CFC charge gateway for non- trading finance profits apply? So that such profits fall to be treated for CFC purposes as within the special Chapter 5 regime. The answer to this question will be yes if the CFC has non-trading finance profits that are not otherwise excluded by the detailed rules in sections 371CB, 371CC and 371CD.

52. Profits that are incidental to the exempt business activity of the CFC are excluded from Chapter 5 under these sections. Profits that fall within Chapter 8 (the solo consolidation rule for banks) are similarly excluded from Chapter 5.

53. Further, a CFC that has non-trading finance profits derived from a "qualifying loan relationship" may claim that the profits arising should be dealt with under Chapter 9 (exemptions for profits from qualifying loan relationships) instead of Chapter 5. Such a claim would apply to all of the CFC's qualifying loan relationships extant during the accounting period excluding those that are not already taken out of the CFC regime because they are incidental to the exempt business activity of the CFC.

Detailed rules

54. Section 371CB provides that Chapter 5 only applies for a CFC's accounting period if the CFC has non-trading finance profits. This is subject to sections 371CC and 371CD, which deal with incidental non-trading finance profits that fall within a 5% safe harbour. The references to non-trading finance profits in this section and Chapter 5 exclude any profits that fall with Chapter 8 (solo consolidation) or within sections 371CB(3) or (4), - incidental non-trading finance profits that are not limited to the safe harbour amounts.

What are non-trading finance profits?

55. Non-trading finance profits are defined in subsections 371VG(1) to (3) and include any profits that fall to be dealt with under Part 5 of CTA 2009 including profits that fall to be dealt with under Part 5 by virtue of Parts 6 and 7. Non-trading finance profits therefore include but are not limited to;

- Related transactions i.e. disposals or acquisition (in whole or in part) of rights or liabilities under a loan relationship
- Exchange gains and losses arising on loan relationships
- Repos and stock lending
- Relevant non-lending relationships
- Disguised interest
- Derivative contracts and related transactions

56. The definition also includes non-trading finance profits arising on relevant finance leases and any amounts that would be chargeable to corporation tax under Part 9A of CTA 2009 (company distributions).

Example

In several territories mandatorily redeemable preference shares are regarded as debt for tax purposes and distributions in respect of them may be taxable as a result of the operation of section 931D(c) CTA 2009. Such distributions will be non-trading finance profits for Chapter 5 purposes.

Non-trading finance profits - finance lease income

57. Finance lease profits are included within the definition of non-trading finance profits because in substance some forms of leasing are very similar to secured loan financing.

58. In the main these profits will normally be regarded as trading finance profits and should therefore fall within the scope of Chapter 10. In some cases however, profits from leasing may be treated as non-trading. Although this is likely to be in exceptional cases the rules allow for non-trading leasing income to fall within the scope of Chapter 5.

59. A lease for these purposes (which includes part of a lease) means the following:

- a long funding lease for the purposes of Part 2 CAA2001 which has to do with plant and machinery,
- A short lease for the purposes of that Part to the extent it meets the "finance lease test" in S70N of that Act (short finance lease).

Non-trading finance profits – group treasury companies

60. It is not uncommon for a multinational group to centralise its finance function in one or more large and complex group finance companies which might have a level of organisation sufficient for part or all of their activity to constitute a trade of a financial nature, such that profit from the trade would fall to be considered under Chapter 6 rather than Chapters 3, 5 and 9. Whether or not the activity constitutes a trade will be a question of fact. However such a company will be effectively operating in a similar manner to a retail bank with a high volume of transactions, a large number of incomings and outgoings, no structural lending activity and a small profit margin.

61. It is intended that a treasury company that has a mixture of [structural lending], non structural lending and other treasury activity should be able to choose between the Chapters 3, 5 and 9 rules for its finance profits, on the one hand, and Chapter 6 treatment, on the other. Structural lending typically will be long term lending for the purposes of capital investment by the group rather than the day to day lending generally undertaken via a cash pool. It is likely that a treasury company that has no structural lending activity and might for example be a standalone finance business or profits centre for the group (rather than simply existing to facilitate or support group activity) would instead choose to have Chapter 6 treatment which it is expected would result in the profits being exempt.

62. Section 371CE provides for a group treasury company to make a claim for all of its trading finance profits to be treated as if they were non-trading finance

profits. Section 371CE(2) provides that where a group treasury company issues a notice to HMRC then its trading finance profits will be treated as non-trading finance profits. However, Section 371CE(3) ensures that those profits are excluded from the incidental non-trading finance profits exemptions within sections 371CB(3) and (4). A group treasury company issuing a notice will not therefore be able to exclude any of its finance profits under those incidental rules.

63. The definition of group 'treasury company' for these purposes is taken from Part 7 of TIOPA 2010 at section 316(5) et seq. Essentially there are two conditions for a company to be entitled to make this claim:

64. The first is that its business should consist wholly or mainly of treasury activities, as defined in section 316(9);

65. The second is that at least 90% of the CFC's gross income for the relevant period is group treasury revenue as defined in section 316(10).

What is excluded from non-trading finance profits?

66. Section 371CB(3) excludes profits which arise from the investment of funds held for the purposes of a trade if that trade is carried on by a CFC and no trading profits for the accounting period pass through the CFC charge gateway. In effect such profits are treated as ancillary to the trade and their CFC status (whether within the scope of the CFC regime or not) depends on the status of the main trading profit.

67. Subsection (4) excludes profits which arise from the investment of funds held by the CFC for the purposes of its UK or overseas property business.

68. Subsection (5) sets out a number of circumstances in which the exclusions in subsections (3) and (4) will not apply and the non-trading profit will remain within the scope of the CFC charge. Those exclusions will not apply to thus non-trading finance profits arising from funds held:

- because of a prohibition or restriction on the payment of dividends imposed under the law of the CFC's territory of incorporation (but see below regarding short term restrictions). Upstream loans to the UK are often put in place in lieu of payment of a dividend and profits arising on these loans should not benefit from full exemption under the incidental exclusion which is targeted at non-trading finance profits incidental to trading activity. However where there is a temporary prohibition or restriction on a CFC paying a distribution such that the funds are still held with a view to making a distribution within 12 months of the end of the accounting period then the funds may still be excluded from non-trading finance profits by one of subsections (3) and (4) – see subsections (6) and (7);

- with a view to paying dividends or other distributions at a time after the relevant 12 month period – this period is defined in section 371CB(6) and (7) as being 12 months after the end of the accounting period. What this means is that groups that pursue an annual dividend policy that put the relevant funds on deposit pending the AGM or other meeting at which the dividend is declared will be able to benefit from the incidental exclusion. However groups that roll up funds indefinitely pending payment of a dividend will not;

- with a view to acquiring shares in any company, or making a capital contribution of some other type. This is because the incidental profits exclusion is meant for funds retained for working capital requirements and not for long term capital investments;
- with a view to investing in land at a time after the relevant 12 month period. Land for these purposes takes its definition from Schedule 1 of the Interpretation Act 1978 so that it includes buildings and other structures, land covered with water, and any estate, interest, easement, servitude or right in or over land. It is felt that 12 months is a sufficiently long period for a new property to be identified or, if not, it is likely that the funds would be distributed to be used more effectively elsewhere in the group. However, this condition is not intended to apply to funds retained for specific repair or maintenance programmes in relation to land and property already owned by the CFC;

- only or mainly for contingencies. A contingency is felt to be too vague in terms of timescale so that it could cause profits to be rolled up for extended periods of time and it is not the objective of the incidental exclusion to shelter such profits, or
- only or mainly in order to reduce or eliminate a tax or duty imposed by any territory. For example, funds might be retained because of a withholding tax on dividends. The incidental exclusion is not intended to cover funds retained for such reasons. However, the condition refers specifically to the reduction or elimination of tax or duty. It is not intended to target the retention of funds in order to meet a tax or duty liability – for example, the temporary retention of funds to cover payroll taxes.

69. In all of these circumstances the non-trade finance profits will remain within the scope of the CFC charge unless another exemption applies.

<u>The interaction of a Chapter 9 claim with Chapters 3 and 5</u>

70. Section 371CB(8) provides that where a chargeable company makes a claim under Chapter 9 (exemptions for profits from qualifying loan relationships) its qualifying loan relationship profits are excluded from the references to non-trading finance profits in this section and in Chapter 5. It is not possible to have some non-trading finance profits arising on qualifying loan relationships passing through into Chapter 5 and others subject to a claim under Chapter 9. A Chapter 9 claim includes all of a CFC's qualifying loan relationship profits except to the extent that they are regarded as incidental under section 371CB(3) and (4).

<u>Section 371CC – Incidental non-trading finance profits: the 5% rule</u>

71. Section 371CC excludes non-trading finance profits from Chapter 5 with the result that no non-trading finance profits pass through the Chapter 5 gateway if one or both of the requirements of section 371CC(1) are met and if those profits do not exceed a fixed 5% limit of "the relevant amount" – see subsection (2). The subsection (1) requirements are:

- (a) - the CFC has trading or property business profits (or both);

- (b) - the CFC has exempt distribution income and throughout the accounting period a substantial part of its business is the holding of shares or securities in companies which are its 51% subsidiaries.

The holding of shares or securities will be a substantial part of a CFC's business where in the accounting period:

- more than 20% of the CFC's gross income is represented by exempt dividend income from its 51% subsidiaries; or

- More than 20% of the net asset value in the CFC's balance sheet is represented by the investment in its 51% subsidiaries.

72. For the purposes of subsection (2), "the relevant amount" is defined in subsection (3) by reference to whether requirement (a) or (b), or both, are met. If requirement (a) is met then the relevant amount is the total of trading or property business profits, as calculated before any deduction for interest or any tax or duty.

73. If requirement (b) is met the relevant amount is the total of the CFC's exempt distribution income. Section 371CC(9) defines "exempt distribution income" as any dividends or other distributions which are excluded from the assumed total profits of the CFC because they would be exempt under Part 9A Corporation Tax Act 2009, the distribution exemption. If both (a) and (b) are met, the relevant amount is the sum of the two totals given by (a) and (b).

74. Where a CFC is within these limits then none of the CFC's non-trading finance profits will need to be considered under Chapter 5 and similarly a claim under Chapter 9 will not be required. Whilst a business cash pool or float needs will vary 5% has been chosen on the basis that it will cover most situations and be generous for many. Where a business consistently has a cash pool requirement in excess of 5% then the incidental rule in sections 371CB(3) and (4) will need to be considered.

Example

75. During AP1 CFC X has exempt trading profits before interest and tax of 1000.

CFC X also receives exempt dividend income from its wholly owned subsidiary Y of 1000. Y has no non trading finance profits arising in the AP

During the AP CFC X accrues non-trading finance profits of 80.

CFC X meets both requirements (a) and (b) and so the relevant amount is 2000.

5% of 2000 is 100 and so all of CFC X's non trading finance profits of 80 will be exempt and so CFC X will not need to consider Chapter 5 further.

76. By section 371CC(4), subsection (5) applies if requirement (b) is met and at any time during the accounting period a 51% subsidiary of the CFC is also a CFC ("the CFC subsidiary") and the subsidiary has relevant non-trading finance profits. If subsection (5) applies, the CFC subsidiary's relevant non-trading finance profits are to be added in with the non-trading finance profits of the CFC for the purpose of testing the 5% limit. This aggregation is required to ensure

that non trading finance profits are not simply accumulated amongst different companies within a group chain thereby effectively manipulating the 5% exclusion.

77. Section 371CC(6) and (7) define the CFC subsidiary's "relevant non-trading finance profits" with reference to whether it has an accounting period that is the same as, or falls wholly within that of the CFC, on the one hand, or, on the other hand, it has an accounting period which otherwise overlaps with that of the CFC.

78. Section 371CC(6) deals with a CFC subsidiary whose accounting period either matches or falls entirely within the accounting period of the holding company CFC, provided that by virtue of section 371CC or section 371CD, Chapter 5 does not apply to the CFC subsidiary for the relevant period.

79. The relevant non-trading finance profits of such a CFC are its non-trading finance profits for the relevant period to the extent they are exempt from Chapter 5 by virtue of s371CC or s371CD.

Section 371CC(7) deals with a CFC subsidiary whose accounting period overlaps with the accounting period of the holding company CFC, again except to the extent that by virtue of section 371CC or section 371CD, Chapter 5 does not apply to the CFC subsidiary for the relevant period. The relevant non-trade financing profits of such a CFC are a just and reasonable proportion of its non-trading finance profits for that period.

Section 371CC(5) only applies where the CFC subsidiary has non-trade finance profits which are exempt from Chapter 5 by virtue of Section 371CC or Section 371CD. If the subsidiary CFC has non-trade finance profits which are exempt from Chapter 5 by virtue of Section 371CB(3) or (4), or by virtue of the entity level exemptions contained in Chapters 10 to 14, then those non-trade finance profits would not fall within Section 371CC(5).

80. Section 371CC(8) excludes any trading profits that pass through the CFC charge gateway for the accounting period from the definition of trading profits for the purposes of this section.

Example

If a holding company has three CFC subsidiaries and the total relevant non-trading finance profits of those companies is 100, then this is added to the non-trading finance profits of the holding company (say 50) to give a total non-trading finance profits amount for the holding company of 150.

If the exempt Part 9A income of the holding company is 4000, the condition is met (4000@5% = 200 which is more than 150).

If the exempt Part 9A income of the holding company is 2500, the condition is not met (2500@5% = 125 which is less than 150).

The consequences of failing the section 371CC 5% safe harbour rule

81. Where the safe harbour in section 371CB is failed then a mixed activity CFC (i.e. one that has both exempt business income and exempt distribution income) would need to consider the application of the further 5% rule in section 371CD. But where the CFC has only exempt distribution income and has failed the 5% safe harbour then all of its non-trading finance profits will need to be considered under Chapter 5 unless it makes a claim in respect of qualifying loan relationship profits under Chapter 9 (the exempt finance profits regime).

Section 371CD – Mixed activity companies with non-trading finance profits exceeding the 5% safe harbour in section 371CC

82. Where a CFC is a mixed activity CFC it is entitled to an incidental non-trading finance profit safe harbour amount of up to 5% of its trading profits and property business profits and 5% of its exempt distribution income as described at section 371CC.

83. Where however a mixed activity CFC exceeds this combined non-trading finance profit limit, Chapter 5 will nevertheless not apply if the CFC's "adjusted non-trading finance profits" are no more than 5% of the total of the CFC's exempt distribution income. The "adjusted non-trading finance profits" are the CFC's non-trading finance profits excluding any profits falling within section 371CB(3) and (4). Thus it is necessary first to establish and exclude any amounts qualifying under subsections (3) and (4) and then to determine whether this amount of non-trading finance profit exceeds 5% of the CFC's exempt distribution income. Where it does all of the non-trading finance profit will fall within Chapter 5.

84. So the rule works in the following way.

    (i) Determine the non-trading finance profits that fall within subsections 371CB(3) and (4).

    (ii) Deduct (i) from the CFC's total non-trading finance profits.

    (iii) If the amount produced by the deduction at (ii) is less than 5% of exempt dividend income then all of the CFC's non-trading finance profits are exempt.

    (iv) If (ii) gives an amount which is more than 5% of exempt dividend income, then that entire amount is within Chapter 5.

85. Section 371CD(4) and (5) specify that the adjusted non-trading finance profits for the test in this section include any CFC subsidiary's relevant non-trading finance profits which are added to the CFC's non-trading finance profits for the purposes of section 371CC(2).

Example

During AP2 CFC X has an exempt trading profit before interest and tax of 2000.

CFC X also receives exempt dividend income from its wholly owned subsidiary Y of 1500. Y has no non trading finance profits arising in the AP

During the AP CFC X accrues non-trading finance profits of 200

CFC X meets both requirements (a) and (b) and so the relevant amount is 3500.

5% of 3500 is 175 which is less than the CFC's non trading finance profit of 200 and so it is necessary to carry out the following steps

(v) Determine the non-trading finance profit that is incidental to the trade. This is determined in the sum of 150.

(vi) Deducting 150 from the CFC's total non-trading finance profit of 200 leaves a balance of 50

(vii) 5% of the exempt dividend income in the sum of 1500 is 75

(viii) As (ii) is less than (iii) all of CFC X's non-trading finance profits pass through the Chapter 5 gateway and CFC X does not need to consider Chapter 5 further.

Example

During AP3 the facts are as above but the exempt dividend income received by CFC X is only 500.

5% of the exempt dividend income in the sum of 500 is 25. As this is more than the balance of non-trading finance profit of 50 after deducting the non-trading finance profits that are incidental to the trade then all of this balance will be dealt with under Chapter 5 (or Chapter 9 on the making of claim)

Section 371CE – Does Chapter 6 apply?

86. Chapter 6 (trading finance profits) applies for a CFC's accounting period only if the CFC has trading finance profits and at any time during the accounting period it has funds or other assets derived directly or indirectly from UK connected capital contributions. Trading finance profits are defined in section 371VG(4) – they are profits arising from loan relationships, derivative contracts or company distributions that are included in a trade profits computation.

87. UK connected capital contributions are defined at section 371VA as any capital contribution to the CFC made (directly or indirectly) to the CFC by a UK resident company connected with the CFC (whether in relation to an issue of shares in the CFC or otherwise). A capital contribution can be in kind or in cash and can involve the issuance of shares or not. However, it will not include a situation where a liability to repay the capital contribution (e.g. by recognising a loan or other future obligation) arises when it is made, provided the contribution gives rise to taxable credits for the UK resident company that made it.

88. Where the CFC is a group treasury company (under section 316 of TIOPA 2010) in the accounting period a notice may be given to an officer of Revenue & Customs requesting that Chapter 6 will not apply and that trading finance profits

will be treated as if they were non-trading finance profits. The notice must normally be given within 20 months after the end of the accounting period, although a longer period may be allowed by an officer of Revenue & Customs.

89. Subsection 371CE(5) allows a company to give such a notice if it would be a chargeable company for the accounting period and the percentage of the CFC's chargeable profits to be apportioned to it would be more than half of the total percentage of the CFC's chargeable profits which would be apportioned to chargeable companies.

90. Subsection 371CE(6) allows two or more companies to give such a notice if they would be chargeable companies and the percentage of the CFC's chargeable profits to be apportioned to them, taken together, would be more than half of the percentage of the total percentage of the CFC's chargeable profits which would be apportioned to chargeable companies.

Section 371CF – Does Chapter 7 apply?

91. Section 371CF provides that Chapter 7 (captive insurance business) applies for a CFC;s accounting period only if at any time during that period the main part of its business is insurance business, and its assumed total profits include amounts derived (directly or indirectly) from contracts of insurance as specified in subsection 371CF(2). These are contracts entered into with :

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

92. a UK resident person where the contract is linked (directly or indirectly) to the provision of goods or services to the UK resident person by a UK connected company. This excludes services provided as part of insurance business.

Section 371CG – Does Chapter 8 apply?

93. Section 371CG provides that Chapter 8 (solo consolidation) only applies for a CFC's accounting period if either of two conditions is met.

94. The first condition is that at any time in the accounting period the CFC is a subsidiary undertaking which is the subject of a solo consolidation waiver under section BIPRU 2.1 of the FSA Handbook, and the CFC's parent undertaking in relation to that waiver is a UK resident company.

95. The second condition is that at any time in the accounting period the CFC is controlled by a UK resident bank (alone or with other persons) which holds shares in the CFC, the UK resident bank must meet the requirements of the FSA Handbook in relation to its capital and any fall in the value of those shares would be (wholly or mainly) ignored for the purpose of determining whether the UK resident bank meets the requirements of the FSA Handbook in relation to its

capital. The application of this condition however is limited to circumstances where the main purpose, or one of the main purposes of the UK resident bank in holding the shares is to obtain a tax advantage for itself or any connected company.

96. Solo consolidation is an arrangement whereby the FSA allows a regulated financial company to treat an unregulated subsidiary for regulatory purposes as if it were a division of the regulated company. A company that wishes to solo consolidate must apply to the FSA for a waiver.

97. Section 371CG(4) provides definitions of the terms “FSA Handbook” and “UK resident bank” used in the section. Subsections (5) and (6) provide that the Treasury may by regulations amend the chapter, or Chapter 8, to take account of changes to or replacement of the relevant regulatory publications.