CHAPTER 9 – EXEMPTIONS FOR PROFITS FROM QUALIFYING LOAN RELATIONSHIPS

Overview

1. Chapter 9 provides the rules for full and 75% exemption of certain non trading finance profits ("NTFPs") that might otherwise pass through the CFC charge gateway because they fall within Chapter 5 (The CFC charge gateway: non-trading finance profits). Chapter 9 only applies to profits that arise from qualifying loan relationships ("QLRs") as defined on the making of a claim and where the business premises condition is met. Chapter 5 in contrast can apply to all NTFPs of the CFC.

2. The exemptions for NTFPs provided within Chapter 9 have been introduced to address the difficult issues which arise as a result of the fungibility of money within a multinational group. The rules represent to a large extent a proxy for establishing the exact source and history (tracing) of a group's financing arrangements and the extent these are borne by the UK.

Partial Exemption

3. In general it is expected that three quarters of the finance income arising on intra group loans between non UK resident members of a UK headed multinational group will be exempt from UK tax. Interest on money deposited with a third party such as a bank will in general be a 'diverted profit' that is within the scope of the Chapter 5 charge gateway. An example might be a cash-rich group that has invested its surplus funds in a bank based in a tax shelter.

Qualifying resources

4. The qualifying resources' rules identify certain circumstances where there is no direct or indirect connection between a CFC's lending and wider group funds. To the extent that it can be shown that a loan is funded out of qualifying resources, an equivalent proportion of the profits derived from the loan will be exempt from the CFC charge. These rules are optional and will only be beneficial where the qualifying proportion exceeds 75% due to their interaction with the partial exemption rules.

Matched interest rule

5. The CFC charge for intra group interest is capped at the level of net UK interest expense within the UK group calculated using worldwide debt cap principles (Part 7 TIOPA 2010). CFC charges in respect of NTFPs are treated as UK financing income for the purpose of calculating the cap. Overall the cap prevents the apportionment of NTFPs when the UK members of the group, in aggregate, have net financing income which is equal to or greater than their net financing deductions.

Limitations

6. As well as rules that limit the extent to which claims for full and 75% exemption of a CFC's NTFPs can be made, the rules in Chapter 9 also include restrictions to

prevent abuse, for example by excluding loans made to the UK, and by excluding arrangements where external loans are moved from overseas to the UK to create a UK tax saving.

Introduction

7. Where a CFC has NTFPs , the UK resident company (the chargeable company) that will be subject to a CFC charge, or would be subject to a CFC charge but for the claim, may make a claim that those NTFPs, to the extent they arise from QLRs, should be taxed in accordance with the rules in Chapter 9 rather than those in Chapter 5. A claim must be made by each chargeable company. So if two UK resident group companies each have a 50% relevant interest in the CFC, both companies need to make a claim that either full exemption or 75% exemption applies to the NTFPs arising on the CFC's QLRs.

8. To be eligible to make a claim the CFC must have business premises at its disposal in its territory of residence from which the business of the CFC is in the main carried out (section 371IA(1)(c) and section 371DG).

9. The claim will apply to all of the NTFPs arising on the CFC's QLRs, unless any such profits are incidental to any exempt business activity of the CFC. Any such incidental profits are fully exempt under the rules for incidental income in Chapter 3 and so are excluded from both Chapter 5 and any Chapter 9 claim (sections 371CB, CC and CD). Exempt business activity for the purposes of the CFC rules is either property business or a trade carried on by the CFC, no trading profits from which pass through the CFC charge gateway for the accounting period.

10. Where Chapter 9 applies, it will operate to partially or fully exempt any CFC charge that would otherwise arise for the chargeable company that makes the claim in respect of the NTFPs from QLRs.

11. In general, only a quarter of the NTFPs from QLRs of the CFC arising in the accounting period (AP) will pass through the CFC charge gateway and so be included in the CFC's chargeable profits i.e. Chapter 9 will operate to exempt 75% of the potential apportionment. This is "the 75% exemption" at section 371ID. The claim extends only to the chargeable company or companies making the claim, so affects the computation of the CFC charge for that company or companies only.

12. In specified circumstances NTFPs from QLRs may be eligible for full exemption either under the "loans funded out of qualifying resources" rule at sections 371IB and 371IC or the "matched interest" rules at section 371IE. While a claim under Chapter 9 is also required to exempt profits under the matched interest rule; this rule only applies to NTFPs from QLRs to the extent that they aren't already exempted under either the qualifying resources rules or the 75% exemption rules.

13. Only certain NTFPs are eligible for a Chapter 9 claim. Typically, the Chapter 9 exemptions will be available where there is straightforward intra group funding. An example might be where CFC X in Country Y needs a long term loan to invest in its exempt (in terms of the CFC rules) business activities. The group has resources to fund this loan and so it is not necessary for CFC X to borrow

externally. Instead it borrows from a group finance company that has been equity funded using surplus group resource from the UK. Many groups have arrangements of this nature and should find identifying the NTFPs and making a claim straightforward. A Chapter 9 claim will therefore cover:

- NTFPs that in substance arise to a CFC from loans to non-UK resident connected persons controlled by the UK person or persons that control the CFC; and
- Consequential profits and losses such as FOREX adjustments on the QLR and any associated hedge of either FOREX or interest rate risk in relation to the QLR or a loan that is the source of funds for the QLR.

14. A Chapter 9 claim will generally not cover:

- NTFPs in respect of loans to UK resident connected persons;
- NTFPs in respect of loans to unconnected persons or connected persons who are not controlled by the same UK person or persons who controls the CFC;
- NTFPs in respect of loans to CFCs where the effect of the loan is to reduce the borrowing CFC's chargeable profits (unless the profits that are reduced are themselves calculated under Chapter 9) or where the debits are relevant to the application of the Low Profits Exemption in Chapter 12;
- NTFPs in respect of loans to UK and non-UK resident connected persons where the loan has been sourced from a UK resident person undertaking banking or insurance business; and
- NTFPs in respect of loans to non UK resident connected persons where the loan is part of an arrangement to replace external debt of the non-UK resident connected person with external debt of a UK resident connected person as part of an arrangement that has a tax advantage main purpose for any person.

15. NTFPs from QLRs may in practice be exempt under the Tax, Exempt Period, Low Profits, Low Profit Margin or Excluded Territories exemptions. Chapter 5 will have no application where a CFC meets the conditions for these entity level exemptions and a CFC which meets the conditions for any of them will be exempt in full on all of its profits.

Scope of the rules

16. Section 371IA(1) introduces Chapter 9 which provides the rules for full and 75% exemption of certain NTFPs that might otherwise pass through the CFC charge gateway because they fall within Chapter 5. Chapter 9 only applies to profits that arise from QLRs as defined at section 371IG and limited by section 371IH and where the business premises condition at section 371DG is met. Chapter 5 in contrast can apply to all NTFPs of the CFC.

17. The business premises requirement for a finance company applies in the same way as the business premises requirement for the trading profits exclusion provided in Chapter 4. The business premises in the territory of residence of the CFC have to be in use by the business with a reasonable degree of permanence, or at least be intended to be used in this way. In some cases, the activities of a financing CFC

with very few loans may not be significant and the business premises will not be used every day, or even for days at a time. In these cases it is not expected that the CFC will have business premises available every day of the year, but that the CFC will have access to those premises when it needs to, and that that access is assured over say a 12-month period.

18. The business premises test is not intended to be an onerous condition to meet but nevertheless the business premises at the CFC's disposal should be sufficient to enable it to conduct its business activities from those premises and should be commensurate with the level of activity. Where the activities of the CFC are undertaken in its territory of residence (for example Board meetings and day to day activities of the company) they must in the main be undertaken from those premises. There is no requirement for all the activities of the CFC to be conducted from the premises and some degree of outsourcing of activities will not mean the test is failed. For example, if legal services are outsourced to a local firm rather than conducted in-house at the business premises, this does not mean the premises test won't be met. However, outsourcing all activity, leaving only an annual board meeting to be held in the business premises is unlikely to satisfy the requirements of the business premises test.

19. It is irrelevant for the purposes of the business premises test whether the premises are owned or leased by the CFC. Nor is there a requirement that the activities must only be undertaken from one location in the CFC's territory of residence.

20. Section 371IA(9) excludes from a CFC charge under Chapter 9 any NTFPs where they:

    - arise from the investment of funds held by the CFC for trading purposes;
    - arise from the investment of funds held by the CFC for the purposes of a property business;
    - fall within Chapter 8 (solo consolidation);
    - arise from a relevant finance lease.

21. Section 371IA(10) explains that a loan relationship for Chapter 9 purposes is limited to a loan relationship that is a money debt arising from a transaction for the lending of money as defined at section 302(1) CTA 2009. This will include;

    - An acquisition of an asset that is left on loan account
    - An instrument issued in exchange for the issue of shares by virtue of section 303(3) CTA 2009
    - Loans where the interest payable may be dependent on the profits of the borrower, or loans which carry a conversion option into shares provided the loan otherwise meets the requirement of section 302(1) CTA 2009.

22. This is in contrast to Chapter 5 where NTFPs will include any profits that fall to be dealt with under Part 5 of CTA 2009 by virtue of Parts 6 and 7 of CTA 2009 and will also include NTFPs 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 local tax purposes and as a result distributions in respect of those shares are taxable as a result of the operation of section 931B(c) or 931D(c) CTA 2009. Such distributions will be NTFPs for Chapter 5 purposes but not for Chapter 9 purposes as they do not arise on a money debt which itself arose from a transaction for the lending of money. The debt has not arisen as a consequence of a funding need of the CFC but instead is a statutory deduction offered by a number of non UK jurisdictions for a variety of tax and non tax related reasons.

23. A chargeable company must make a claim to an officer of Revenue and Customs under Section 371IA(2) in order for Chapter 9 to apply. Where a claim is made the rules in Chapter 9 apply by virtue of section 371CB(8) to all of the NTFPs arising from QLRs of the CFC for the accounting period.

24. The full and 75% exemptions are given by way of an adjustment that is made to a CFC's chargeable profits and creditable tax for an accounting period at step 2 of section 371BB(1). Section 371IA(3) provides that it is only those QLR profits that are not fully exempt under Chapter 9 that will form part of a CFC's chargeable profits.

Example

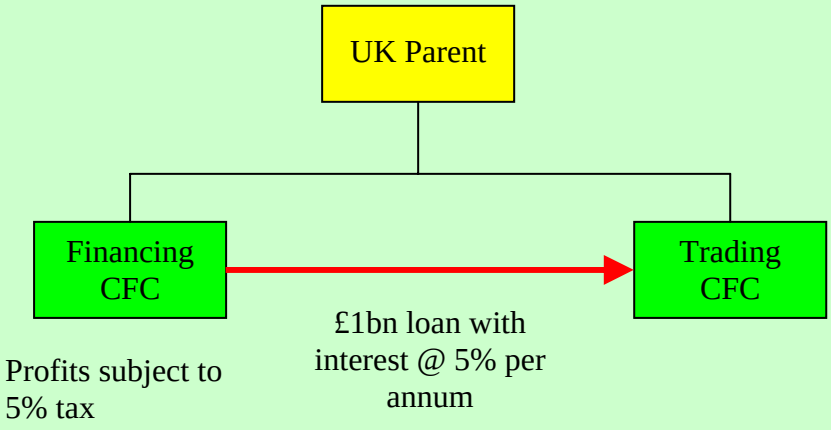
A CFC has the following NFTPs arising in an accounting period

- £10m from loan A that is a QLR
- £20m from loan B that is a QLR
- £15m that are non-exempt distributions

A claim is made for Chapter 9 to apply, specifying that section 371IB should apply to the profits in respect of loan A, exempting 90% of the NFTPs from that loan. Section 371ID applies to loan B. As a result of the claim profits of £6m pass through the CFC charge gateway by way of Chapter 9 (£1m from loan A and £5m from loan B); the remaining profits of £15m do not pass through the CFC gateway by way of Chapter 9 as the non-exempt distribution profits do not fall within section 302(1) CTA 2009. Instead the £15m non-exempt distributions will pass through the CFC gateway by way of Chapter 5 (on the assumption for this example that the profits fall within Chapter 5)

25. For Chapter 9 purposes double tax relief will be proportionate to the profits that are subject to tax in the UK in accordance with Chapter 16.

Example



The CFC has NFTPs of £50m. A claim under Chapter 9 is made, exempting 75% of the NFTPs. The CFC pays tax of £2.5m in its territory of residence; a quarter of that tax, £0.63m is creditable tax that is taken into account in calculating the CFC charge at step 5 of section 371BC(1).

26. Section 371IA(5) provides that profits are exempted firstly by applying the qualifying resources and 75% exemption rules at sections 371IB and 371ID respectively and then by applying the matched interest rule at section 371IE.

27. This particular order of claim is largely a by-product of the fact that the qualifying resources rule and the 75% exemption rule apply on a loan by loan basis and are therefore given priority to the matched interest rule which applies to all of the QLRs of a CFC. However in practice if a group considers it would be eligible for full exemption under the matched interest rule in respect of all of its qualifying NTFPs, there will be no need to consider the qualifying resources rule or the 75% exemption rule and the Chapter 9 claim should stipulate that all NTFPs are exempt under section 371IE.

What is a "qualifying loan relationship"?

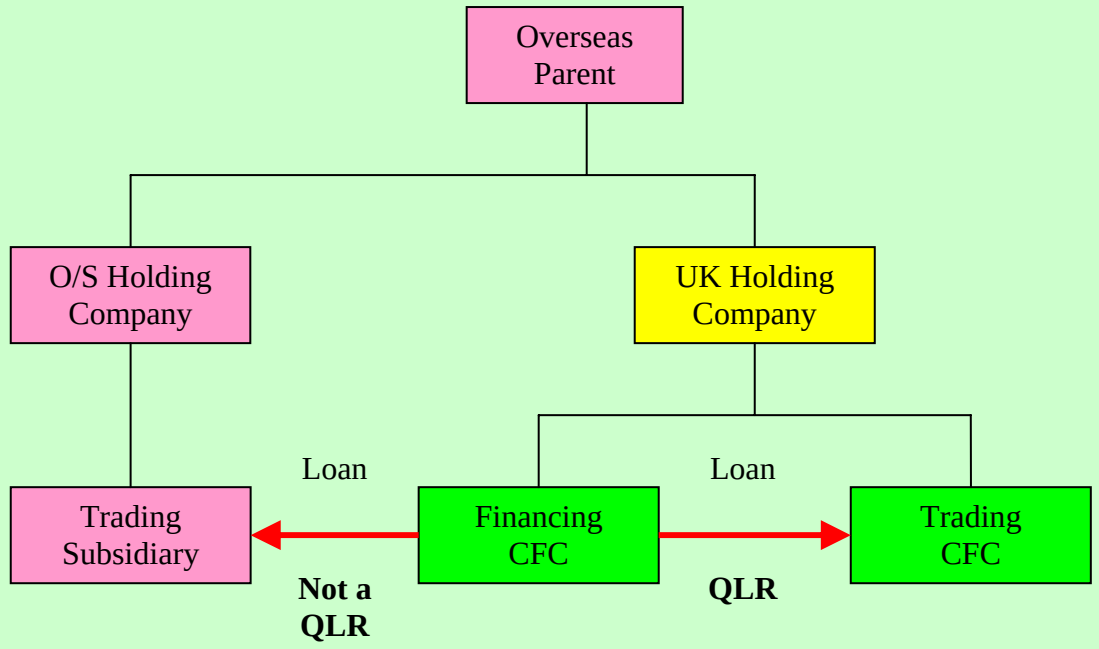
28. Section 371IG(1) sets out the conditions for a loan relationship of a CFC to be treated as a QLR. These are where in relation to the QLR:

- the CFC is the creditor;
- "the ultimate debtor" is a "qualifying company" (which is defined in section 371IG(8) as a company that is both connected to the CFC and controlled by the same UK resident person or persons that control the CFC); and
- section 371IH does not apply to treat the loan as non-qualifying.

29. Section 371IG (1)(a) and (8) mean a Chapter 9 claim only applies to loans between non UK resident connected persons where the ultimate debtor is controlled by the same UK resident persons who control the CFC lender. Control in this context means control as defined by Chapter 18. Without this condition, the effect of allowing a Chapter 9 claim would be similar to the consequences resulting from allowing a Chapter 9 claim on loans to third parties.

The requirement for common control also prevents arrangements under which the UK takes on large amounts of debt in order to fund intra-group financing arrangements for non-UK headed groups.

Example



<u>The ultimate debtor rule - overview</u>

30. The ultimate debtor rule was introduced in part to ensure that loans that would otherwise qualify for the finance company exemptions within Chapter 9 are not prohibited from so qualifying because they are routed through one or more companies for commercial reasons. The rule "looks through" intermediate steps to establish where money is actually being lent. Those steps might be a straightforward conduit with a loan being made using back to back to arrangements with another person, or might involve a more complex arrangement using an equity investment in a conduit company which makes an equity investment in a second conduit which in turn makes a loan to the ultimate debtor.

Example

Money is deposited with a third party bank by a CFC, as part of an arrangement by which the bank makes a loan to a connected person, P. The loan was routed via the third party bank because of local restrictions on intra group borrowing. A loan from the CFC direct to P would qualify for the exemptions within Chapter 9. In this scenario the ultimate debtor rule applies to treat P as the ultimate debtor rather than the bank so that the Chapter 9 exemptions are available to the CFC.

31. The ultimate debtor rule also operates to prevent any planning to circumvent other rules within Chapter 9 (mainly the qualifying loan relationship rules), again to ensure a claim under Chapter 9 is considered by reference to the actual borrower.

Example

A loan is provided from a CFC to another overseas group company (that is able to claim the tax exemption under Chapter 14), which places the money on deposit with a bank, or makes an upstream loan to a UK resident group company. The terms of the loan more or less match those of the deposit with the bank or the upstream loan. In either case, the bank or the UK resident group company is treated as the ultimate debtor.

32. The ultimate debtor rule is not intended to impose a tracing requirement on each and every loan within the group. It is however in part intended to prevent the qualifying company rules being exploited and where this appears to be a risk, groups should be expected to provide evidence sufficient to establish the identity of the ultimate debtor. And while the ultimate debtor rule is also intended to provide groups with the opportunity of conduiting loans, groups wishing to take advantage of the rule will need to be able to provide evidence sufficient to establish the identity of the ultimate debtor.

<u>The ultimate debtor rule – detailed application</u>

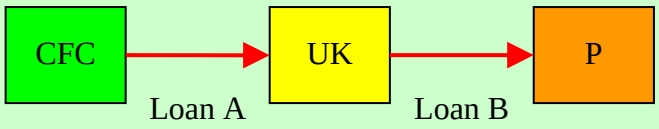
33. The "ultimate debtor" condition ensures that a QLR is defined by reference to who, in substance, the real borrower is. Section 371IG(2) provides that the ultimate debtor is the immediate debtor in relation to a QLR unless section 371IG(3) applies to look through any conduit type arrangements.

34. Sections 371IG(3) to (6) establish who the ultimate debtor is where a loan is made and used (directly or indirectly) to fund another loan. They provide that the ultimate debtor will be a person ("P") if:

- the loan to the debtor of the CFC is made for the purposes of funding a loan to P;
- the loan to P is not used for the purposes of funding a loan to any other person; and
- the loan to P gives rise to a loan relationship in relation to which P is the debtor.

Example

A loan is provided to a UK resident person as part of an arrangement to facilitate a loan on substantially the same terms from that UK resident person to a non UK resident connected person, P. The ultimate debtor rule applies to treat P as the ultimate debtor.



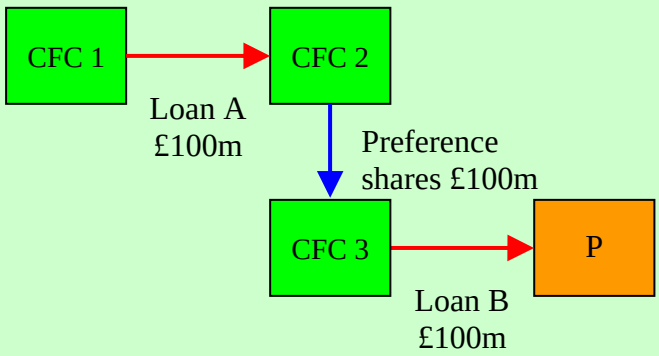
35. It is possible that this type of arrangement is being used to avoid another country's withholding tax. If a CFC in country A were to lend £100m to a group company

resident in country B, that company might be required to withhold tax on the interest paid on the loan. However if the double taxation agreements between country A and the UK and country B and the UK provide that interest can be paid gross, then it might be argued by the group that routing the loan via the UK means the withholding tax that would be charged by country B is avoided. This type of arrangement does not affect any claim under Chapter 9, but if it is considered that such an arrangement is in place in order to avoid another country's withholding tax you should provide details of the arrangements to CTIAA Business International, Outward Investment Team so consideration can be made as to whether the terms of a DTA or the European Directive relating to the exchange of information require the UK to exchange information with another fiscal authority.

36. In other cases where a UK resident company is used as a conduit, the UK resident company may claim double taxation relief in respect of withholding tax deducted from interest paid to the UK conduit company. In these circumstances relief for foreign tax is restricted as the UK is being used a conduit rather than being the primary lender. Guidance on the application of this restriction can be found through this link [insert hyperlink to guidance on FB13 changes to DTR]

37. The look through provisions are not restricted to cases where funds are passed by way of loans. Section 371IG(3) refers to loans that are used to fund (directly or indirectly) other loans, but does not provide any restriction on the form of that funding. Funds might be provided using an arrangement that involves an equity investment.

Example

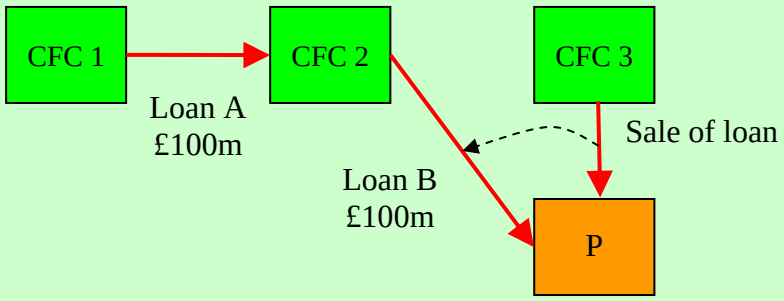


A loan (loan A) of £100m is made by CFC 1 to CFC 2, which in turn acquires £100m preference shares issued by CFC3. That CFC makes a loan of £100m to P. The first loan and the investment in preference shares are all part of an arrangement to provide CFC 3 with the funds to make a loan of £100m to P. This second loan (loan B) has been indirectly funded from loan A. The ultimate debtor is P.

38. Funding a loan for the purposes of the ultimate debtor rule includes lending money to another company for the second company to acquire an existing loan.

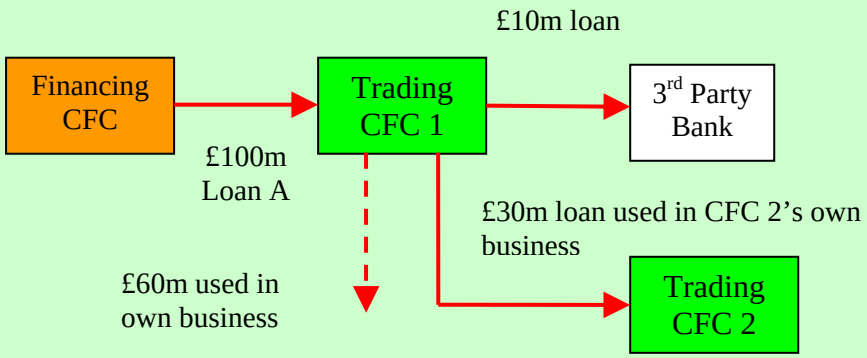
Example

CFC 1 lends to CFC 2 which acquires a loan to CFC P from CFC 3. CFC P has used the funds for qualifying purposes under section 371IH. P is the ultimate debtor in respect of the loan from CFC 1 to CFC 2.



39. For the purposes of the ultimate debtor rule a part of a loan may be treated as a separate loan. By virtue of sections 371IG(6) and (7), where a loan from a CFC to a debtor A is used partly for the purposes of A's trade and partly to fund a loan to B then there will be two loans with two ultimate debtors, A and B.

Example



In this example the ultimate debtor rule by virtue of section 371IG(6) and (7) establishes there are three ultimate debtors and so three deemed loans, each of which are considered separately (by reference to the particular ultimate debtor) as to whether they are QLRs.

£60m of the £100m is treated as a QLR as it is made to a qualifying company and is used by that company wholly within its trading business. £30m of the £100m is also a QLR for the same reason. The remaining £10m is not a QLR as it is not made to a qualifying company.

Test by reference to accounting period

40. The ultimate debtor rule is an accounting period by accounting period test. This means that the assessment of who is the ultimate debtor in relation to a loan (or part of a loan) needs to be re-assessed in each accounting period. This means that,

with a change of ultimate debtor or a change in the circumstances of the ultimate debtor, a loan could change from being qualifying to non-qualifying, or vice versa. The purpose behind the borrowing is only important to the extent that a loan is made to one person with the intention that it is then on-lent (in whole or in part) to another person. Otherwise the purpose for borrowing (e.g. to provide working capital for a group company) will not have a bearing on any possible change in circumstances of the ultimate debtor. In practice it is expected that once the ultimate debtor is established in relation to a loan then there should be no need to retest on an annual basis unless there has been a change in facts and circumstances. As the loans subject to the ultimate debtor rule are likely to be the significant structural loans within a group those individuals within the group managing the loan should be aware of the need to notify the tax department of any change to the facts and circumstances of the loan.

Example

A loan is made by a CFC to another CFC which is a qualifying company. The loan is used to fund a distribution by the second CFC and is agreed to be a QLR. Three years later the tax residence of the second CFC changes because central management and control is exercised from the UK and so the company is now treated as a UK resident company. From that point onwards the company is no longer a qualifying company and so the original intra-group loan is no longer a QLR.

Example

A loan is made by a CFC A to another CFC B which is a qualifying company. The loan is used by the second CFC to acquire a foreign investment property. The loan is agreed to be a QLR. After 3 years the property is sold and the funds deposited with a local bank. At that point the loan will cease to be a qualifying loan as the ultimate debtor will be an unconnected third party. It is possible that the NTFPs arising on the bank deposit by CFC B will be treated as incidental by virtue of section 371CB(4) and so won't be caught by Chapter 5, but that is a separate issue and the answer to that question will not change the fact that the loan is no longer a QLR.

Loans to partnerships and other transparent entities

41. Some intra-group financing arrangements will involve loans to a partnership or other type of transparent entity. While UK tax rules treat a UK corporate partner in a partnership as the borrower for tax purposes (rather than the partnership), this will not necessarily be the case when looking at an entity with overseas corporate partners. Whether the ultimate debtor for the purposes of s371IG(1)(a) are the partners or the partnership will depend on how the relevant partnership is treated for tax purposes in its territory of residence i.e. are there similar "look through" rules that treat the entity as "transparent" or in the absence of such rules whether under its governing law, corporate or otherwise, how it is treated i.e. does the partnership have legal personality (and so could be sued)? Where a CFC makes a loan to an entity within a group that is transparent from a local tax perspective and doesn't have a separate legal personality, the company partners will likely be the

ultimate debtors in relation to such a loan, rather than the partnership. This means that a claim under Chapter 9 can still be considered in respect of the loan, but the question of who are the ultimate debtors may be settled by reference to who the partners are.

42. Establishing the identity of the ultimate borrower is important because under s371IG(1)(a) TIOPA 2010, one of the conditions for a loan made by a CFC to be a QLR is that the ultimate debtor is a qualifying company. There is no definition of company within Part 9A (other than to include cells in a cell company as if they are separate companies) and so the general definition at section 1121 CTA 2010 is applicable. Under s1121 CTA 2010, "company" means any body corporate or unincorporated association, but does not include a partnership. Therefore, a partnership is not a company for the purpose of assessing whether a loan is a qualifying loan relationship.

43. Where a loan is treated as made to the partners that are companies, rather than the partnership, then the loan would be split between the company partners in accordance with the partnership's profit sharing arrangements or other legal agreements that govern the share of the partnership's profits, assets and liabilities.

Loans to banking and insurance companies, and group treasury companies

44. The ultimate debtor rule is modified for banking or insurance groups. Section 371IG(7) disapplies the look through provisions in subsections (4) and (5) in respect of a loan made by a CFC to a qualifying company whose main business is banking or insurance and the loan is made in the ordinary course of that business (in other words the group company receives that money as part of its business and uses that money to make loans in the ordinary course of its business).

45. However, the look through provisions still apply if that group banking or insurance company uses the loan to fund a loan to a UK resident qualifying company; instead the lending must be to a third party. If a loan from a CFC passes through one banking or insurance company to another banking or insurance company, then the subsequent lending by the second company is tested to see whether it is made to a UK resident qualifying company.

46. Without this effective 'switch off' of the ultimate debtor rule for banks and insurance companies, it would be difficult for the 75% exemption to apply to CFCs lending to such companies as the funds received would always be used to on-lend given this is the trading activity of such companies. There may be arguments that a banking or insurance company would not be able to identify loans from a CFC that are then used to fund loans to other group companies rather than third parties. However there is a distinction between say a CFC that might deposit surplus cash with a member of the same group that carries on banking activity and earn interest that would be treated as incidental NTFPs under section 371CB or CC , and a financing CFC whose profits fall within Chapter 5. If such a CFC is funding a banking or insurance company, then we would expect the group to be able to demonstrate there is no subsequent lending to other UK resident qualifying companies; or, if there is lending that is it clear there is no link with the lending from the CFC.

47. Banking business is defined in section 371VA to mean the business of;

    a. banking, deposit-taking, money-lending or debt-factoring, or

    b. any activity similar to an activity falling within paragraph (a).

48. It is possible that a treasury company in a non-financial services group could be undertaking banking activity that falls within s371VA so that it would then be potentially subject to section 371IG(7). This could present problems where the treasury company is a UK resident group company that is a qualifying company, as the treasury company may be treated as the ultimate debtor, as opposed to say another non-UK resident qualifying company that the UK treasury company on lends to. However if it can be demonstrated in any case that a treasury company is simply a conduit and there is a clear link between a loan going in and a loan going out then section 371IG(7) will not apply in respect of that loan.

49. A company will only fall within the banking definition in section 371VA where there is significant activity with a high volume of transactions that indicates that the treasury company is effectively acting as an in-house bank for the group. Any claim that the activity of a group treasury company meets the definition of banking business will need to be considered critically where the treasury company is making loans to UK resident group companies or has deposited significant amounts of money with a third party.

Interaction of amounts exempted under Chapter 9 and subsequent adjustments under Chapter 6

50. The fact that the ultimate debtor rule would almost certainly prevent any loan to a financial trader from being a QLR is mitigated by removing that restriction in the case of a loan to a bank or insurance company that lends the money on in the ordinary course of its banking or insurance business. However to the extent that the loan then qualifies for full or partial exemption under Chapter 9, it will be treated as if it were an equity investment for the purposes of section 371FA, by way of subsection 371FB(2). So if a CFC's NTFPs from a QLR to a connected CFC within Chapter 6 are wholly exempt, then 100% of the principal value of the loan outstanding during the accounting period should be added to the balance of the CFC's free capital (as defined in subsection 371FA(2)) if the CFC is a bank or free assets (as defined in subsection 371FA(3)) if the CFC is an insurance company. Section 371FC applies a similar rule where the creditor is not a CFC but an exempt PE within Chapter 3A of Part 2 of CTA 2009. So loans that are treated as QLRs from exempt PEs will therefore be counted as equity for Chapter 6 purposes in the same way as loans that are treated as QLRs from CFCs.

    This rule has the effect that profits from QLRs where a banking or insurance CFC is the ultimate debtor can qualify for full/partial exemption provided that the loan is not funded from the UK directly or indirectly from a UK resident bank or insurance company. If the loan leads to overcapitalisation of the banking or insurance CFC, this does not prevent the profits of the lending CFC from being exempt but a charge under Chapter 6 may arise on the banking or insurance CFC if some or all of the overcapitalisation is derived from UK connected capital contributions.

Cash pooling

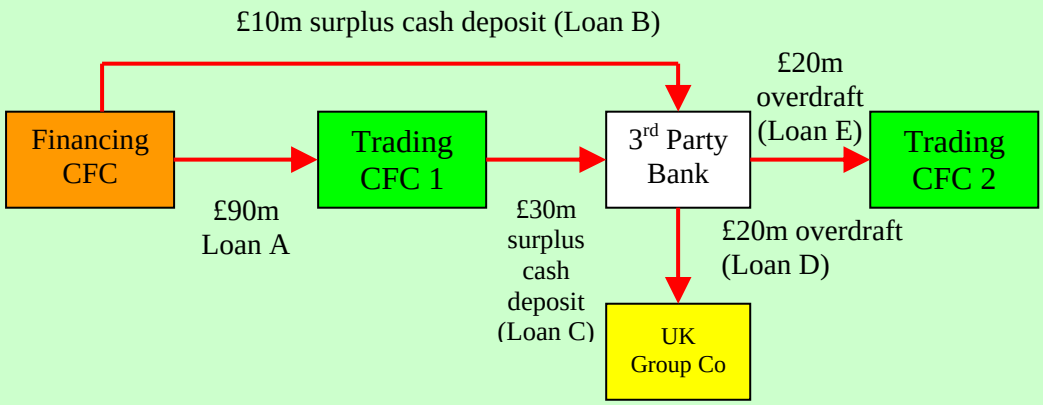
51. There are a number of circumstances where a CFC may deposit funds for a short period of time with a bank or a group treasury company. For example, a CFC may deposit cash from dividends received from subsidiaries or cash received from the issue of shares for a short period of time in its bank account. NTFPs earned in respect of such deposits will not be NTFPs from QLRs. However monies on deposit in this way should most likely benefit from the holding company incidental income exclusion in one of sections 371CC or 371CD. However if those exclusions are unavailable then amounts may pass through the chapter 5 charge gateway as the ultimate debtor in these circumstances is an unconnected company.

Example

The funds provided by a loan made by a CFC to a qualifying company are temporarily deposited with a local bank for two weeks before being used in the company's property business. The deposit for this short period would not be treated as though the loan from the CFC had been used to make a loan to another person; the deposit would just be treated as merely incidental to the purpose of making the investment and not as making a further loan for that period. Whether NTFPs arising on a short term deposit of this nature with a third party or with a UK connected company should be treated as incidental to the intended business purpose of the loan will be a question of fact.

52. It is possible that the ultimate debtor rules might have an impact on a group's cash pooling arrangement. For example, a group might operate a cash pool that is centralised in a UK treasury company, with all members of the group being required to use the cash pooling arrangements. A cash pool is usually used to manage the short term working capital requirements of the group. CFCs within the group that have cash on deposit with the pool would be expected to benefit from the incidental finance income exclusions within Chapter 3 [sections 371CB, CC and CD] and so the ultimate debtor rule would not apply to such short-term loans (because the NTFPs from the short-term loans would not fall within Chapter 5). However, if a CFC makes a long-term loan to the UK resident treasury company, which in turn uses the funds to make a series of short term loans to other group members, then the NTFPs of the CFC will most likely fall within Chapter 5 and, if a claim under Chapter 9 is made, the ultimate debtor rules will need to be considered. In practice groups will need to separately identify such loans from the generality of the cash pool for accounting purposes and so the tracing requirement imposed by the ultimate debtor rule should not be unduly onerous.

Example



The above cash flows represent a highly simplified snap shot of what a group's cash pooling arrangement might look like. In order to apply Chapter 9 to such arrangements the following are some of the factors that should be borne in mind;

- A group's cash pooling arrangements (even where the Financing CFC does not directly participate) will require review and consideration as part of the overall risk assessment for the group
- Physical cash sweeping arrangements may be more difficult when establishing the ultimate debtor for Chapter 9 purposes where this is necessary i.e. the cash pool includes non incidental loans
- Incidental temporary fluctuating surpluses (e.g. Loan C) placed with a bank by a foreign borrower are unlikely to taint an otherwise qualifying loan (Loan A)
- BUT, structural deficits funded from the cash pooling arrangement may cause problems (e.g. if the £20m overdraft (Loan D) to the UK has some degree of permanence the UK may be the ultimate debtor in relation to the structural deficit and so a CFC charge may be applicable in relation to NTFPs arising on the balance – a Chapter 9 claim would not be available).
- If loan B was a long term loan, this would mean the NTFPs earned on that loan would be caught under Chapter 5. Unless the group could demonstrate that loan B was wholly used to fund loan E, the loan would not be a QLR as it would be treated as a loan to a third party.

What is excluded from the definition of a "qualifying loan relationship"?

53. While section 371IG explains what a qualifying loan relationship (QLR) is, section 371IH sets out specific circumstances under which a loan cannot be a QLR. In brief these are:

- A loan used for the purposes of a UK permanent establishment or UK property business
- The ultimate debtor is a UK resident company, unless the loan is attributed to an overseas exempt permanent establishment

- The loan relationship debits result in no CFC charge or a reduced CFC charge under the low profits exemption or the gateway chapters
- The loan is part of a tax-driven arrangement to refinance foreign external debt in the UK
- There is an arrangement for the ultimate debtor to provide funding for a loan or quasi loan to another person (modified for banking and insurance business).
- The loan is funded by a UK resident connected bank or insurance company, unless the funding is provided by way of a loan
- The loan is connected to an arrangement which gives rise to a trading deduction for a UK resident connected bank/insurance company

54. Section 371IH(1) sets out the circumstances under which a loan relationship cannot be a QLR where the ultimate debtor is a non-UK resident connected company. These are where some or all of the borrower's debits are being taken into account for the purposes of determining the profits attributable to:

- a UK permanent establishment of the ultimate debtor under Part 2 of CTA 2009, or
- a UK property business of the ultimate debtor under Part 3 of ITTOIA 2005.

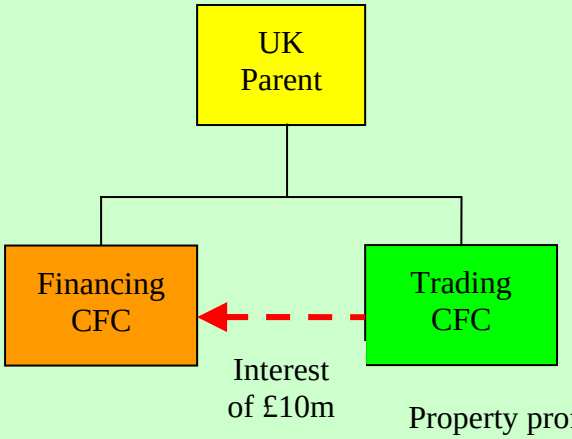
55. Section 371IH(2) provides that a loan cannot be a QLR where the ultimate debtor is a UK resident company unless it is taken into account for the purposes of determining the profits attributable to an exempt foreign permanent establishment of the ultimate debtor, an election is made under section 18A of CTA 2009 in relation to the ultimate debtor and all the company's debits are brought into account in determining the exemption adjustment under that section.

56. Section 371IH(3) provides that a loan relationship cannot be a QLR where:

- the ultimate debtor is itself a CFC to which Chapters 3 to 8 (the gateway) or Chapter 12 (the Low Profit Exemption) apply in any of that CFC's accounting periods and some or all of the debits of the CFC are being brought into account for the purposes of those Chapters, and
- as a result there is no CFC charge for the accounting period in question, or the charge is reduced.

57. The loan relationship is disqualified from being a QLR if the CFC charge apportioned from the ultimate debtor's profits is reduced to any extent by debits in respect of the loan relationship. Although not all of the debits may reduce the CFC charge, the test in section 371IH(3) is an all or nothing test, where the conditions in both sub-sections (a) and (b) are met. If the condition in sub-section a.) is met, but that doesn't lead to a reduction in the CFC charge then the condition in sub-section b.) is not met.

Example



Property profit before interest	£30m
Trading profit before interest	£20m
Interest	(£10m)
Profit	£40m

Financing CFC provides a loan to Trading CFC on which interest arises of £10m. Trading CFC has profits of £40m. The interest on the loan is allocated between the Trading CFC's exempt property business profits (of £30m) and trading activity (£20m), the profits of which pass through the Chapter 4 charge gateway. The loan was used to acquire the property and trading assets and so the interest is pro-rated between the two activities – 40% of the interest allocated to the non-exempt trading activity. As a result of the interest charge the profits that pass through the CFC charge gateway by way of Chapter 4 are reduced to £16m – if there was no loan the CFC charge would be £20m. On this basis the debits in Trading CFC do reduce the CFC charge under Chapter 4 and so, by virtue of section 371IH(3), the loan made by Financing CFC A will not be a QLR for the purposes of Chapter 9.

58. Section 371IH(5) is an anti-avoidance rule. It excludes claims under Chapter 9 where there is an arrangement having a main purpose of securing that the ultimate debtor (determined by other parts of Chapter 9) provides a loan or funds that give a return that is economically equivalent to interest to someone else. The rule works by preventing a loan relationship from being a QLR where it is an arrangement, or is connected to an arrangement, the main purpose or one of the main purposes of which is for the ultimate debtor to provide, directly or indirectly, funding for a loan relationship, or a transaction that is economically equivalent to the provision of a loan relationship, to another person. .

59. One of the intentions of the ultimate debtor rule is to ensure that only loans that are in substance qualifying loan relationships actually benefit from the Chapter 9 exemptions. Section 371IH(5) supplements the ultimate debtor rule and should therefore have limited application if the ultimate debtor rule is working as intended. It is targeted at artificial arrangements designed to conceal the true identity of the ultimate debtor, or arrangements structured so as to prevent the funding to an ultimate debtor being a loan relationship (an arrangement for example where the funding to the ultimate debtor is structured by way of a loan

relationship to an intermediary group company, but then structured as funding which isn't a loan relationship to the ultimate debtor).

Example

A loan is made by the CFC to another non-UK resident company and that company arranges for a loan to be made (using the funds from the first loan) by another person to a UK resident company connected with the CFC. The CFC is asked only to make the loan to the non-UK resident company and is not informed that the loan will be used to fund a further loan. The main purpose of the arrangement is for the CFC to make a loan to the UK resident connected company, even though the CFC is not informed about the ultimate borrower. The loan by the CFC is not a QLR.

Example

CFC A lends to CFC B which uses the funds to pay a dividend. CFC B uses the cash generated from its activities to lend to a UK resident person (rather than using the cash to fund the dividend). Absent an arrangement and looking just at the transactions in isolation the purpose of the loan from A to B is not to provide funds for lending but to fund a dividend and so would be a qualifying loan. However if a main purpose of the arrangement was to provide a loan from CFC A to a UK resident connected person then section 371IH(5) will apply to treat the loan to B as non- qualifying.

60. As with the ultimate debtor rule, the anti avoidance rule in section 371IH(5) works in a different way for banking and/or insurance groups. Section 371IH(6) disapplies subsection 5 in respect of a loan made by a CFC to another group company whose main business is banking or insurance and the loan or arrangement is made in the ordinary course of that business. This recognises that a banking or insurance company will in most cases be providing funding that is used to make a loan to another person, or provide funds in a way that the return on the provision of funds will be calculated in a similar way to that for a loan.

61. This relaxation of section 371IH(5) for banking and insurance CFCs does however open up the possibility for section 371IH(6) to be exploited by banking and insurance groups. To deal with this section 371IH(7) prevents a loan from a CFC being a QLR if the bank or insurance company which is the ultimate debtor uses the loan to fund a loan or other arrangement - as set out in section 371IH (5)(a) or (b) - to create a tax advantage for the ultimate debtor.

Funding from a connected UK bank or insurance company

62. There is a specific restriction in relation to CFCs which make loans from funds provided by a UK resident connected company whose main business is either banking or insurance. That company does not have to be a qualifying company (i.e. it does not have to be controlled by the same UK resident person that controls

the CFC), it is enough that the UK bank or insurance company is connected to the CFC. The restriction applies where the UK resident connected company provides the funds (directly or indirectly) to the CFC other than by way of a loan (e.g. by shares or capital contribution) or the funds are provided by way of arrangement that gives rise to a deduction for the UK resident connected company (apart from the ultimate debtor) in the calculation of its trading profits..

63. The restriction is provided by sections 371IH(8) and (9) which prevent a creditor loan relationship of a CFC from being a QLR where it is:

- sourced to more than a negligible extent from relevant UK funds (other than a loan) derived from a UK resident connected company which has a main business of banking or insurance; or
- where the loan relationship was created as part of an arrangement which gives rise to a taxable Case I deduction for a UK resident connected bank or insurance company (apart from the ultimate debtor). This would include for example interest on a loan.

64. The restriction in section 371IH(8) is not limited by any rule that specifies the source of the funds provided to the CFC by the UK resident bank or insurance company. So a structure used by the UK resident company to source and differentiate funds which doesn't give rise to a direct taxable deduction will not prevent the application of restriction in sub-section (8).

Example

A CFC has received capital investment of £100m from a UK connected company undertaking banking activity and those funds have been used to provide the funding for loans of £500m made by the CFC. £250m has been lent to a UK resident group company (and so is not a QLR) and £250m has been lent to another CFC. Absent section 371IH(8), the latter loan would be a QLR. The restriction provided by section 371IH(8) means the loan of £250m to the other CFC will not be a QLR because more than a negligible part of the loan is funded by a UK connected bank. This is the case even though at least some of the loan has been funded from another source.

Example

A UK resident bank makes an equity investment of £100m in a UK resident subsidiary, which in turn makes an equity investment in a CFC (which is also connected to the UK bank). The CFC uses the investment to part fund a loan of £500m made to another CFC. As the loan is funded to more than a negligible extent out of funds that have indirectly been provided from a UK connected bank, the loan is not a QLR.

65. As with section 371IG(7) the rules in sections 371IH(6) to (8) could potentially apply to a group treasury company within a non financial services group whose activities fall within the definition of banking business. In many cases the

majority of group financing transactions may originate from funds raised by the group treasury company or from transactions routed through it. Whether the treasury company (which might be a UK resident company or a CFC) is treated as trading is a matter of fact to be considered on a case by case basis.

Example

A US CFC pays a dividend to an offshore holding company and the funds are placed on deposit with the UK treasury company (in line with treasury policy). The funds are later returned to the offshore holding company, which makes an equity investment into another CFC, which in turn uses the funds to make a loan to a US CFC. The UK treasury company is considered to be carrying on a trade.

The initial deposit of funds with the UK treasury company by the offshore holding company may fall within the incidental finance income safe harbour for holding companies at sections 371CC and 371CD in which case the ultimate debtor rules in sections 371IG and IH are not considered (as the profits will not pass through the CFC charge gateway by way of Chapter 5). Where however the NTFPs arising on the loan exceed the safe harbour then section 371IG(7) will apply to treat the UK treasury company as the ultimate debtor. However provided the treasury company t uses the funds in the ordinary course of its banking business and does not on-lend or enter into arrangements outlined in section 371IH(5(a) or (b) in order to obtain a tax advantage, section 371IG(7) will not apply.

The loan from the CFC to the US CFC will not be caught by section 371IH(8) as the funds were simply deposited with the UK treasury company for a short period of time before the funds are used by the holding company to make another investment. In such a case we would treat the loan as not being made out of funds as a result of an arrangement within section 371IH(8)(b), unless there are circumstances that indicate the funds originated from a different source than the original deposit within the treasury company..

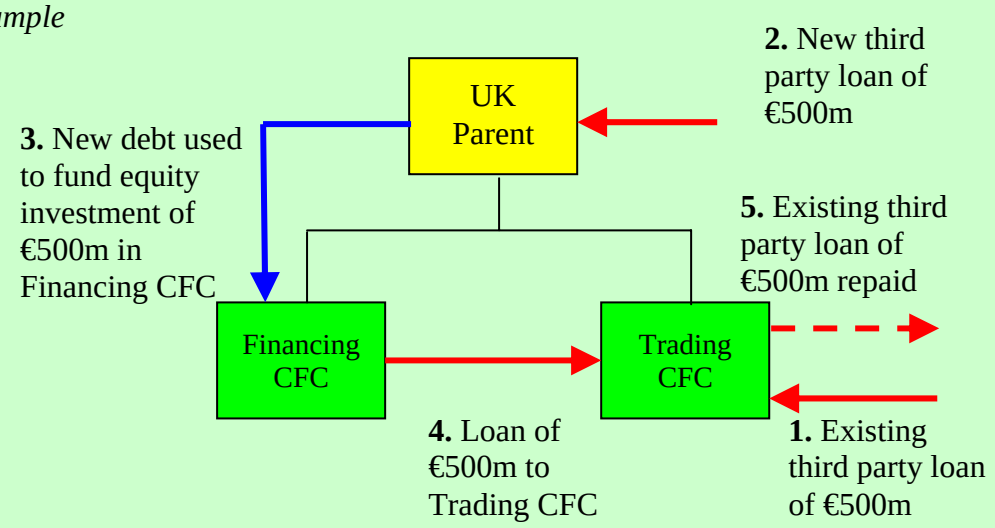
66. Sections 371IH(10) and (11) prevent a loan from being a QLR where third party debt of a non-UK resident group company is repaid (in whole or in part), and effectively replaced with new UK debt under or in connection with an arrangement the main purpose or one of the main purposes of which is to obtain a tax advantage for any person. The rule catches arrangements that give rise to an increase in debt in the UK whether provided by a third party or to a non UK resident connected persons. If a loan is made to a UK resident group company, which in turn lends to another UK resident group company then the UK to UK element is ignored.

67. The test of purpose in subsection (10) must be applied to the whole of the arrangement, not just to particular loans which form part of the arrangement. In particular, it should apply even if the CFC itself has no tax purpose in making its loan. The fact that the existing external debt was used for a commercial purpose may have little bearing on what the main purpose of an arrangement is.

68. The transactions detailed in subsection 371IH(10), namely the loan to the UK resident connected company, the funding of the CFC and the use of those funds to

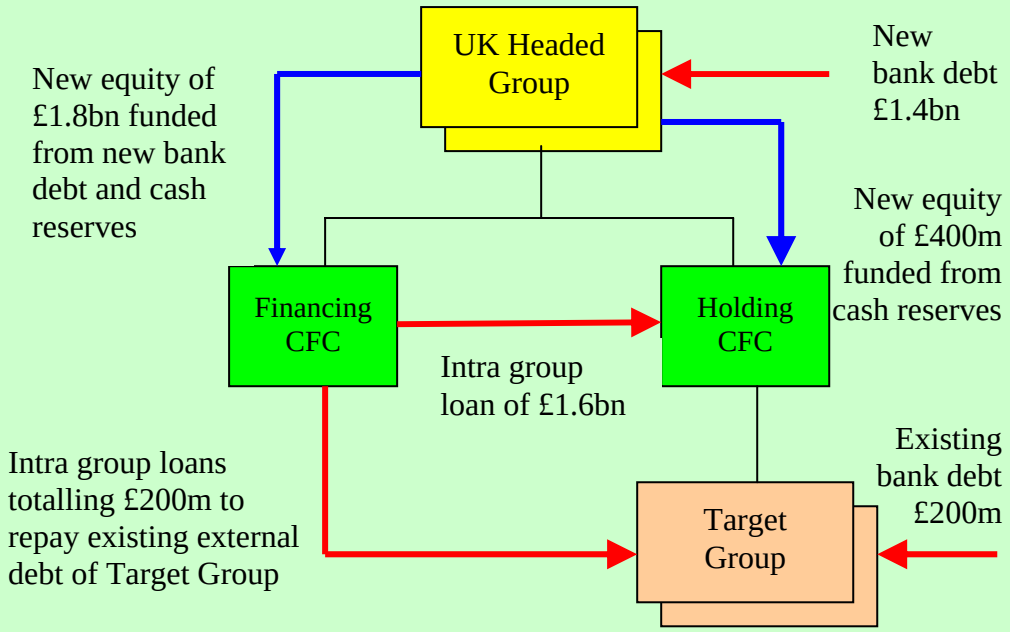
enable a non-UK resident group company to repay external debt must occur under the same arrangement. Thus the raising of UK debt should not be regarded as "indirectly connected" to a later funding of an overseas subsidiary to repay external debt unless there is a link between the two funding flows.. Where a UK headed group raises debt in the UK , for example in the context of an acquisition transaction, the UK group may need to raise funds to repay debt of the target group. The arrangements by which this additional funding is structured may require closer scrutiny.

Example



UK Parent borrows €500m, which is used to buy shares issued by Financing CFC. This CFC then makes a loan of €500m to Trading CFC, which in turn repays its existing external debt of €500m. The arrangement has created two loans where before there was only one, with the interest on one of the loans being sheltered by Financing CFC. It is very likely that the new UK tax deduction was taken into account in the decision to enter into this arrangement. Accordingly the arrangement will therefore have a main purpose of obtaining a tax advantage for UK Parent and so the loan to Trading CFC is not a QLR.

Example



A UK-headed group acquires another, overseas headed group for £2bn. The acquisition vehicle is a new overseas intermediate holding company, Holding CFC. The UK parent borrows £1.4 billion, which together with cash reserves of £400m, are invested as equity in Financing CFC, an existing group treasury company. The terms of the new external borrowing provide £1.2bn to fund the acquisition of the Target Group and £200m to replace that group's existing external borrowings (all held by non-UK resident companies). The UK parent also makes an equity investment of £400m in Holding CFC. Financing CFC lends Holding CFC £1.6bn, which, together with its equity of £400m is used to fund the purchase of Target Group. On the day of acquisition Financing CFC also makes loans totalling £200m to Target Group subsidiaries, to repay the existing external debt of £200m of that group.

NTFPs are generated by Financing CFC in respect of:

- The proportion of the £1.6bn loan to Holding CFC, funded by new UK external debt of £1.2bn;
- The proportion of the £1.6bn loan to Holding CFC, funded by cash reserves of UK parent; and
- The loans of £200m to the new overseas subsidiaries, funded by new external debt of £200m.

Sections 371IH(10) and (11) should not apply to prevent £1.2bn of the loan to Holding CFC being a QLR. This is because the arrangement is primarily concerned with the acquisition of the new group. These sections will also not have any effect for the balance of loan of £1.6bn to Holding CFC. However the loans of £200m to Target Group overseas subsidiaries will require closer scrutiny as the choice of effectively replacing their external debt with debt ultimately funded by the UK is likely to indicate a main purpose of obtaining a UK tax advantage.

69. Whether or not there is an arrangement with a main purpose to obtain a tax advantage will be a question of fact and it is difficult to generalise the circumstances in which the repayment of non UK external debt in as the circumstances outlined in the above example might constitute such an arrangement as there may be a number of factors involved in the refinancing. Some of the circumstances which may need to be taken into account would include:

- Whether aligning the banking relationships of the target group with those of the acquisition group of necessity required the overseas external debt to be replaced with UK external debt.
- Whether the existing external debt of the target group is part of cash pool arrangements that can no longer continue under the banking arrangements of the acquiring group.
- Any banking covenants that have to be maintained as conditions of new debt being taken on in the UK part of the group.

How do you determine the profits of a qualifying loan relationship?

70. If the CFC was a UK resident company, its credits and debits from all its non-trading loan relationships would be aggregated to form a total figure of a non-trading profit or a non-trading deficit. This is how the assumed total profits of the CFC are calculated for the purposes of Chapter 5. However a CFC may have a number of non-trading loan relationships, and not all of these may be QLRs. So it is necessary to separate the NTFPs of a CFC which are subject to a claim under Chapter 9 as they arise from QLRs from the rest of the assumed total profits of the CFC. This is provided by section 371IF which sets out the steps to be followed to calculate the profits of each QLR. These profits will either be exempted under the various parts of Chapter 9, or will pass through the CFC charge gateway at Chapter 5.

71. Section 371IF contains five steps for calculating the profits of any QLR. The steps are intended to cover a large range of possible scenarios. In most cases it is likely that the profits of a QLR will only consist of its loan relationship credits (the interest payments due on the loan) and so the calculation won't need to go any further than step 1.

    Step 1 – determine the credits from the QLR that are brought into account for the purposes of determining the CFC's NTFPs for the accounting period. This will include interest receipts and any FOREX gain in respect of the QLR. The amount determined is "the Step 1 credits";

    Step 2 – add to the Step 1 credits any excess of credits over debits arising from derivative contracts or other arrangements such as back to back loans that are a hedge of interest rate or FOREX risk relating to the QLR. If the debits exceed the credits, subtract that excess from the Step 1 credits. The amount determined is "the Step 2 credits";

    Step 3 – allocate to the QLR a just and reasonable proportion of any credits (which will be any FOREX gains) relating to relevant debtor loan relationships of

the CFC i.e. borrowings of the CFC that are the source of funds for the QLR. [The debits of these debtor loan relationships are taken into account in step5]. Add the credits to the Step 2 credits to give "the Step 3 credits";

Step 4 – add to the Step 3 credits any excess of credits over debits arising from derivative contracts or other arrangements such as back to back loans that are a hedge of interest rate or FOREX risk relating to the debtor loan relationships identified in step 3. If the debits exceed the credits, subtract that excess from the Step 3 credits. The amount determined is "the Step 4 credits";

Step 5 - calculate the debits (so far as not reflected in the Step 4 credits) that are brought into account for the purposes of determining the CFC's NTFPs for the accounting period. This will include debits (such as interest payments and FOREX losses) from debtor loan relationships used to directly fund the QLR, and from loan relationships that are general borrowings of the CFC. A just and reasonable proportion of the debits are subtracted from the step 4 credits to give the CFC's QLR profits for the QLR in question. The debits subtracted here will also include a just and reasonable proportion of any brought forward non-trading debits (provided that they relate to accounting periods beginning on or after 1 January 2013).

72. While section 371IF provides for FOREX gains and losses of creditor and debtor loan relationships to be included in the calculation of the profits of a QLR, those FOREX gains and losses actually have to form part of the NTFPs of the CFC in the first place. The NTFPs are derived from the assumed total profits of the CFC, which is essentially the UK tax measure of the profits of the CFC. It is unusual for FOREX gains and losses to be included as loan relationship credits and debits as they are generally disregarded under specific rules or form a hedge for accounting purposes and so aren't taken into account for the purpose of loan relationship rules.

73. Steps 3 to 5 require that finance expenses in respect of the CFC's borrowings are taken into account in calculating the profits of a QLR. Where the CFC exists only to provide medium to long term structural loans, there may be no borrowings; and where there are any borrowings they will inevitably relate to the funding of specific loans made by the CFC. Where those loans are QLRs then all the financing expenses of the borrowing used to fund the QLR will be taken into account in calculating the profits of the QLR. As with debits and credits in relation to FOREX gains and losses where expenses of borrowing would be taken into account as a loan relationship debit, then they are taken into account in calculating the profits of a QLR. For example, legal fees in connection with a loan to a non UK resident connected person would be offset against the NTFPs on that loan as a directly attributable expense.

74. By contrast if the CFC undertakes both financing activities and other trading activities, then it may be the case that any borrowings of the CFC would relate wholly to the trading activities and so its financing expenses would not be taken into account in the calculation of any QLR profits. Whether the borrowings support the trading activity or the intra-group lending activity will be a question of fact.

75. The CFC may have borrowings that are not directly referable to the funding of lending activity or of trading activity. For example a CFC undertaking wider treasury activities may incur borrowing costs in relation to the acquisition of its business premises or a mixed activity CFC may have incurred borrowing costs in relation to the acquisition of that CFC's business. In such cases a reasonable proportion of the borrowing costs should be taken into account when calculating the profits of any QLR. The legislation is not prescriptive in how such expenses are to be allocated. In some cases an allocation by reference to capital requirements may be reasonable; in other cases allocation by reference to level of activity (which might be measured by reference to employee headcount) may be a reasonable measure. While one method may appear to be more accurate than another method, provided the first method is reasonable based on the particular circumstances of the case, then its use should be accepted.

Example

A CFC has made a loan to each of two CFCs. Both loans are QLRs.

The first loan is for $500m and is charged at a LIBOR floating rate. During the year the CFC receives interest of $30m (£25m). At the beginning of the year the loan is worth £420m. At the end of the year the loan is worth £405m.

The second loan is for €750m and is charged at a LIBOR floating rate. During the year the CFC receives interest of €42m (£39m). At the beginning of the year the loan is worth £680m. At the end of the year the loan is worth £685m.

The source of the funds for the CFC's lending activity is equity capital provided by the UK, together with a loan of $250m that has been specifically used to fund the loan of $500m. The loan is charged at a LIBOR floating rate and during the year the CFC pays interest of $12m (£10m). At the beginning of the year the loan is worth £210m. At the end of the year the loan is worth £202m.

The CFC has also entered into the following hedging arrangements

- UK parent made a loan of €750m to the CFC and the CFC makes a matching loan of £680m to UK parent. During the year CFC pays €42m (£39m) interest to UK parent and receives £37m interest from UK parent. When everything nets out, CFC has a sterling loan asset and UK parent has a Euro FOREX risk.

- It enters into an interest rate swap in respect of half of its $500m loan receivable, swapping floating $ interest for fixed $ interest. The interest rate swap is net paying and during the year CFC makes net payments of $1.2m (£1m).

The NTFPs of the CFC are calculated on the basis that they are profits of a UK resident company that is party to loan relationships. The overall profit or deficit from the loan relationships in this example are made up from the following loan relationship debits and credits:

	Non-trading credits	Non-trading debits	QLR profits s371IF
$500m loan receivable			
Interest receivable	£25m		Step 1
FOREX		£15m	Step 5
€750m loan receivable			
Interest receivable	£39m		Step 1
FOREX	£5m		Step 1
$250m loan payable			
Interest payable		£10m	Step 5
FOREX	£8m		Step 3
€750m hedging loan payable			
Interest payable		£39m	Step 2
FOREX		£5m	Step 2
£680m hedging loan receivable			
Interest receivable	£37m		Step 2
Interest rate swap			
Net payments		£1m	Step 2
Totals	£114m	£70m	
Non-trading profit	**£44m**		

a. In this example both of the CFCs loan receivables of $500m and €750 are agreed to be QLRs. In order to determine the profits of each QLR we follow the steps in s371IF. First we want to take account of the credits and debits of each QLR. This is step 1.

$500m QLR **step 1 credits £25m**

€750m QLR **step 1 credits £44m**

b. Next we take account of all debits and credits from a hedging transaction that hedges the QLR. This is step 2

$500m QLR step 1 credits £25m

Subtract hedging debits (£1m)

Step 2 credits £24m

€750m QLR step 1 credits £44m

Hedging credits £37m

Hedging debits (£44m)

Overall debit of £7m to subtract from step 1 credits

Step 2 credits £37m

c. The calculation takes account of any credits in respect of borrowings used to fund a QLR. This is step 3.

$500m QLR	step 2 credits £24m
Funding credits of £8m to add to step 2 credits	
	Step 3 credits £32m
€750m QLR	step 2 credits £37m
No adjustment under step 3	
	Step 3 credits £37m

d. Where any loan borrowed by the CFC used to fund the QLR was itself hedged, then any credits or debits relating to the hedging relationship are included in the profits. This is step 4. In our example there are no step 4 credits and so:

$500m QLR	**step 4 credits £32m**
€750m QLR	**step 4 credits £37m**

e. The last step identifies any other borrowing costs of the CFC that are indirectly attributable to the QLR, together with any debits of the QLR or debits of any debtor loan relationships used to fund the QLR. In this example there are no indirect borrowings, but there are adjustments in respect of QLR FOREX losses and funding expenses directly attributable to one of the QLRs:

$500m QLR	step 4 credits £32m
FOREX loss debits	(£15m)
Funding loan debits	(£10m)
	Step 5 credits £7m
€750m QLR	**step 5 credits £37m**

f. The profits of the QLRs of the CFC are therefore £7m in respect of the QLR of $500m and £37m in respect of the QLR of €750m.

76. The rule in step 5 requires all debits of the CFC relating to its QLRs to be taken into account (so far as not already done so in steps 2 and 4). Chapter 19 provides an assumption of UK residence in computing a CFC's assumed total profits and in particular section 371SF requires, with some specific exceptions, all beneficial claims and elections to be assumed to have been made by the CFC. There may be certain instances where it is beneficial for a CFC to claim double tax relief by making a deemed election against credit under section 27 TIOPA 2010, which would mean, by virtue of section 112 and following sections of TIOPA 2010, that relief would be available by way of deduction. This debit will be taken into account for the purposes of calculating the QLR profits under section 371IF.

77. Step 5 of section 371IF only allows debits from the CFC's loan relationships to be deducted on a just and reasonable basis. A reasonable amount of expenses of management may also be deducted from the CFC's QLR profits in determining its chargeable profits. However this is dealt with by section 371BA(3)(b) rather than Chapter 9.

78. If the calculation in Section 371IF produces a QLR "loss" (which could be the case if a CFC does not hedge FOREX risk and its QLRs give rise to a foreign exchange loss), the loss will be treated as a non-trading loan relationship debit or deficit and will be available for offset against profits of the CFC under the normal loss relief provisions in Chapter 16 CTA 2009. A loan relationship deficit from an earlier or later accounting period is brought into the calculation at step 5. A loan relationship deficit is only taken into account if it is a deficit for an accounting period of a company that is treated as a CFC by virtue of Part 9A.

Example

A group has a CFC that has been making intra-group loans for a number of years. The group and all its subsidiaries prepare their accounts to 31 December each year. In each of 2012 and 2013 the CFC, based on a UK tax measure of profits, has an overall non-trading deficit (£5m and £13m respectively) due to un-hedged FOREX losses on the loans and interest on borrowings used as part of the source of funds for the CFC's on-lending. There is no CFC apportionment in either of the years 2012 or 2013

The non-trading deficit in 2013 is created by a FOREX loss of £40m and loan interest paid of £8m. 75% of the FOREX loss (£30m) related to loans that are QLRs in that accounting period. 60% of the loans made by the CFC in 2013 were QLRs and the borrowings used to fund those loans is considered to support the loan book as a whole rather than separate loans – so 60% of the borrowings are attributable to the QLRs.

In 2014 the CFC has non-trading loan relationship credits totalling £80m made up as follows:

- £40m from loan relationships that are QLRs
- £30m from loan relationships that are non-QLRs
- £10m from a loan to the UK which is part of a back to back arrangement with the UK group treasury company to hedge some of the FOREX exposure on some of the CFC's loan book. All the loans hedged are QLRs.

The CFC pays interest on the back to back loan (£10m) and on the loan to fund its loan book (£7m) in 2014. The CFC also pays expenses of £500,000 that would be treated as management expenses if it were a UK resident company.

The calculation of the CFC charge for 2014 is set out in the table below, taking account of the following

- The non-trading deficit for 2012 is not taken into account in calculating the CFC charge for 2014 as this arose in an accounting period before the commencement date for the new CFC rules in Part 9A of 1 January 2013
- The assumed taxable total profits of the CFC for 2014 are £50m (non-trading loan relationship credits of £80m, less non-trading loan relationship debits of £17m, less non-trading deficit brought forward from 2013 of £13m). Note this is the UK tax measure of profits. It is not the amount of profits that necessarily pass through the CFC charge gateway.
- The non-trading deficit for 2013 is treated on a just and reasonable basis as being split as follows
    - Total deficit is £13m
    - 40/48 of deficit represented by FOREX loss = £10.8m
    - 75% of that proportion of the FOREX loss relates to QLRs = £8.1m
    - 8/48 of deficit represented by interest = £2.2m
    - 60% of the interest relates to QLRs = £1.3m
    - £9.4m (£8.1m + £1.3m) of the non-trading deficit for 2013 treated on a just and reasonable basis as relating to QLRs
- £10m of the interest payable in 2014 relates to the back to back loan which has been used to hedge QLRs
- The remaining £7m of the interest payable in 2014 is apportioned on a just and reasonable basis as 4/7 relating to QLRs (£4m) and 3/7 relating to non-QLRs (£3m)
- The interest received on the back to back loan to the UK in 2014 is treated as being received in respect of a QLR
- The management expenses for 2014 are apportioned on a just and reasonable basis as 4/7 relating to QLRs (£285,714) and 3/7 relating to non-QLRs (£214,286).

Calculation of profits that pass through the CFC gateway under Chapters 5 and 9	**2013**	**2014**
Non-trading deficit	(£13m)	
Non-trading finance profits (made up of)		
QLR credits		£40m
Credits on hedging loan (also treated as a QLR)		£10m
Non-QLR credits		£30m
Non-trading loan relationship debits		(£17m)
Non-trading loan relationship deficit B/F		(13m)
		£50m

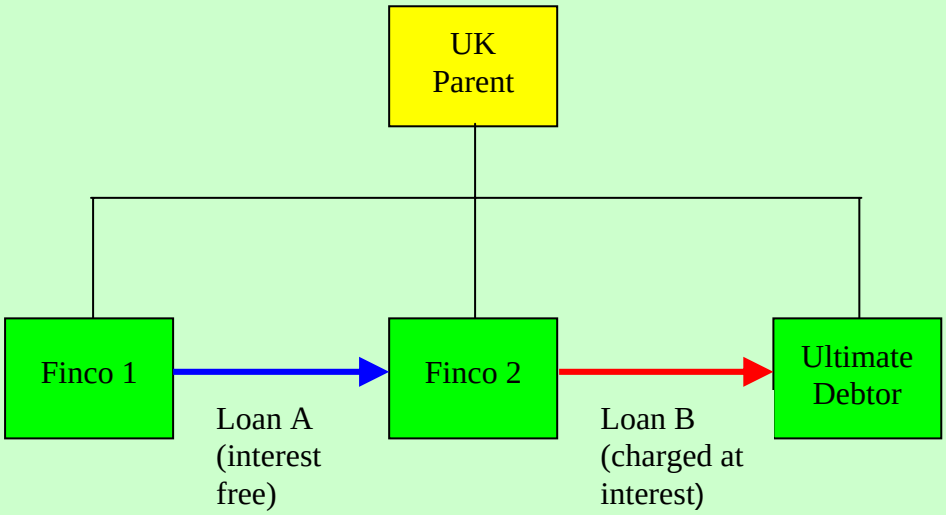
Calculation of profits that pass through the CFC gateway under Chapters 5 and 9	2013	2014
QLR profits		**£26.6m**
Exempt QLR profits (75%)		(£19.2m)
QLR profits from Chapter 9 that pass through the CFC charge gateway		**£7.4m**
Profits from non-QLRs		
NTFP excluding those in Ch 9 (made up of)		
Non-QLR credits		£30m
Non-trading loan relationship debits		(£3m)
Non-trading loan relationship deficit B/F		(3.6m)
Chargeable profits from Chapter 5 that pass through the CFC charge gateway		**£23.4m**
S371BA(3)(a) assumed total profits that have passed through the CFC charge gateway		**£30.8m**
Management expenses relieved under S371BA(3)(b)		(£0.5m)
CFC chargeable profits		**£30.3m**

Transfer pricing adjustments in the context of Chapter 9

79. When calculating the UK measure of profits of a CFC (the assumed taxable total profits), transactions between the CFC and other connected persons have to be priced in accordance with the arm's length principle. Another consequence of taking account of the assumptions made when calculating the assumed taxable total profits (see Chapter 19) are that the CFC is assumed to be a company tax resident in the UK. This means that the CFC can be assumed to have made a claim for a compensating adjustment under section 174 TIOPA if that provides a beneficial outcome in relation to the calculation of the CFC's assumed taxable total profits.

80. There may be transactions between two CFCs, whereby one CFC's profits are increased because of a transfer pricing adjustment, and the other CFC's profits are calculated taking account of an assumed claim for a compensating adjustment. The amount of the compensating adjustment is unaffected by the outcome of any claim under Chapter 9 in respect of the CFC whose profits have been increased in line with the arm's length principle. At first glance this may seem odd, and even to confer some sort of advantage. However, as the following example shows, the overall outcome means the profits from lending to the ultimate debtor are only considered once in relation to the CFC rules. To the extent the profits "pass through" one of the CFCs, those profits are only effectively brought into charge and partially exempted in relation to the second CFC.

Example



Finco 1 (Ireland) issues shares to UK Parent and uses the funds to make an interest free loan to Finco 2 (resident in say Luxembourg or Netherlands), which in turn makes a loan at interest to Ultimate Debtor. Assume that Finco 2 receives £10m interest from Ultimate Debtor in an accounting period.

Ireland does not have transfer pricing rules that would apply to the interest free loan. Netherlands and Luxembourg would both allow Finco 2 to claim a deemed interest deduction in respect of the interest free loan. Assume that the deemed interest deduction is £9.9m. When set against the interest received from the loan to Ultimate Debtor, this leaves Finco 2 with a very small profit of £100,000 which is charged at the Luxembourg or Netherlands full rate of tax. However the effective rate of tax is much lower because of the deemed interest deduction. This structure creates the CFC shelter for the interest received on the loan to Ultimate Debtor.

Finco 1 applies the transfer pricing rules in calculating its assumed taxable total profits and imputes interest of £9.9m in respect of the interest free loan. For the sake of this example Finco 1 has no expenses and so the NTFPs are £9.9m. UK Parent makes a valid claim under Chapter 9 for the accounting period in respect of Finco 1's profits and so only £2.475m profits are apportioned to UK Parent.

Finco 2, in calculating its own assumed taxable total profits will take account of an assumed claim to a compensating adjustment, in the same amount as the interest imputed in calculating the CFC profits of Finco 1. This leaves Finco 2 with a small profit of £100,000. UK Parent makes a valid claim under Chapter 9 for the accounting period in respect of Finco 2's profits and so only £25,000 profits are apportioned to UK Parent.

So of the £10m interest paid by ultimate debtor:

- £9.9m is profit of Finco 1 - £2.475m of which are apportioned to the UK
- £0.1m is profit of Finco 2 - £0.025m of which are apportioned to the UK

Essentially Finco 2 is acting as a conduit in this structure – at the end of the day only one amount of interest (received from Ultimate Debtor) is being sheltered and only a quarter of that interest is in effect apportioned to and taxed in the UK. If Finco 2 was not able to take account of the full compensating adjustment in calculating its assumed taxable total profits, then more than a quarter of that interest would be apportioned and taxed in the UK.

UK company used as a conduit in a CFC shelter

81. The structure in the above example is a common shelter used by UK multi-national groups. A simpler structure could be used, such as a lender in a territory that doesn't charge tax on company profits. However such territories don't tend to have double taxation agreements with other territories, and so the group companies paying interest will generally be liable to tax in their territory of residence (usually by way of withholding tax). The company in the nil tax territory won't provide any double tax relief in respect of that withholding tax because there is no tax to set the withholding tax against. Groups tend therefore to use more complex shelters involving territories with good treaty networks, where in most cases taxation in the form of withholding tax will be ceded by the source territory.

82. Following the introduction of the new CFC rules, a number of groups have adopted a CFC structure very similar to the one involving a Luxembourg or Dutch conduit, but instead using a UK company as a conduit.

83. The UK conduit company will receive the interest free loan from Ireland (or a similar territory that does not apply transfer pricing rules to interest receipts) and then lend on to the ultimate debtor. Just as for a CFC, the UK conduit company can claim a compensating adjustment under the transfer pricing rules in respect of the adjustment made by the Irish CFC (the imputation of interest on the interest free loan) in calculating its assumed taxable total profits. This will leave the UK conduit company with only a very small margin which is liable to tax.

84. There may be a number of reasons why a UK company is used as the conduit. This may or may not include using the UK company to avoid another territory's withholding tax. This is a matter for the other territory to consider and take action if they deem appropriate. However, as the UK will inevitably have a double taxation agreement with that territory, HMRC will generally provide information about the arrangement to the other territory under the exchange of information article in the treaty. HMRC won't look to establish whether there is a motive to avoid another territory's source taxation, neither will they engage in correspondence with the group about the issue.

85. Once you become aware of such an arrangement, please send details to the CFC team at CTISA Business International. They will then arrange for the information to be passed to the UK Competent Authority and exchanged with the other territory.

Double Taxation Relief in cases involving QLRs and UK companies used as a conduit in a CFC shelter

86. Some groups have traditionally structured intra-group financing so that loans made to overseas group companies, where the interest is subject to withholding tax (WHT), have been made by UK companies, in order to best manage the double taxation relief (DTR) in respect of the WHT.

87. With the advent of the new CFC rules, groups may consider, in cases where the ultimate debtor will have to deduct WHT,

    - exporting UK loan receivables;
    - making new intra-group loans;
    - restructuring existing loans made by one CFC to another CFC

    so they are made from financing CFCs, but structuring the arrangements in such a way so they can also claim DTR in respect of the WHT in the UK. This will involve using a UK company as a conduit in the CFC financing arrangement, as described in paragraphs 82 to 86. So while the UK conduit company only makes a very small margin, the UK would provide DTR on the whole of the interest paid by the ultimate debtor, rather than just in relation to the margin made by the conduit company.

88. In order to manage any such restructuring [Finance Bill] 2013 introduced an additional limit on the DTR available in certain circumstances involving qualifying loan relationships of CFCs. These rules are detailed in Section 49A and S112(3) TIOPA 2010.

89. These rules will apply where there is:

    - a QLR between two non UK resident group companies as defined by Section 371IG, and
    - a claim has been made for full or partial exemption under Chapter 9, and
    - one or more UK companies is a conduit to the arrangement.

    The DTR available to any UK company that sits between the lending CFC and the ultimate debtor is restricted by reference to the profits of the loans routed through the UK and realised by UK companies in the period, not the other profits of the QLR. This is referred to in the legislation as the "relevant profit amount" or amount "S"

Restrictions to DTR by way of credit

90. The limit to DTR by way of credit is calculated using the formula

    R x S

    Where

    R is the rate of corporation tax payable by the relevant UK company (before any credit relief).

S is the UK company's share of the relevant profit amount (or the proportion of this amount that arises in the period)

91. The relevant profit amount is calculated by reference to "Loan A" which is the subject of a creditor relationship with the lending CFC and "Loan B" which is made to the Ultimate Debtor and is funded by Loan A. The calculation takes account of any UK company in the lending chain, directly or indirectly.

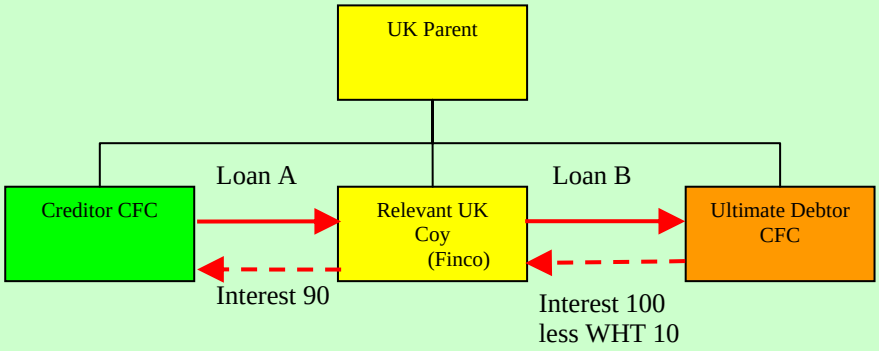
92. The relevant profit amount ("S") is calculated using the following steps:

Step 1 - establish the loan relationship credits in the period from "Loan B"

Step 2 – determine the loan relationship credits of the Creditor CFC's qualifying loan relationship for the period and then subtracts this sum from the amount established in Step 1 above. This is the relevant profit amount.

Step 3 – where there is more than one company in the lending chain, the relevant profit amount is allocated between all the parties on a just and reasonable basis.

Example



Creditor CFC lends (Loan A) to Relevant UK Company that in turn lends (Loan B) to the Ultimate Debtor CFC. Ultimate Debtor is obliged to deduct withholding tax on the interest it pays to Relevant UK Company.

<u>In the relevant period</u>

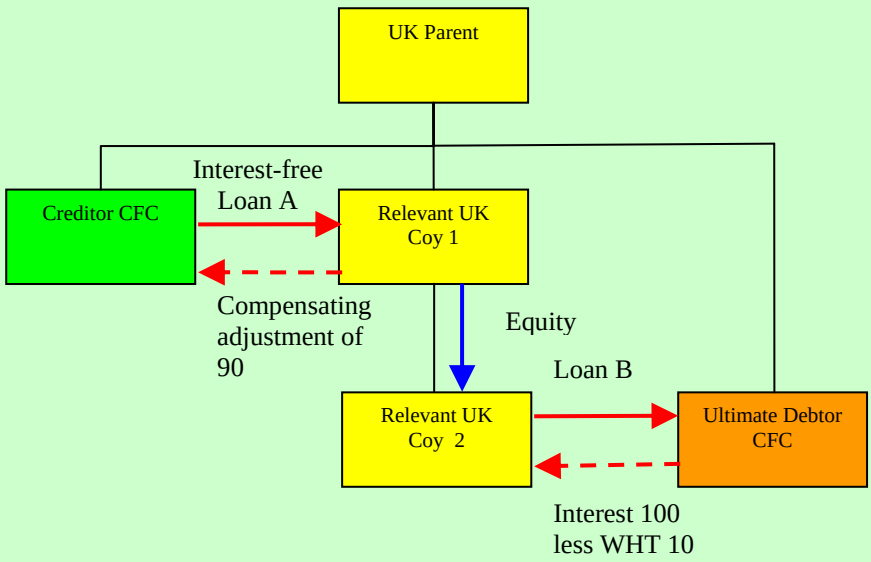
- The UK relevant company has interest receivable of 100 on Loan B from the Ultimate Debtor
- CFC Creditor has interest receivable of 90.

The relevant profit amount is therefore 10. If the UK corporation tax rate is 24%, any claim for DTR is limited by the formula R x S and so any DTR claim is limited to 10 x 24% = 2.4

93. Where there is more than one conduit in the lending chain, the relevant profit amount is apportioned amongst these persons on a just and reasonable basis. It will include anyone who has made or received a loan in that lending chain

(including persons who only provide part of the funds for "Loan B"). The relevant profit amount will also be apportioned to persons who have received a loan but then pass on the funds as an investment by way of preference shares in another company in the lending chain.

Example



The facts are the same in the previous example, except there are now two UK companies in the chain and the loan from Creditor CFC is an interest free loan. The first UK company borrows from Creditor CFC and invests the money in the second UK company by way of equity. The second UK company then uses the investment to make a loan to Ultimate Debtor. In calculating it profits for the purposes of the CFC rules, Creditor CFC imputes additional profits of 90 representing an arm's length amount of interest in respect of the loan it makes to the first UK company. This in turn means the first UK company can make a compensating adjustment of the same amount in calculating its profits for tax purposes.

As in the previous example, the relevant profit is 10, and this would all be apportioned to the second UK company on a just and reasonable basis as it is the second company that will be taxed on its interest receivable of 100. Any claim for DTR that company makes will be limited to relief of 2.4

94. The relevant profit amount will also be apportioned to any CFCs in the lending chain where a just and reasonable apportionment would allocate part of the relevant profit to that company. The share of the relevant profit amount will be calculated on the assumption that they are UK resident, within the charge to corporation tax and consequently in receipt of loan relationship credits (as defined by Part 5 CTA 2009).

Restriction to DTR by way of deduction from income

95. Similar restrictions exist where a claim for DTR by way of credit is not made and relief is instead permitted as a deduction from the income subject to the foreign tax (under S112 TIOPA 2010).

96. The conditions for these rules to apply are the same as where DTR is given by way of credit (under S49A TIOPA 2010). The conditions are that there is,

- a QLR between two non UK resident group companies as defined by Section 371IG, and
- a claim has been made for full or partial exemption under Chapter 9, and
- one or more UK companies is a conduit to the arrangement.

97. Where the loan relationship credits received by the relevant UK company have been subject to foreign tax, the DTR by way of deduction under S112(1) TIOPA is further restricted by the rules set out in S112(3B).

98. The restriction to DTR by way of deduction is determined with reference to the formula:

    R x S

    Where

    R is the rate of corporation tax payable by the relevant UK company (before any credit relief).

    S is the UK company's share of the relevant profit amount (or the proportion of this amount that arises in the period)

    S is the UK company's share of the relevant profit amount (or the proportion of this amount that arises in the period)

99. Where there has been a repayment of the foreign tax, the amount to be considered for deduction is reduced by the amount of the repayment. This net amount is defined in the legislation as "Z". The net amount "Z" is compared to R x S to determine whether there is any DTR available by way of deduction. Where Z is nil (because all the foreign tax had been repaid), there would be no DTR available by way of deduction. Where Z equals the amount of the foreign tax deducted (because there is no repayment of foreign tax) then the amount of DTR available by deduction is restricted by the formula R x S.

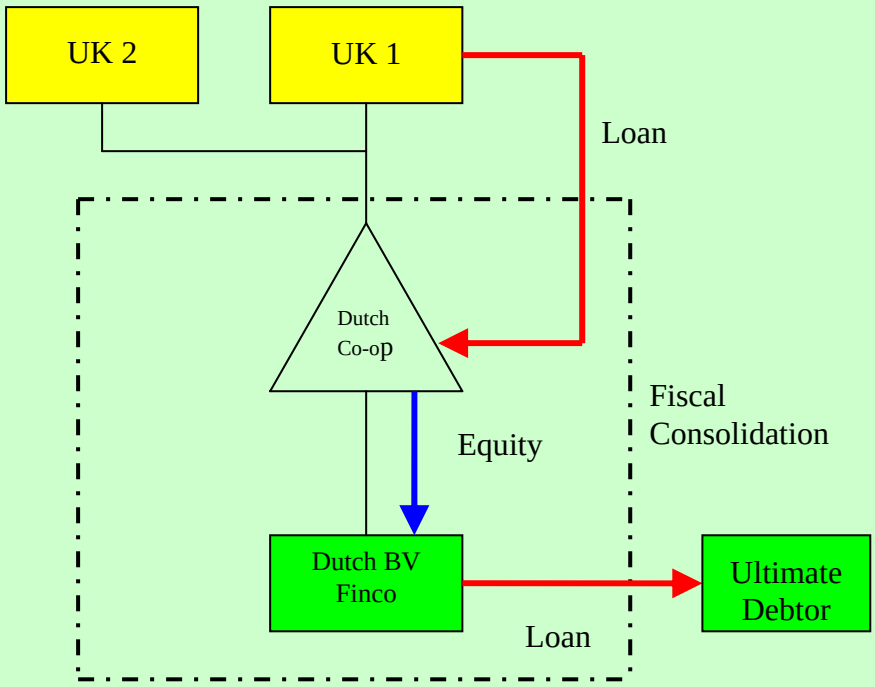
Interaction of the Chapter 9 exemptions with the arbitrage rules in Part 6 TIOPA 2010

100. It is likely that groups will use structures involving hybrid instruments or hybrid entities in conjunction with a finance company in order to minimise tax in the jurisdiction of the finance company (including overseas withholding taxes). This is so that the overall effective rate of the tax on the finance income (both UK and foreign) is minimised. The existence of a hybrid entity or instrument in a structure should not of itself affect the availability of the Chapter 9 finance company exemptions. However a group will still need to consider whether the

arbitrage rules will apply and in particular will need to consider what the comparator is for determining whether there is a UK tax advantage under section 234 TIOPA.

Example

The Dutch co-op structure is a common shelter for intra-group loan receivables, relying on the arbitrage between the UK and Dutch tax rules. There is a lot of flexibility in setting up a co-op and there are three different types under which the members have different levels of liability. A common structure, with two UK members, is shown below:



UK 1 and UK 2 are the members of a Dutch Co-op. UK 1 makes a loan to the Dutch Co-op, which in turn subscribes for shares in a Dutch company. That company uses the money from issuing the shares to make a loan to Ultimate Debtor.

The Co-op is regarded as an opaque entity for Dutch tax purposes and forms part of the Dutch fiscal consolidation (it becomes the tax liable entity for the profits and losses of the group). In the Netherlands it is claimed that the use of the Co-op means that in the Fiscal Consolidation the interest income arising to the Dutch BV Finco on the loan to Ultimate Debtor will be offset against the interest expense on the loan issued by the Dutch Co-op. So from a Dutch perspective the Netherlands is flat for tax purposes. The interest received from the loan to Ultimate Debtor is matched by the interest paid by the Dutch Co-op to UK 1.

Under UK tax law, the Dutch Co-op it is likely to be treated as a partnership and hence transparent. If it is a partnership, it is not taxed in its own right; its profits

and losses are attributed to the UK corporate partners. UK 1 will include in its calculation of its corporation tax profits the loan relationship credits on the loan it has made to the Dutch Co-op. UK 1 and UK 2 will include in their calculations of their corporation tax profits the interest deductions of the Dutch Co-op as they are treated as loan relationship debits. The debits are allocated between UK 1 and UK 2 in accordance with the profit sharing arrangements of the Co-op. So from a UK perspective the UK is flat for tax purposes. The interest receipt from the loan to the Dutch Co-op is matched by the interest deductions allocated to the two UK corporate partners.

Overall the group obtains a deduction for the interest paid by Ultimate Debtor, but that interest is not effectively taxed. The interest receipt is effectively sheltered from tax by using the Dutch Co-op, which is a hybrid entity, being treated as transparent for UK tax purposes and opaque for Dutch tax purposes.

Dutch BV Finco is a CFC. Its assumed taxable total profits will likely consist almost exclusively of the interest received from Ultimate Debtor. The fact that the Dutch Co-op is a hybrid entity will not in itself affect any claim under Chapter 9 for the profits of Dutch BV Finco to be either partially or fully exempt.

However the use of a hybrid entity means that the arbitrage rules (see Part 6 TIOPA) will potentially apply in respect of the loan relationship debits attributed to UK1 and UK 2.In applying those rules the fact that there is a CFC structure does not necessarily mean that there is a UK tax advantage or that the purpose of the hybrid arrangement is to obtain a UK tax advantage. For example, if the hybrid structure is only being used to minimise Dutch tax there is unlikely to be a tax advantage.

Full exemption – Qualifying resources

Aims

101. The aim of the qualifying resources rule is to give full exemption for non-trading finance profits (NTFPs) of a qualifying loan relationship (QLR) that is funded in a way that places no demands on group resources outside the borrower's own jurisdiction. Qualifying sources of funding are:

- funding from group profits arising in the borrower's territory;
- funds raised by issuing shares from the group's top company.

Note that each QLR is considered separately.

What are qualifying resources?

102. Qualifying resources (QR) are defined by reference to the borrower's territory: this is called the 'relevant territory' and must be identified before it is possible to determine whether resources are qualifying resources. In outline, the categories of qualifying resource are:

- profits from lending to the territory;

- profits earned in the territory;
- QRs arising from shares issued by the group top company;
- share for share exchanges;
- funds derived from share issues.

Claims for Qualifying Resources

103. Section 371IB sets out the rules to be applied to establish the extent to which profits from a QLR will be fully exempt where it is funded out of qualifying resources. A claim can be made for up to 100% of profits of a QLR, although a claim for less than 75% exemption will not arise in practice, as a claim for partial exemption under section 371ID will be more beneficial. If the claim establishes that X% of the resources used to fund a QLR are qualifying resources then X% of the non-trading finance profits are fully exempt.

104. It is not possible to make a claim under section 371IB for full exemption in respect of part of a QLR and a claim under section 371ID for 75% exemption in respect of the remainder. Any profits of a QLR not exempted by way of a claim under section 371IB will be apportionable in full unless the matched interest rule in section 371IE applies to exempt part or all of the balance.

105. Section 371IB places the burden of proof upon the claimant company, which must demonstrate that at least X% of the resources used to fund the QLR throughout the accounting period are qualifying resources. See paragraph 144 below for more detail about the nature of evidence required.

106. The claimant must determine the sources of funding for the QLR as it stands in the accounting period. This may need historical investigation and may require direct or indirect funding sources to be considered.

Example

A £100m loan is funded at the beginning of an accounting period (the relevant period) entirely out of qualifying resources and this loan is increased to £150m half way through the year with the balance of the loan being funded out of non qualifying resources.

Throughout the relevant period the percentage of the loan funded from qualifying resources is 100% for the first 6 months and 67% for the second 6 months so that over the relevant period the percentage of profits that was funded from qualifying resources was 83%. However the chargeable company's claim for the relevant period should specify X to be 67%. This is because section 371IB(2)(a) requires at least X% of the principal outstanding on the relevant loan to be funded wholly out of qualifying resources at all times during the relevant period. For the second 6 months only 67% of the principal was funded out of qualifying resource. In this scenario a claim under section 371ID would be more advantageous for the company than a section 371IB claim.

If for the first relevant period it is subsequently established that in fact 100% of the loan was derived from qualifying resources at all times during the relevant period then it is possible for the chargeable company to withdraw the claim under section 371ID and make a section 371IB exemption claim instead.

Categories of qualifying resource: s371IB(6)

107. This is the first section to consider when determining if resources are qualifying resources. Two types of qualifying resource are identified by this subsection:

- profits from lending to the relevant territory, and
- funds derived from shares.

108. Funds derived from shares may arise from shares held by the CFC in group companies, or from shares issued by the CFC to group companies.

109. Funds derived from shares are subject to conditions in s371IB(7) and are qualifying resources only if they meet the further conditions in that subsection.

Profits from lending to the territory

110. A CFC that makes a QLR to a group company in territory X will earn profits from the loan. Those profits are qualifying resources if they are re-lent by the same CFC to the same borrower, or to another group borrower also in territory X (section 371IB(6)(a)).

111. Unlike other categories of qualifying resource, this type of profit is qualifying only if it is used directly by the company in which the profit arose, in other words the company making the loans. There is nothing in the legislation to allow these profits to be qualifying resources for any other company.

112. If the profits are distributed by the CFC, they lose their character as its profits and so cannot be recreated as qualifying resources if they are returned to the CFC, for example as a new capital contribution. Lending however does not alter the character of the profits in the same way.

113. It would be unusual to find that in every case, profits derived by a CFC from lending to a group company in a particular territory are immediately lent back to the same company or other group companies in the same territory. Where such profits are not immediately re-lent in that way, it is most likely that the money has been left on deposit in a bank account or deposited with a group treasury company. Where the CFC can demonstrate that lending profits have been put on short-term deposit in this way, then subsequent use of the money for more lending activity will not prevent the original profits from being qualifying resources – the profits from the original lending have not been distributed; they still belong to the CFC. The interest earned from the short-term deposit, if also used to fund subsequent lending to group companies in the relevant territories, will not represent qualifying resources. And if lending profits are placed on short-term

deposit with a UK resident group company, a full CFC charge will arise on these interest receipts.

114. A CFC may invest its lending profits in other group companies.

Example

- A CFC makes a loan L1 to a group company in territory X
- The CFC accumulates profits P from this loan
- Using the funds P the CFC makes another loan L2 not to territory X
- L2 is repaid and the CFC uses the funds to make a loan L3 to a group company in territory X.

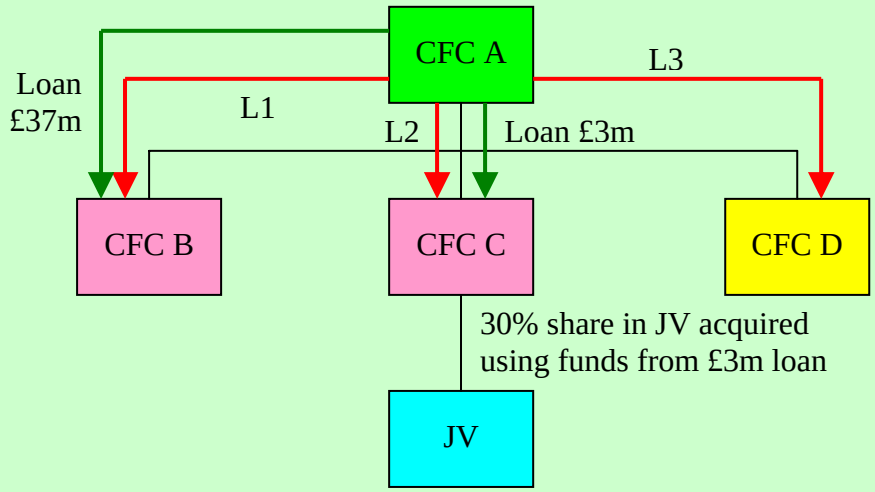
The funds making up loan L2 are not qualifying resources because the borrower is not resident in territory X

The funds making up loan L3 are qualifying resources, because they are the profits earned from loan L1. Both L1 and L3 are made to borrowers in territory X. The fact that the profits P were lent to a non-qualifying company does not mean they necessarily lose their character as potential qualifying resources that may be subsequently lent to a group company.

115. As an alternative to depositing funds from profits of lending in a bank account or with a group treasury company before using those funds for further lending, a CFC may invest those profits in another group company. For example, a financing CFC may invest its profits in redeemable preference shares issued by a UK company as an alternative to upstream lending the profits to the UK. If the shares are redeemed, then the funds from the repayment of the shares may then be used as funding for further loans by the financing CFC with the proviso that the group can demonstrate that the return of the funds solely represents the profits that were originally earned from lending to the relevant territory. If this is the case, then the repaid funds may subsequently be used as qualifying resources.

116. To qualify under section 371IB(6)(a), profits must arise from a loan made to the relevant territory that is used for group business in the relevant territory. For example, profits from a loan to a group company resident in territory X used for the purpose of acquiring shares in a territory Y or for the purpose of lending to other group companies in territories Y and Z will not represent qualifying resources if subsequently used to make loans to group companies resident in territory X. This is because the profits have not been generated from lending that has been used for the purposes of the business of the CFC group in territory X. While in the second example the loans may have been made by a group company resident in territory X, that company may not be the ultimate debtor and the loans have been used to fund group business outside of territory X.

Example



CFC A owns CFC B and CFC C that are resident in Germany and CFC D that is resident in Italy. CFC A lends to CFCs B and C in Germany and D in Italy (loans L1 to L3). The loans are all for business purposes of those CFCs in their respective territory of residence.

CFC A subsequently makes a further loan of £37m to CFC B, funded out of £20m of NTFPs received by CFC A in respect of the original loan L1 to CFC B, £15m of NTFPs received by CFC A in respect of the original loan L2 to CFC C and £2m of NTFPs received by CFC A in respect of the original loan L3 to CFC D.

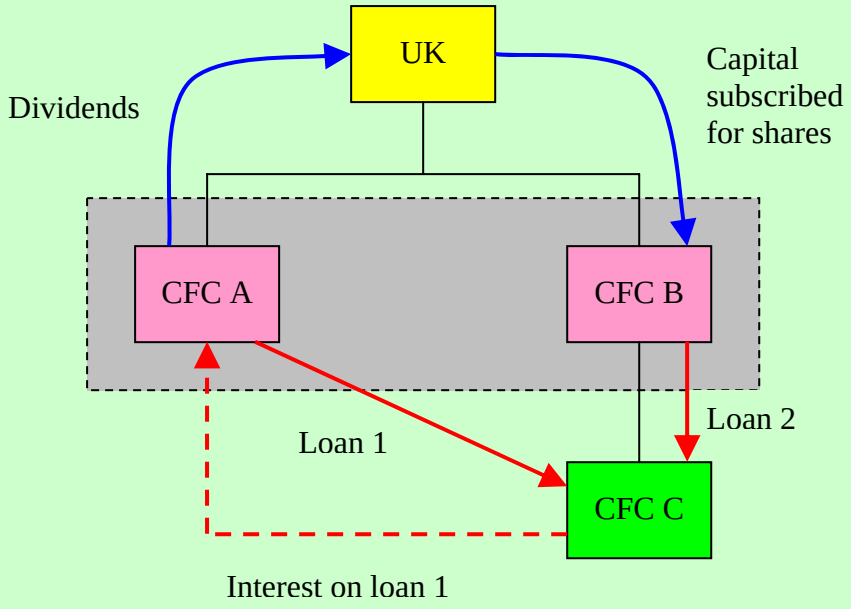
CFC A also makes a further loan £3m to CFC C funded out of NTFPs received by CFC A in respect of the original loan L3 to CFC D.

CFC B uses the funds to acquire plant and machinery used in the trade of CFC B in Germany (no profits of which pass through the CFC charge gateway). Out of the further loan of £37m, £35m is funded by qualifying resources as defined in section 371IB. This is because £35m is funded out of profits made by CFC A on loans made to relevant members of the CFC group, CFCs B and C – which are connected companies resident in Germany (being the same territory of residence as the ultimate debtor of the new loan of £37m, CFC B). The remaining £2m of the loan is not funded out of qualifying resources as the funds were sourced from the profits on the loan made by CFC A to CFC D in Italy.

CFC C uses the funds from the loan of £3m to acquire shares in a French joint venture. The further loan from CFC A to CFC C is not funded out of qualifying resources as the funds were sourced from the profits on the loan made by CFC A to CFC D in Italy. The loan would also not be treated as funded out of qualifying resources as the loan is not used for the business purposes of CFC C in Germany.

Note that the source of funds for the original loans to CFCs B and C does not need to be tested to establish whether the profits made on those loans by CFC A meet the conditions to be treated as qualifying resources. What is required is that the loans were made to the same territory and used by those CFCs for their business purposes in that territory.

Example



CFC A and CFC B are both tax resident in the same territory. CFC C, the ultimate debtor in respect of loan 2, is tax resident in another territory, "the relevant territory".

The dividend from CFC A is funded from lending to CFC C in the relevant territory, but it is not derived from group profits arising in the relevant territory. These are Luxembourg profits.

Although profits from lending to CFC C can qualify under s371IB(6)(a), they do so only if they are used directly by the lending CFC to make a further loan to the same territory. Funds derived from lending into a territory is not a category under s371IB(7) and there is nothing in s371IB(6)(a) that allows indirect sources of funding to be considered.

117. There may be cases where interest on a QLR is capitalised. Any claim that profits in respect of that capitalised interest falls within section 371IB(6)(a) on the basis that

- the interest represents profits of the CFC's business arising from a loan to a qualifying group company, and
- the interest is lent to the qualifying group company (because it is capitalised) for business purposes and is used solely for the purposes of that company's business

should be considered critically. Generally this would be considered as an accrual of the interest cost that can't be said to represent new funds for the borrower to use in its business. Normally an expense (including interest) which has accrued but not been paid is not considered to be a loan – a transaction for the lending of money - under the loan relationship rules.

How are funds derived from shares?

118. The second type of qualifying resource is funds derived from shares (section 371IB(6)(b)). Shares may be used to create funding for a loan through a wide range of transactions, including:

- the CFC exchanges shares for debt;
- the CFC funds a loan from a distribution;
- equity is invested in the CFC and used by the CFC to make a loan;
- a loan may be 'pushed down' to the CFC in return for newly issued shares.

The conditions under which funds are considered to be derived from shares are set out in section 371IB(7)

119. It is possible that shares can be used to create funding for a loan through a capital contribution. So, for example, if a UK company owns shares in a CFC and provides funds derived from qualifying resources to the CFC by way of a capital contribution, rather than the issue of new shares in the CFC, the funds will be treated as being derived from shares.

120. This conclusion is not so obvious if the capital contribution was not made by the direct shareholder. However where qualifying resources are sourced by a member of the CFC group and provided as funds by way of a capital contribution directly to a CFC in which that member has an indirect shareholding, then provided it is clear the capital contribution is made in relation to the shareholding in the CFC, the qualifying resources will be treated as derived from shares.

What funds derived from shares are qualifying?

121. There are three categories given in section 371IB(7):

i) Profits derived from group operations in the relevant territory. These may be realised or unrealised profits.

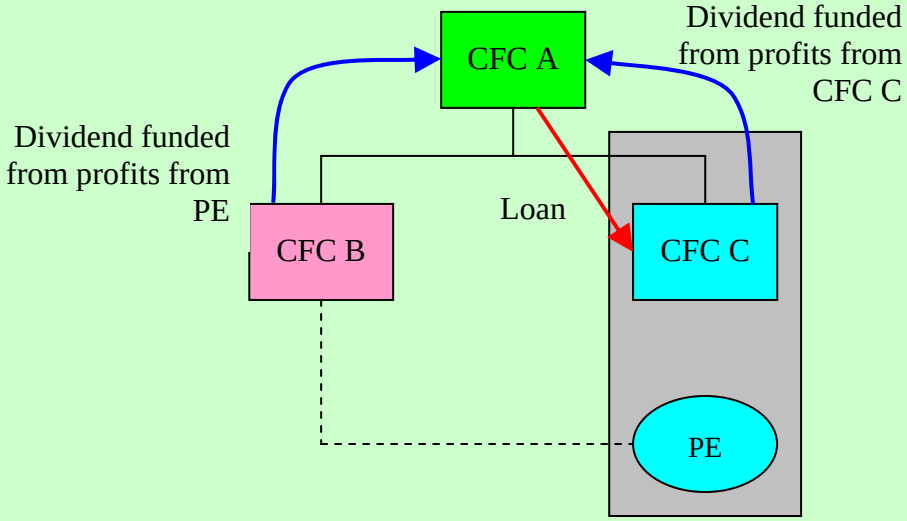
ii) Value representing consideration in a share for share exchange.

iii) Proceeds of a rights issue.

122. There is no exhaustive definition of what represents profits derived from group operations in the relevant territory. However, sections 371IB(10)(d) and (e) specifically exclude certain profits that do not in substance arise from group operations in the territory from this category of qualifying resources. The specific exclusions are:

- profits that are derived from lending outside the territory,
- distributions received from third countries, and
- profits earned in permanent establishments in third countries.

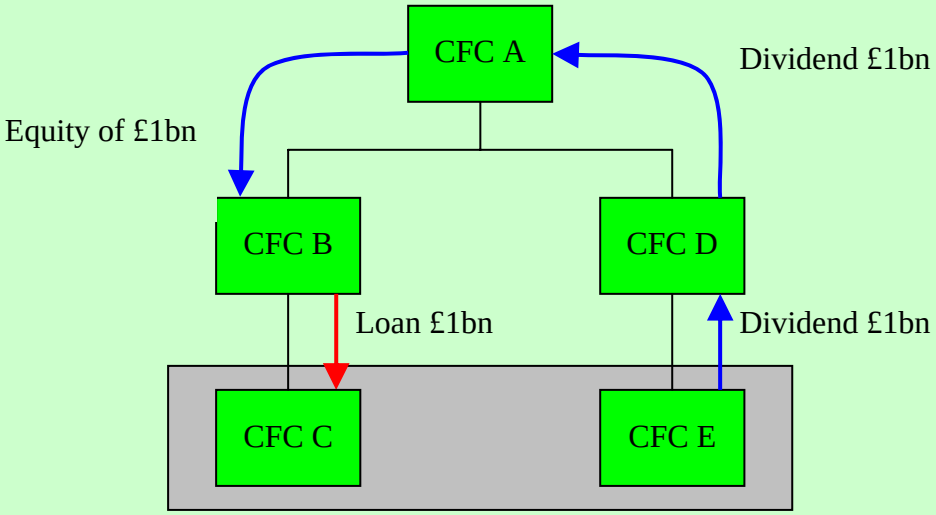
Example



Here there is a QLR from CFC A to CFC C funded partially out of dividends paid to CFC A from CFC C and partly from dividends received from the CFC B. The relevant territory is the territory where CFC C is tax resident as that is the territory of the ultimate debtor. To the extent the QLR is funded from the dividend paid by CFC C, the QLR will be treated as funded out of qualifying resources.

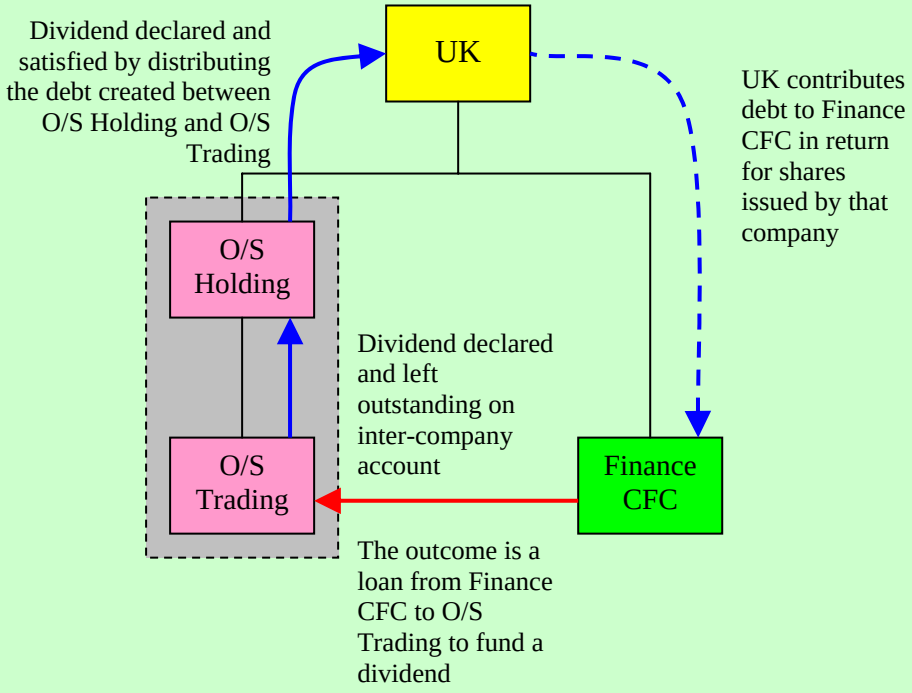
The dividend received from CFC B will also be qualifying resources under section 371IB(6)(b) and 371IB(7)(a) because all the profits out of which the dividend is paid are profits of the business of the CFC group in the same territory that CFC C, the ultimate debtor, is tax resident in.

Example



Here both CFC C and CFC E are resident in the same territory. The loan of £1bn from CFC B to CFC C is funded out of qualifying resources if the group can demonstrate that the loan has ultimately been funded from the dividend of £1bn paid by CFC E. Provided the chain of funding can be properly evidenced, it doesn't matter if the funds pass through companies that are not resident in the relevant territory.

Example



In this case O/S Trading declares a dividend, but rather than borrowing to pay a cash dividend, the dividend is left on inter-company account, creating an intra-group loan receivable. An intra-group debt created in this way can be a QLR as it is a debt brought into being by an instrument and so is a loan relationship that falls within section 302 CTA 2009. The intra-group loan receivable is then distributed by O/S Holding to the UK parent, who in turn contributes that loan receivable to Finance CFC in return for an issue of shares. So the final outcome is a loan from Finance CFC to O/S Trading to fund a dividend.

The loan is funded out of qualifying resources as the loan to O/S Trading is funded out of the profits of the business of the CFC group in the relevant territory.

123. Profits derived from group operations in the relevant territory are not limited to the provision of goods or services in that territory. Profits may well be derived from customers in other territories. For example a service company in the relevant territory may provide legal services for a number of group companies in other territories and so the company is trading with customers in those territories, rather than trading in those territories. Where the company is trading in another territory, the profits from that activity are not derived from group operations in the relevant territory. If the company is trading in another territory, it will generally do so through a permanent establishment in that other territory (in which the case the limitation in section 371IB(10)(e) will apply), but there may be instances where a company trades in another territory without creating a permanent establishment. While this would be unusual, profits earned from such trading are not profits derived from group operations in the relevant territory.

124. Profits derived from group operations in the relevant territory can include both realised and unrealised profits in respect of the increased value of assets held in that territory. Not all territories will allow a company to make distributions out of unrealised profits but it is possible in the US in certain circumstances.

125. Profits derived from group operations in the relevant territory do not include share capital, or amounts that are equivalent to share capital, so for example a distribution by a US company that is paid in respect of a contribution of capital made by a UK resident company (e.g. a repayment of share capital) will be excluded because the profits are not derived from US profits.

126. However, if a US holding company holds shares in other US group companies and the value of those companies increases because of the profits they have earned, including unrealised profits in the form of increases in the value of assets held in the US (for example warehouses used by the US business), a distribution made possible by such increases in value is indirectly derived from US profits and so may be profits derived from group operations in that territory. Put another way, profits are not prevented from being the direct or indirect source of amounts within section 371IB(6)(b) solely because they are unrealised profits, but of course they must in other respects represent profits of the CFC group in the relevant territory in order to meet the condition in section 371IB(7)(a)

127. In each of the three cases summarised in paragraph 122, funds derived from shares may be qualifying resources if they **directly or indirectly** represent amounts derived from any of those three cases. It is therefore necessary to undertake an investigation into the **original source** for the funds.

128. A CFC may borrow to fund a loan temporarily, but if the arrangement for the creation of the loan includes the repayment of that temporary loan (i.e. the intention at the outset was for the loan to be funded from a specific source but temporary funding was needed while the permanent funds were appropriated), the funds used to repay the temporary borrowing are in substance used to fund the CFC's loan and so it is the nature of these funds that will determine whether the loan is a qualifying loan. Note however where the temporary loan is UK debt, the rules provided by sections 371IB(8), (9) and (9A) may place a restriction on an amount that be considered to be qualifying resources.

Share for share exchange

129. A group may make an acquisition of another group by offering newly issued shares to the shareholders of the 'target' group. An acquisition effected in this way is referred to as a share for share exchange.

130. Resources obtained from a shareholding (e.g. by selling the share or from a distribution) are qualifying if the sum received represents an amount obtained by the group in a share for share exchange. For example, the following will (subject to the conditions on share for share exchanges being met) be qualifying resources:

- a distribution of pre-acquisition profits;
- a repayments of share capital that existed when the acquisition was made.

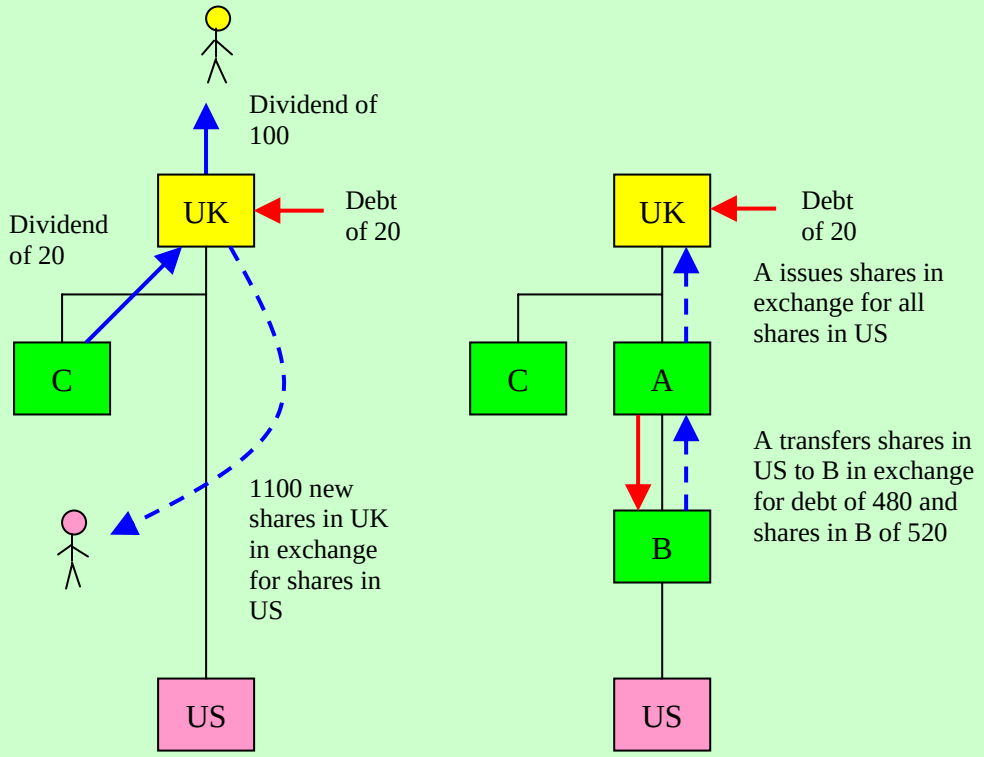
Conditions for share for share exchanges to create qualifying resources

131. The conditions to be satisfied so that funds derived from share for share exchanges can be treated as qualifying resources are provided by section 371IC. The original shareholders must be given shares in the acquiring group in return for their shares in the target group. The shares must be newly issued by a company in the group that is not the 51% subsidiary of any other company. Usually the only company to qualify in this way is the group's ultimate parent company.

132. The proportion of resources obtained from a share for share exchange that are qualifying resources are reduced if the acquisition was partly for shares and partly for cash, or if an 'extraordinary distribution' was paid to shareholders in connection with the acquisition. In such a case the proportion of the resources from the share for exchange that are qualifying resources is given by the formula:

$\frac{100\% \times B}{A + B}$, where A = Share value, B = dividend and/or cash

Example



A UK group acquires a US group through the following steps:

- The US group shares are acquired in exchange for newly issued shares in the UK group. The value of the newly issued shares is 1100.
- To compensate the existing UK group shareholders, an extraordinary dividend is paid to them immediately before the exchange of shares. The value of the dividend is 100.

- The dividend is funded as follows: Cash reserves of 60, dividends received from foreign subsidiaries of 20 and debt taken on by the company paying the dividend of 20.

The newly acquired shares are transferred to CFC A, which is resident in the Cayman Islands, in return for shares issued by A. A in turn passes the shares to CFC B, which is resident in the US, in return for shares worth 520 and debt of 480.

The group makes a claim under s371IB for the profits derived by CFC A on the qualifying loan relationship of 480. It has to establish what part of the loan of 480 made from CFC A to CFC B is funded out of qualifying resources.

As the loan is funded by the sale of the newly acquired shares in US by CFC A to CFC B the group has to consider s371IC to determine the qualifying proportion.

In the formula in s371IC(5), A is 1100 and B is 100, therefore 11/12 of the funds derived from the shares are qualifying. Therefore 440 out of 480 of the loan qualifies for full exemption.

If the dividend paid to UK's shareholders had been wholly UK debt funded, subsections 371IB(8) and (9) would have been relevant. These require the non-qualifying resources to be not less than the new net debt created under the arrangement.

In this example the non-qualifying resources are 40. This exceeds the new debt of 20 so subsections 371IB(8) and (9) have no effect. But if the dividend had been funded out of debt of 100 the non-qualifying part must be increased to 100 by these subsections, to match the new debt. Therefore only 380 of the loan from CFC A to CFC B would be treated as being funded out of qualifying resources. And so only X% = 380/480 = 79.2% of the non-trading finance profits arising from the loan of 480 would be exempt under s371IB.

A few years after the acquisition of US, CFC A has retained profits of 200 arising entirely from its loan to CFC B. The US sub-group has increased in value and the group wants to 'thin out' the sub-group to increase the US tax deduction for interest. The following steps are taken

- CFC A borrows funds of 1000 using a daylight facility provided by a UK resident third party lender
- CFC A makes a loan of 1200 to CFC B, using the retained profits and the borrowed funds.
- CFC B pays a dividend of 1000 to CFC A
- CFC A repays the daylight facility of 1000

200 out of the 1200 lent by CFC A to CFC B is derived from lending to CFC B. This is a qualifying resource under s371IA(6)(a).

The remaining 1000 is initially funded by the UK daylight facility, but due to the relaxation (see paragraph 140 below) provided by s371IB(9A) and (9B), that debt is ignored in considering any restriction of qualifying resources due to UK debt. But once the temporary loan is repaid, it becomes necessary to consider the source of funds for the repayment, which is the dividend from CFC B. This is the

ultimate source for the other 1000 of CFC A's lending and it is derived from a group shareholding, so falls within s371IB(6)(b), subject to subsection (7).

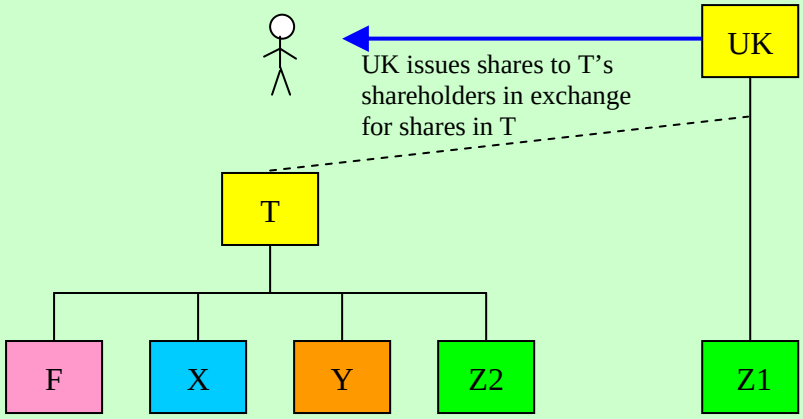
It is therefore necessary to consider the source of the distributed funds. The distributed funds could fall within s371IB(7)(a) if the distribution is sourced from group profits arising in the US, such as post-acquisition profits of the acquired group. They could also fall within s371IB(7)(b) if they are funded out of amounts comprised in the earlier acquisition, although in this case only the proportion established above (i.e.11/12) would qualify.

They could also fall into neither category if the distribution is sourced from non-US distributions, non-US lending or other non-US operations such as foreign branches.

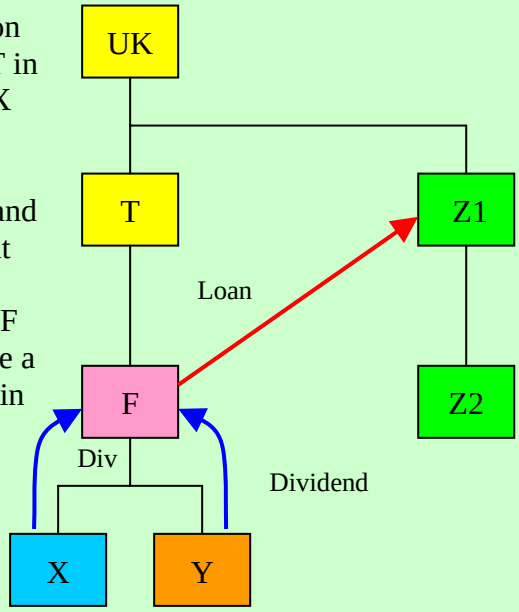
The greatest possible proportion is 100% qualifying resources if the funds all derive from the group's US operations post acquisition.

Example

Target (T) and its subsidiaries were acquired from unconnected persons in return for an issue of shares by a UK resident parent (UK). One of T's subsidiaries acquired was finance CFC (F), tax resident in territory F.



Following the acquisition F issues new shares to T in exchange for shares in X and Y (which are tax resident in territories X and Y respectively). X and Y pay dividends to F out of profits that accrued prior to the acquisition. F uses those funds to make a loan to Z1 (tax resident in territory Z). Z uses the loan to part fund an acquisition Z1 from T.



The dividends potentially represent qualifying resources as they are funds received by F from the qualifying value of relevant pre-acquisition funds or other assets. There is no restriction because the dividends are paid out of profits derived from different territories from that of the ultimate debtor as there would be for dividends qualifying under section 371IB(7)(a) i.e. profits of the CFC group in the relevant territory. This is because the dividends qualify as relevant pre-acquisition funds or assets under section 371IB(7)(b)

Example

Shares in an unconnected company are acquired in exchange for the issue of new shares worth £100m in the acquiring group's parent company plus cash of £20m. At the same time an extraordinary dividend is paid to existing shareholders of the acquiring group's parent company of £5m. Half of these shares are passed to a CFC in return for shares issued by the CFC. The acquired company distributes all of its pre-acquisition profits, the CFC receiving a dividend of £60m. The CFC makes a qualifying loan to another non-UK group company of an amount £30m. There is no other significant investment of capital in the CFC.

The value of the acquired shares is £120m and so the value of the investment in the CFC is 60. The non-qualifying costs are £20m + £5m = £25m. The qualifying proportion of the pre-acquisition profits is therefore reduced by Y%, given by the formula in section 371IC(5), where A is £100m and B is the sum of £20m and £5m:

$$100\% \text{ x } \frac{25}{100+25} = 20\%$$

So, in relation to the loan of £30m the qualifying value of the pre-acquisition profits is reduced by 20% from £30m to £24m. The distribution therefore comprises qualifying resources to the extent of 80% of its value. Therefore the non-trading finance profits from this loan are 80% exempt (i.e. the qualifying resources are £24m).

Example

UK group A acquires an unconnected UK group B by issuing new shares in A to the shareholders of B. Group B had an existing overseas financing company, that had made a number of intra-group loans to non-UK members of group B. The funding of those intra-group loans has come from a variety of sources, mainly equity from the UK. The loans are not treated as being funded out of qualifying resources simply because they have come into group A via a share for share exchange; the requirements are more specific than that. The resources used to create the loan must be derived from amounts that represented value in the share exchange, which would not be the case for an intra-group loan that pre-existed within the acquired group B.

Rights issues

133. The third category of funds derived from shares are funds raised from a rights issue. This is referred to in the legislation as the proceeds of a share issue. The proceeds of a share issue are qualifying resources if the following conditions are met (see section 371IB(7)(c)):

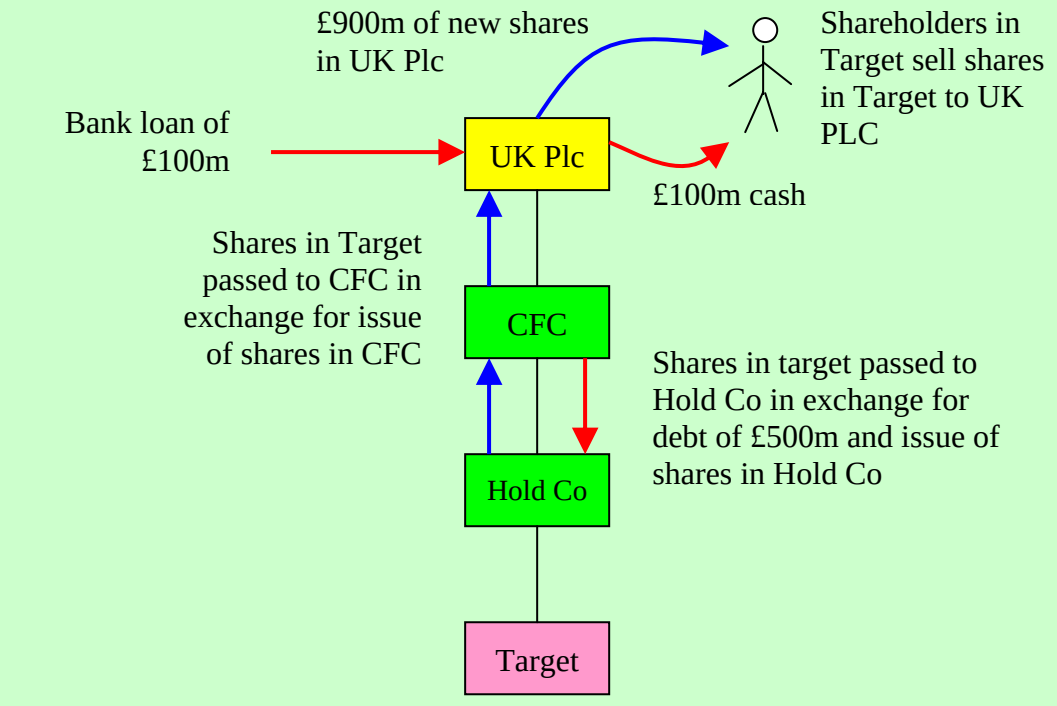
- The shares are issued by a group company that is not the 75% subsidiary of any other company (typically the group's ultimate parent company), and
- the shares are ordinary, non-redeemable shares and are issued to persons who are not members of the CFC group. Typically rights issues are offered to members of the existing ultimate shareholder base of the group.

134. Proceeds of a rights issue can be qualifying resources if the CFC obtains funds in relation to shares (section 371IB(6)(b)) and the funds are indirectly obtained from the rights issue (section 371IB(7)(c))

Qualifying resources – restriction in relation to UK debt

135. There is an important restriction on qualifying resources where the source of the funding includes UK debt. The restriction is set out at section 371IB(8), (9) and (9A) to (9D). If a qualifying loan relationship is created as part of an arrangement that increases the group's UK debt by an amount X, then at least X of the resources must be non-qualifying. The term "arrangement" has a wide meaning and the restriction applies whether the UK debt is created as a direct step in providing funds to the CFC that makes the qualifying loan relationship or is connected with the provision of that loan in some other way.

Example



A £1 billion share acquisition of Target is funded by giving the original shareholders £900m of newly issued shares in the acquiring group and £100m cash. The cash is all obtained by new debt taken on in the UK. The shares in Target are passed to CFC in return for new shares issued by the CFC. The CFC sells the shares to Hold Co in return for £500m of shares and £500m debt.

The CFC's loan to Hold Co is funded by the sale of the newly acquired shares in Target. The sale proceeds fall within section 371IB(6)(b) and (7)(b) so are potentially qualifying resources.

Section 371IC gives the proportion Y% that is deducted from the qualifying resource using the formula $\frac{100\% \times B}{A+B}$. Here A = 900m and B = 100m, so Y% = 10%. Therefore, in the absence of subsections 371IB(8) and (9), the qualifying resource proportion X% would be 90%.

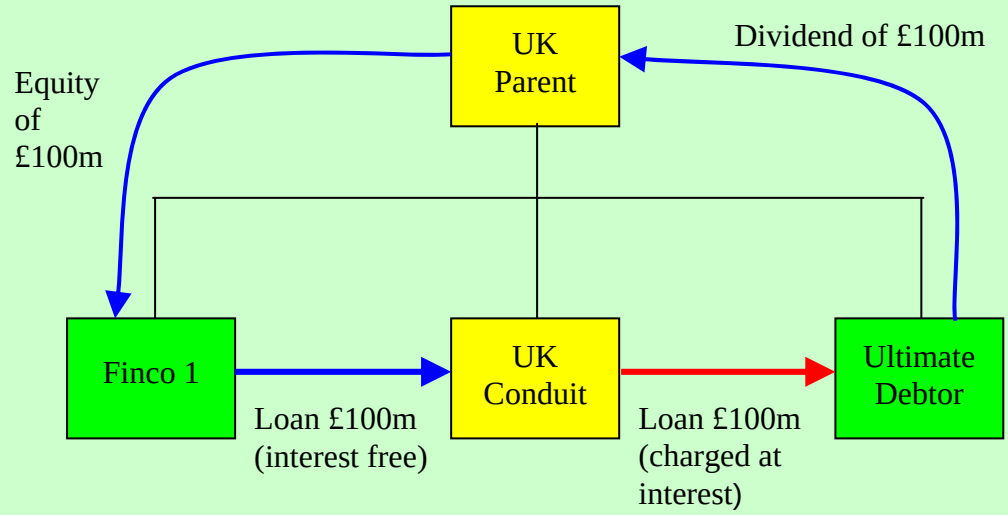
However section 371IB(8) and (9) require the non-qualifying resources to at least match the new UK debt, which is £100m. This represents 20% of the loan to Hold Co and so the qualifying resource proportion is correspondingly reduced to 80%.

136. The restriction in relation to UK debt remains in place even if the debt created under the arrangement is subsequently repaid. The repayment of the debt does not affect the nature of the resources that went into the creation of the CFC loan.

137. If the original QLR made by a financing CFC is subject to a restriction in respect of UK debt, and the QLR is repaid and replaced with another one, which is funded otherwise than through the proceeds of the repayment of the first loan, then the new loan will be considered afresh and section 371IB(8) and (9) would not necessarily continue to be relevant. However this type of restructuring will be considered critically. Consider for example a UK company that subscribed for 1 billion £1 ordinary shares in a CFC, funding the subscription through a rights issue of £600m and new external debt of £400m. The CFC then made a loan of £700m which is a QLR. Any claim that the loan was funded out of qualifying resources would be subject to a restriction under section 371IB(9) in relation to the new UK debt. Some years later the external debt has been repaid and the £700m loan by the financing CFC is also repaid and two new loans made, for £600m and £100m. In this case the restriction would remain; the fact that the original loan by the CFC has been repaid does not alter the fact that the funding of the CFC was a mix of resources.

138. The restriction simply refers to a debt incurred in the UK. So if a UK company is used as a conduit to pass funds from a financing CFC to another member of the CFC group, it is the gross amount of debt of the UK company, and not the net debt which is taken into account in considering the restriction under section 371IB(9).

Example



Ultimate Debtor distributes profits of £100m to UK Parent. UK Parent immediately uses the cash to subscribe for £100m shares in Finco 1, which lends the funds interest free to UK Conduit, which in turn lends the funds at interest to the Ultimate Debtor. In calculating the assumed taxable total profits of Finco 1, interest is imputed in respect of the interest free loan and in turn UK Conduit claims a corresponding adjustment in the same amount of interest. The loan from Finco 1 is a qualifying loan relationship, but although the loan is funded by profits of the Ultimate Debtor (and so are profits of the business of the CFC group in the relevant territory) and are funds received by Finco 1 in relation to shares issued by it to UK Parent, the loan is made as part of an arrangement that involves debt of £100m incurred by a UK member of the CFC group. As such the qualifying resources are reduced by £100m i.e. to nil qualifying resources. It is still possible however to make a claim under section 371ID (for 75% exemption) as long as all the other conditions in Chapter 9 are met.

139. The limitation in relation to UK debt incurred by a member of the CFC group that is part of, or connected to an arrangement to provide funds for a qualifying loan relationship is relaxed in two specific cases (see section 371IB(9A)). These are;

- where the debt is a daylight borrowing facility, and
- where the debt is used to initially provide the funds for a transaction (typically an acquisition) and the funds are repaid out of a rights issue.

140. The relaxation in respect of a daylight borrowing facility is provided by sections 371IB(9A) and (9B). Some financing structures will require funds to "kick-start" the financing and typically a daylight borrowing facility is used to provide the necessary funds. In the example above, the Ultimate Debtor may not have sufficient funds to pay the dividend. Instead UK Parent borrows £100m from a bank and lends the money to Ultimate Debtor. The subsequent steps beginning with the payment of the dividend and ending with the loan to Ultimate Debtor take place within a matter of hours. At the end of the series of transactions, Ultimate

Debtor repays the temporary loan of £100m to UK Parent which in turn repays the £100m to the bank. The bank receives a fee in return for providing the short-term facility.

141. Section 371IB(9B) defines the type of funds that can benefit from the relaxation of the restriction in sub-section (9) as UK debt that is repaid within 48 hours. To ensure this relaxation is not exploited, section 371IB(9C) contains a purpose based anti-avoidance rule. If the main purpose, or one of the main purposes of an arrangement that involves repaying the UK debt is to secure the relaxation provided by sub-section (9B), then that relaxation is denied. So if for example there is an arrangement to put in place a facility to gain the exclusion, or if there is an arrangement to recycle a facility (so that there are a series of 48-hour loans) then the main purpose test will deny the application of section 371IB(9B).

142. The relaxation in respect of a rights issue is provided by section 371IB(9D). Rights issues are typically used to either reduce external borrowings usually where there is a likelihood of borrowing covenants being breached or to fund an acquisition. The relaxation is intended to support the latter scenario, where in some cases it may take some time to raise the necessary funds through a rights issue. The acquisition may be made using short-term external borrowing facilities that are replaced with (and are intended to be replaced with) funds from a rights issue.

143. There are a number of conditions that must be met for the relaxation in section 371IB(9D) to be given.

- There must be an issue of shares that meets the requirements of sections 371IB(7)(c)(i)-(iii) – essentially the issue of new ordinary shares by the ultimate parent of the group to third parties (typically part of the existing shareholder base).
- There must be an expectation that the UK debt incurred before the issue of those shares, will be repaid by the company from the funds derived from the issue of those shares.
- The above repayment must be made within 6 months from the day on which the loan is incurred, and
- The loan must be made by a third party, and in circumstances whereby the third party is not provided with the funds (for example in a back to back arrangement with a bank).

Nature of evidence required

144. The legislation is not prescriptive about the nature of evidence required to establish the source of funding of qualifying resources. Where the legislation allows indirect sources of funding to be considered, it will be necessary to consider how the group of companies ultimately obtained the resources used to create the CFC's loan.

145. Groups will likely find it easier to restructure financing arrangements going forward and demonstrate clearly that the source of the funds are qualifying resources. However groups will also be looking at existing financial arrangements

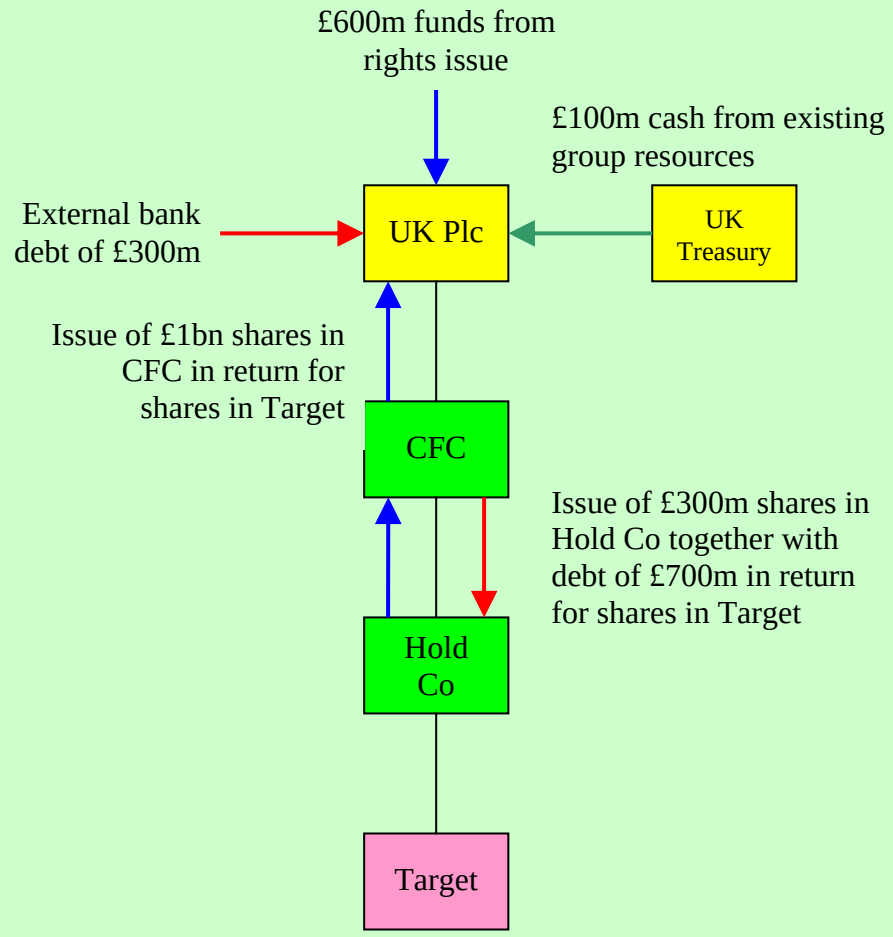
and the potential for restructuring existing financial arrangements so that intra-group lending is funded from qualifying resources. Demonstrating that funds are derived from qualifying resources in these circumstances will inevitably be more challenging as groups generally won't have split funding sources in a readily identifiable manner.

146. In some cases an amount of funding may be obtained from a pool of resources that include both qualifying and non-qualifying resources. For example:

- a distribution may be made out of profits of which some but not all fall within section 371IB(7)(a);
- a sale of shares may occur when share value is partly attributable to an earlier share for share exchange and partly attributable to other sources of value, such as post acquisition profits or capital contributions;
- an external acquisition that is pushed down to a CFC through steps involving the issue of shares and intra-group debt, may ultimately be funded by a mix of resources such as a rights issue and external borrowings.

147. In such cases, if there is no evidence to support any particular funding source, the resource must be assumed to include a proportion of all the available funding sources.

Example



Target is acquired for £1bn, funded by a mix of bank debt £300m), existing group cash reserves (£100m) and a rights issue (£600m). The shares in Target are pushed down to CFC and then to Hold Co. The loan of £700m to Hold Co is a qualifying loan relationship. The group claim that the loan is funded by the rights issue of £600m and the cash reserves of £100m. However the issue of shares in CFC cannot be split between the three sources so that the loan to Hold Co can be attributed to particular sources. The three sources of funds have been mixed to acquire Target and cannot be unmixed so as to attribute particular sources to the qualifying loan relationship.

The qualifying loan relationship is treated as though it were funded by £420m from the rights issue, £210m from the bank loan and £70m from the group's cash reserves. In addition, section 371IB(9) states that the amount of non-qualifying resources cannot be less than the amount of UK debt of £300m. So of the potential qualifying resources of £420m there is further restriction of £20m, reducing the qualifying resources to £400m,

In this case UK Plc would make a claim under section 371ID for partial exemption of the profits from the loan from CFC to Hold Co, as this would be more beneficial than a claim under section 371IB.

Example

The following table illustrates the consequences for full exemption of combinations of qualifying and non-qualifying resources for the profits of a QLR made by a CFC and where the QLR produces different amounts of profits. All the other conditions for full exemption in section 371IB are met. In none of the examples given is there any evidence to demonstrate that a particular QLR can be matched with a specific qualifying resource.

Qualifying resource	Non-qualifying resource	Profits derived from a QLR and claims that can be made under s371IB and s371ID			
		Total	Fully exempt	Balance apportioned	Claim for partial exemption
100	0 (or negligible)	80	80	0	60
100	0 (or negligible)	100	100	0	75
100	20	120	100	20	90
100	40	120	86	34	90
100	100	120	60	60	90
100	100	80	40	40	60

US sub-groups

148. US sub-groups can present some particular difficulties with evidence of source of funds, because:

- US companies do not necessarily prepare statutory accounts;

- Some US states do not have any requirement to match a distribution with any particular profits or other source of funds. Distributions are permitted on the sole condition that the company remains solvent after the distribution.

149. In such cases a pragmatic approach will be necessary to determine the most plausible source for funds. For example, funds derived from a distribution will be qualifying resources for a CFC's loan to the US providing it is reasonable to suppose that in substance the distribution is sourced from the group's US profits. In making this judgement, take account of the following factors (as well as any other factors that may be relevant to the particular case):

- Does the group have sufficient US sourced profit to make the distribution?
- Have distributions been made to the US from non-US group subsidiaries that the group intended be subsequently distributed out of the US?
- Is interest on the loan attributed to US profits or to foreign dividends for US tax purposes?
- Are there any special factors that link the distribution to non-US sources of value within the group?

Section 371ID – The 75% exemption

150. Section 371ID applies to a qualifying loan relationship (QLR) where a claim has not been made under section 371IB that non-trading finance profits (NTFPs) earned from QLRs that are funded out of qualifying resources should be exempt. It provides that 75% of the profits of the QLR shall be exempt.

151. It is possible to make a 75% exemption claim under section 371ID in Year 2 in respect of a QLR when in Year 1 a qualifying resources claim was made under section 371IB if the facts and circumstances for making a claim change.

Section 371IE – Matched interest

152. Claims under section 371IB for up to full exemption, or then under section 371ID for partial exemption are made by reference to individual loans, or in some cases parts of loans {where the ultimate debtor rule applies to identify more than one debtor). The other exemption provided in Chapter 9 applies only to any qualifying loan relationship (QLR) profits of the CFC that haven't been exempted by either section 371IB or 371ID. The exemption under section 371IE doesn't have to be claimed separately; the structure of Chapter 9 means that profits can only be exempted under section 371IE once any claim for exemption under section 371IB and then section 371ID have been dealt with.

153. Although the matched interest rule is considered for each chargeable company that (were it not for the rule) has non-trading finance profits (NTFPs) from its QLRs apportioned to the UK, the calculation requires an examination of the finance costs of all the UK resident companies in the group and the NTFPs earned from QLRs from all the other group CFCs that would be apportioned to those UK group companies but for the matched interest rule. However, the figures from this examination will be used for all cases where section 371IE applies (and so the majority of the calculation will be the same for each CFC).

154. The matched interest rule in section 371IE applies for an accounting period when:

- there remain NTFPs in respect of QLRs of the CFC that are not exempt after the application of sections 371IB and 371ID (these are referred to as the "leftover profits"); and
- (apart from the application of this section) profits under Chapters 5, 6 or 9 would be apportioned to a UK resident group company and would be added to that company's financing income for the purposes of the worldwide debt cap rules (under section 314A); and
- the "tested income amount" (TIA) for the group (taken from the calculation under worldwide debt cap rules and including amounts added under section 314A) exceeds the "tested expense amount" (TEA) of the group (again taken from the calculation under the worldwide debt cap rules).

The extent to which the leftover profits will be exempt will depend on the make up of the figure of tested income amount, taking account of amounts that would otherwise to be added to the UK group companies financing income amounts.

155. The matched interest rules make use of certain calculated amounts from the worldwide debt cap rules in Part 7 of TIOPA 2010.

156. The worldwide debt cap rules in Part 7 have been amended by the insertion of section 314A TIOPA 2010 which provides that the amount of any CFC charge in respect of "relevant finance profits" (under Chapters 5, 6 or 9 of Part 9a) is added to the finance income amount of the company for the period of account of the worldwide group. "Relevant finance profits" for these purposes are defined at section 314A(4) as finance profits within Chapters 5, 6 or 9 of Part 9A excluding any amounts relating to derivative contracts or that are excluded credits within section 314(3) i.e. exchange gains, reversals of impairment losses and profits from related transactions. The worldwide debt cap rules work by essentially comparing interest or interest-like costs. And so section 314A operates so that only the interest or interest-like amounts of a CFC charge on a UK company are added to that company's figure of financing income amount. This ensures consistency between finance income amounts included within Part 7 as a result of the application of Part 9A and finance income amounts included within Part 7 more generally.

157. The comparison of TIA against TEA (both as added to if directed by the relevant finance profits of a group's various CFCs) is essentially a comparison of interest and interest like income against interest and interest like expense. However the leftover profits that will be potentially exempted under the matched interest rule could be made up of amounts that wouldn't be included in either the figure of TIA or TEA. Whilst in most cases a CFC's leftover profits will be made up of interest receipts, it is possible that those profits will include other amounts such as FOREX gains.

158. The exemption provided by the matched interest rule will apply to all the amounts that make up the leftover profits, even if the comparison test does not include those amounts. So if the leftover profits are made up of interest receipts of £50m and a FOREX gain of £10m, and the comparison provides that

a.) all the leftover profits should be exempted then all the profits of £60m are exempted; or

b.) 50% of the leftover profits should be exempted then £30m of the leftover profits are exempted.

159. Section 371IE(2) provides that all of the leftover profits will be exempt if the TIA (ignoring amounts that would otherwise be added to the TIA through the application of section 314A for each UK group company – collectively referred to as the "relevant amounts") exceeds or equals the TEA. This will tend to apply most in cases where the UK part of a group has very little or no borrowing costs.

Example

A UK company is a member of a group for which the TIA is 30 and the TEA is 20. A CFC charge in respect of Chapter 5 profit arises of an amount of 40.

The CFC charge is reduced from 40 to zero because the TIA exceeds the TEA even before any CFC apportionment.

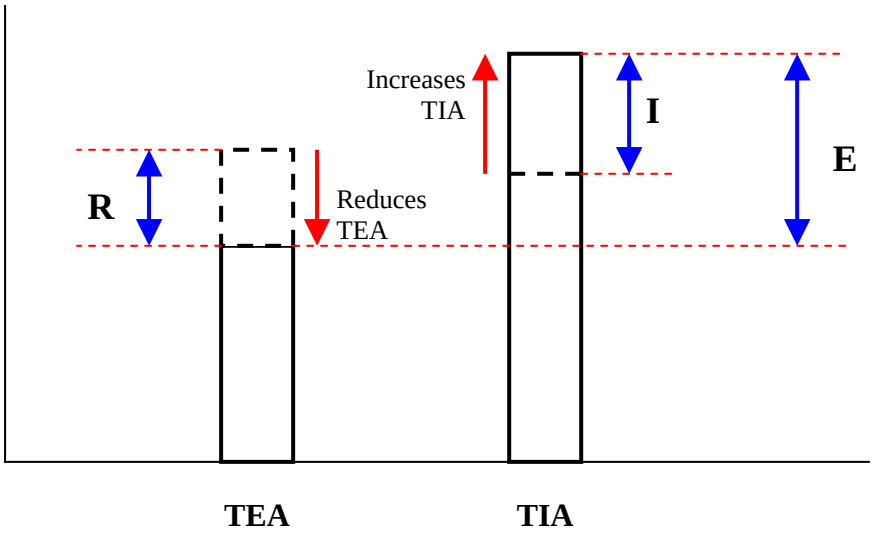
160. However most cases are likely to be more complex. There will be cases where the TIA would only exceed the TEA because of the relevant finance profits that would be apportioned to the UK chargeable companies. In these cases section 371IE(3) provides that a percentage of the left-over profits in respect of the CFC's QLRs will become exempt if the various CFC charges in respect of the relevant finance profits cause the TIA to exceed the TEA. The percentage (Z%) of the leftover profits is given by the calculation in section 371IE(4):

$$\frac{100\% \times E}{I + R}$$

Where

- E is the amount by which the total of the leftover profits as computed in accordance with section 314A(1)(d) TIOPA from QLRs apportioned to the chargeable companies in a group would cause the TIA to exceed the TEA.
- I is the amount by which the figure of TIA would be increased through the apportionment of the leftover profits as computed above from QLRs to the UK chargeable companies in the group (the "relevant amounts").
- R is the amount by which the figure of TEA would be decreased through the apportionment of the leftover profits as computed above from QLRs to the UK chargeable companies in the group (the "relevant amounts").

This is demonstrated pictorially below



Example

A UK resident company is a member of a group for which the TIA is £26m and the TEA is £30m before any apportionment of NTFPs. The UK company, before apportionment has a net financing expense amount (for the purposes of the worldwide debt cap) of £15m. The UK company wholly owns a CFC which has leftover profits of £10m that, apart from the application of section 371IE, would pass through the CFC charge gateway by way of Chapter 9. The application of section 314A (again if section 371IE doesn't apply) means the UK company must take account of an amount of financing income of £10m, which in turn reduces its net financing expense amount by £10m to £5m. As the UK company still has a net financing expense amount, that amount is part of the aggregate figure of TEA, which as a result is reduced to £20m

E = £6m (the amount by which the TIA exceeds the adjusted figure of TEA)

I = nil

R = £10m (the amount by which the figure of TEA is reduced)

The percentage Z is 60% and so 60% of the leftover profits, £6m are exempt under section 371IE. The remaining leftover profits of £4m pass through the CFC charge gateway and are also added to the UK company's figure of net financing amount for the purposes of the worldwide debt cap.

161. The calculation in section 371IE(4) may involve relevant amounts derived from a number of CFCs. It is possible that the calculation will just have a figure for R, or just a figure for I. It is also possible the calculation will include a figure for I and a figure for R.

Example

A group has six UK companies that have interest receipts and interest deductions. Two UK companies, F and G, are chargeable companies and have leftover profits (i.e. NTFPs from QLRs that are not exempt by virtue of sections 371IB or 371ID) that will be subject to a CFC charge, subject to the application of the matched interest rule.

The relevant finance income amounts and finance expense amounts of the six UK companies are set out in the table below. The second part of the table includes the finance income that would be taken into account under section 314A TIOPA if the leftover profits are apportioned to the UK companies F and G.

Note that the finance expense of £20m payable by company G is included twice in the table, to better demonstrate an example where the apportionment of leftover profits would affect both the tested expense amount (TEA) and tested income amount (TIA). However the amount is only included once in the calculation of the TEA

	Finance income	**Finance expense**	**Net FI or FE**	**Part of TEA**	**Part of TIA**
Company A	(£20m)	£60m	£40m	£40m	Nil
Company B		£100m	£100m	£100m	Nil
Company C	(£100m)		(£100m)	Nil	£100m
Company D	(£10m)		(£10m)	Nil	£10m
Company E	(£75M)	£80M	£5m	£5m	Nil
Company G		£20m	£20m	£20m	Nil
Total TIA & TEA				**£165m**	**£110m**
TEA - TIA				**£55m**	
Applying s314A					
Company F	(£60m)		(£60m)	Nil	£60m
Company G	(£15m)	£20m	£5m	(£15m)	Nil
Adjusted TIA & TEA amounts				**£150m**	**£170m**
TEA - TIA				**(£20m)**	

E is the amount by which the total of the leftover profits (£75m) apportioned to the chargeable companies in the group would cause the TIA to exceed the TEA (£20m)

I is the amount by which the figure of TIA would be increased through the apportionment of the leftover profits to the UK chargeable companies in the group (£60m)

R is the amount by which the figure of TEA would be decreased through the apportionment of the leftover profits to the UK chargeable companies in the group (£15m)

Z% = 100% x E / I + R

Z% = 100% x £20m / £60m + £15m; and so Z% = 26.67%

Company F has leftover profits of £60m and so 26.67% of those profits - £16m – are exempt under section 371IE. Company G has leftover profits of £15m and so 26.67% of those profits - £4m – are exempt under section 371IE.

162. For the purposes of the matched interest rule, where there are amounts treated as financing income amounts under Chapters 5 or 6 as well as Chapter 9, it is assumed that the Chapter 9 amount creates or increases any excess of TIA over TEA. This is in order to maximise relief under section 371IE.

163. Section 371IE(6) to (9) provide modifications to the worldwide debt cap rules in Part 7 TIOPA, but only for the purposes of applying this section. One effect is to require that a calculation of TIA and TEA be made for a UK group, if one has not already been made as a consequence of the various exemptions and exclusions within Part 7. This ensures that banking and insurance groups and groups that are not large groups can take advantage of the matched interest rule as well as groups that have not met the gateway conditions within section 261 so that Part 7 does not apply to them.

164. Section 371IE(9) provides a limitation that excludes debits, credits and other amounts that arise from UK banking or insurance business in determining what the TIA and TEA would be. This is because such companies are likely always to be in a net finance surplus position in respect of their trading finance debits and credits and so to include such amounts would mean that the matched interest rule would apply to fully exempt all the NTFPs arising on QLRs in respect of such companies.

Section 371IJ– Claims

165. Section 371IJ provides that a Chapter 9 claim must be made in the UK chargeable company's tax return for the period and sets out the time limits for the claim and for varying or withdrawing that claim. In practice the claim will be made in the corporation tax computation supporting the return rather than on the face of the return itself.

166. A later claim may be made, varied or withdrawn if allowed by an Officer of Revenue and Customs. A claim may also be varied or withdrawn outside of the usual time limits where there are changes to the TIAs and TEAs, provided that the claim is made within 12 months of such a change and the claim is made to take account of that change (and not for another purpose).

167. Only one claim per company is required so full and partial exemption claims are made in respect of the company at the same time.