CHAPTER 9

CONTROLLED FOREIGN COMPANIES

9.1 Introduction

ICTA 1988, s.747

The provisions dealing with controlled foreign companies (CFC) are **anti avoidance** legislation. The legislation aims to prevent UK resident companies setting up subsidiaries abroad with a view to keeping low taxed profits outside the UK tax net. The income would normally only be taxable in the UK when a dividend is paid to the UK company. Therefore, if the profits are not needed in the UK they could be retained overseas with the lower overseas tax charge only being applied.

A CFC is a company which:

ICTA 1988, s.747(1)

- is **not resident** in the UK;
- is **controlled** by UK residents; and
- is subject to a **lower** level of taxation.

9.2 Control

ICTA 1988, s.755D

A company is controlled by persons resident in the UK if they have the power to secure that the affairs of a company are conducted in accordance with their wishes. This may be obtained through shares or by powers in the articles of association or other document.

The definition of control includes persons who hold the majority of rights to the CFC's income or assets or the disposal proceeds on the sale of any shares in the CFC.

ICTA 1988, s.755D(1A)

Control also exists where:

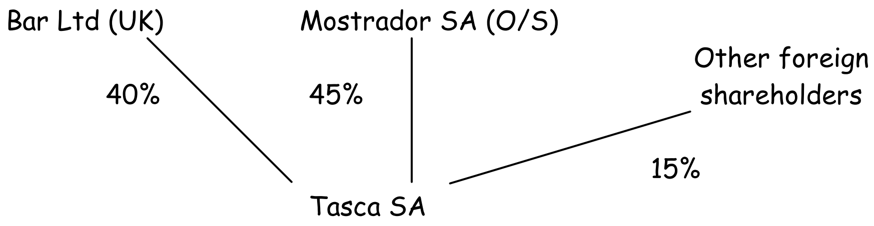
- there are two persons who taken together control the company;
- one of those persons is resident in the UK and is a person in whose case the **40% test** in s.755D (4) is satisfied; and
- the other is a person in whose case the 40% test is satisfied.

If a company becomes non UK resident under the tiebreaker clause in a double tax treaty it is still treated as UK resident for determining UK control of a CFC. Companies that became non UK resident under a tiebreaker clause before 1st April 2002 fall outside the CFC legislation unless they break certain conditions on or after 22nd March 2006. ICTA 1988, s.747(1B)

Two or more persons taken together may control a company. The 40% test is satisfied here if one of them has at least 40%, but not more than 55% of the rights and powers in relation to the company.

Illustration 1

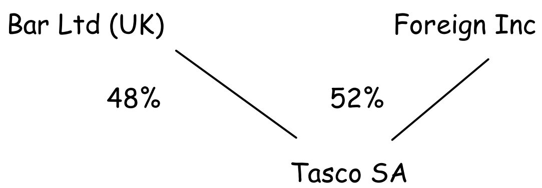
Take a look at this scenario:



Applying the control test we have two companies who taken together control Tasca Ltd, both own at least 40% and Mostrador Ltd does not own more than 55%. Thus Tasca SA is controlled in the UK.

Illustration 2

If the ownership structure were as follows, control will be held to be in the UK.



Looking at the control test, one party is UK resident, both parties own at least 40% and neither holds more than 55%, thus control is in the UK for the purposes of s.747(1A) ICTA88.

9.3 Lower level of taxation

ICTA 1988, s.750

A company will be taken to be subject to a lower level of taxation if the tax payable overseas is **less than 75% of the UK tax** that would be payable on its income, if it were UK resident.

We are comparing the tax payable where the company is resident with the **corresponding UK tax** on those profits. In calculating the UK tax, we assume that the company is UK resident and allow it all the claims that would be available to a UK resident company. Small companies relief is available even though for the purpose of this test we assume that the company is not part of a group relief group.

Groups of companies have attempted to distort the comparison of UK and foreign tax by diverting income into the overseas company that is not subject to UK tax thus making the foreign tax a greater proportion of the UK tax that would be payable. This technique has been addressed by the Finance (No 2) Act 2005 for accounting periods beginning on or after 2 December 2004, preventing such UK excluded income from distorting the test. F(No.2)A 2005, s.44

The Finance (No 2) Act 2005 also addressed the avoidance technique whereby tax paid by the overseas company was repaid in some way to an associated person. Tax repaid in this way is excluded for accounting periods beginning on or after 2nd December 2004, from the comparison of UK and foreign tax.

In calculating the corresponding UK tax, we reduce the UK tax bill by any **DTR** available under the normal rules for taxes paid in other countries. **We never include the taxes paid in the country of residence.** We also take account of any income tax or corporation tax suffered by the company. This will arise where the company has rents arising in the UK subject to deduction of tax at source or where they are trading through a branch in the UK paying corporation tax.

In looking at the tax payable in the territory of residence we take account of **any relief given for taxes paid overseas.**

Illustration 3

A company resident in Ruritania, which is a subsidiary of a UK company, which has 5 other subsidiaries, has chargeable profits of £250,000 in the accounting period to 31 December. The company pays £33,000 tax in respect of those profits in Ruritania and in addition pays £25,000 tax in Utopia where it trades through a branch. This is its only source of income. The £33,000 tax paid in Ruritania is net of tax relief given by Ruritania for the tax paid in Utopia. The comparison to be made is as follows:

Corresponding UK tax:

		£
UK tax	@28% x 250,000	70,000
DTR	Tax in Utopia	(25,000)
Corresponding UK tax (A)		45,000

Full relief is given for the Utopian tax as it is < 28% of profits from that source. Local tax paid in Ruritania is £33,000 (B). As (B) is less than three quarters of (A), the company is subject to a lower level of taxation in its territory of residence.

Illustration 4

The facts are as in Illustration 3, except that included in the company's profit is income from a branch in the UK of £45,000. Tax paid in Utopia and Ruritania is unchanged. The computation of its corresponding UK tax is now as follows:

		£
UK tax on profits	28% x 250,000	70,000
DTR	Tax paid in Utopia	(25,000)
UK corporation tax paid	£45,000 x 28%	(12,600)
Corresponding UK tax		32,400

The Utopian tax still qualifies for full relief. The local tax of £33,000 is more than three quarters of the corresponding UK tax so the company is not subject to a lower level of taxation.

Illustration 5

The facts are as in Illustration 3, except that the tax paid in Ruritania is £3,000 and the tax paid in Utopia is £62,500. The computation of the corresponding UK tax is now as follows:

		£
UK Tax	28% x 250,000	70,000
DTR Tax in Utopia		(62,500)*
Corresponding UK tax		7,500

*Still gets full DTR as less than 28% of income source = £250,000.

The local tax of £3,000 is less than three-quarters of the corresponding UK tax so the company is subject to a lower level of taxation.

These illustrations show that the comparison to be made is between the corresponding UK liability and the tax paid in the territory of residence, rather than the total taxes paid by the company abroad. Even if it is subject to relatively high rates of tax worldwide, a company may still be subject to a lower level of tax in its territory of residence.

If a company does **not have** a **country of residence** then it is **deemed** it to be **resident in a lower tax territory** and the above test is not applied. "Resident" means that the foreign company is subject to tax in a territory by reason of domicile, residence or place of management. ICTA 1988, s.749(5)

Example 1

Month Ltd, a UK company, has a 100% subsidiary, Day Inc, which is resident overseas. Day Inc has profits of £300,000 and it paid tax of £15,000 on interest of £35,000 from a German bank account and received rental income from the UK on which tax of £10,000 was withheld. Month Ltd has 40 other subsidiaries worldwide. The tax paid by Day Inc was 22% of profits, full relief being given for overseas tax suffered.

You are required to decide whether Day Inc is resident in a lower tax territory.

9.4 Designer rate provisions

ICTA 1988, s.750A

Provisions have been introduced to counter the fact that certain countries have tax laws which allow companies a great deal of influence over the rate of tax payable.

If a company is resident in a territory listed in **STI 2000/3158** then, even if the tax payable appears to be more than 75% of the UK corresponding tax, the company is deemed to be resident in a lower tax territory. The countries currently listed are Jersey, Guernsey, the Isle of Man and Gibraltar.

9.5 Exceptions to the CFC rules

A company will not be subject to the CFC rules if its income profits for the year in question are less than **£50,000** or if the company is resident in a territory which is on the excluded countries list in STI 1998/3081. ICTA 1988, s.748

Further exceptions can be found in Schedule 25 ICTA 1988.

1) The company carries on **exempt activities**. To meet this test the company must satisfy the following conditions: ICTA 1988, Sch 25 Para 6

- it must have a business establishment in the territory in which it is resident throughout the accounting period; ICTA 1988, Sch 25 Para 6 (1a)
- its business affairs in the territory are effectively managed (see below) there; ICTA 1988, Sch 25 Para 6 (1b)
- and any of the following apply:

  a) its business is not that of investment or it does not deal in the delivery of goods to or from the UK or to or from connected or associated persons; ICTA 1988, Sch 25 Para 6 (2)

  b) it is a local holding company i.e. at least 90% of its gross income is received in the country in which it is resident and is from companies it controls which are resident in the same territory but are not themselves holding companies but are otherwise carrying on exempt activities. ICTA 1988, Sch 25 Para 6 (3)

c) a holding company which receives at least 90 per cent of its gross income during the relevant accounting period from local holding companies which it controls; or companies otherwise engaged in exempt activities but not as local holding companies, holding companies **or** superior holding companies; or exempt trading companies; these are often referred to as non local holding companies. ICTA 1988, Sch 25 Para 6 (4)

d) It is a superior holding company which receives at least 90 per cent of its gross income during the relevant accounting period from qualifying exempt activity income of its subsidiaries; and which is derived directly from companies which it controls or which are maximum permitted shareholding companies or 40/40 JV companies (see above) and which, throughout that period, are—

(1) companies engaged in exempt activities including local holding companies, holding companies or superior holding companies; or

(2) exempt trading companies; and

(3) for accounting periods of a CFC beginning after 20 March 2000, in the form of qualifying dividends or received in the territory of residence of the holding company (ie the income must not be received in an overseas permanent establishment of the holding company) where the income is derived from a company falling within (1) or (2) which is resident in the same territory as the holding company.

For income accruing on or after 12 March 2008 we include income accruing to a trustee of a trust in relation to which the company is a settlor or beneficiary. (Where there is more than one settlor or beneficiary, the income is apportioned between to all the settlors and beneficiaries on a just and reasonable basis); and any other income which accrues to a partnership of which the company is a partner (apportioned between the partners on a just and reasonable basis). A partnership, for these purposes, includes an entity established under the law of a country outside the UK with similar characteristics as a partnership. ICTA 1988, Sch 25 Para 6 (5C& D)

A *holding company* is a company whose business consists wholly or mainly in the holding of shares or securities of companies which are either—

(a) local holding companies (see below) which are its 90 per cent subsidiaries;

(b) trading companies which are its 51 per cent subsidiaries; or

(c) trading companies in which it holds the maximum amount of ordinary share capital permitted in the territory in which the trading company is resident (referred to as *maximum permitted shareholding companies*) or which are CFCs by virtue of satisfying the 40 per cent test. The UK-resident must hold an interest of 40 per cent or more in the CFC and also controls the holding company in question (referred to as *40/40 JV companies*).

A company is also a holding company if it would fall within one of these categories if there were disregarded so much of its business as consists of holding property or rights for use wholly or mainly by companies which it controls and which are resident in the same territory.

A *superior holding company* is a company whose business consists wholly or mainly in the holding of shares or securities in companies which are holding companies or local holding companies or are themselves superior holding companies. A company is also a superior holding company if it would meet that definition if there were disregarded so much of its business as consists of holding property or rights for use wholly or mainly by companies which it controls and which are resident in the same territory. ICTA 1988, Sch 25 Para 12A

If a company is mainly engaged in wholesale or distributive, financial or services business, less than 50% of its gross trading receipts must be received from persons with a 25% holding or from associated or connected persons, including associates of parties which have a 40% or more control under the joint venture test described in 9.2 above.

The exemptions for non local holding companies that are superior holding companies do not apply to accounting periods beginning on or after 1 July 2009 unless transitional provisions apply.

The transitional provisions mean that in some cases the abolition of the exemption will be delayed until July 2011.

Where a CFC has an accounting period which straddles 1 July 2009 for the purposes of the CFC rules it is to be treated as split into two separate accounting periods. The CFC's gross income, chargeable profits and creditable tax should be apportioned between the two periods on a time basis according to their respective lengths. The same approach will be taken for accounting periods straddling 1 July 2011.

To qualify for the transitional relief a company must be a qualifying holding company which means that it meets the requirement of being an qualify as an 'exempt holding company' for the duration of the last accounting period to end before 1 July 2009 but specifically excluding an accounting period that straddles 1 July 2009. FA 2009 Sch 16 Para 12

An 'exempt holding company' is a company which throughout a particular accounting period was engaged in exempt activities under the special rules applying to non-local and superior holding companies.

FA 2009 Sch 16 Para 13

Transitional relief is not automatically available to qualifying holding companies where levels of non-qualifying gross income exceed historic flows. These criteria are set out in para 17 Sch 16 FA 2009.

Basically the conditions are that;

a) At all 'material times' the group of companies of which the CFC was a member must have had the same ultimate parent; and

FA 2009 Sch 16 Para 15

b) The amount of the CFC's gross income in the accounting period that is 'non-qualifying gross income', i.e. gross income which does not help a CFC satisfy the existing non-local and superior holding company rules does not exceed the highest amount of non-qualifying gross income arising in an earlier reference period or periods.

'Material times' means as at the beginning of 9 December 2008 and all times during the accounting period in question.

"A reference period " is an accounting period of the CFC that is any one of its last three accounting periods ending before 9 December 2008, and an accounting period in relation to which the CFC was an exempt holding company. However where there is no reference period, the Schedule specifies a default reference period of 12 months ending on 9 December 2008.

FA 2009 Sch 16 Para 17

Time apportionment applies where amounts X and Y arise in periods of differing length to ensure that the comparison between the two amounts is consistent.

The effect is to limit the amount of non-qualifying gross income in the transitional periods to the highest amount arising in any of up to three earlier reference periods.

There is an anti-avoidance rule. It applies where a company alters its accounting date so that a particular period that otherwise would have fallen into an accounting period ending on or after 9 December 2008 instead falls into an accounting period ending before that date.

FA 2009 Sch 16 Para 19

Non EEA CFCs will meet the requirement of being effectively managed where they are resident if they have sufficient numbers of employees to deal with the volume of the company's work, and any services performed for persons resident outside the country are not performed in the UK. For these purposes anyone engaged wholly or mainly in the business of the company and whose remuneration is paid by a person connected with and resident in the same territory as the company shall be treated as employed by the company. ICTA 1988, Sch 25 Para 8 (1&2)

For companies resident in EEA territories (EU members plus Iceland and Norway) the conditions relating to effectively managed will only be met where there are sufficient individuals working for the company in the territory who have the competence and the authority to undertake all or substantially all of the company's business. For this test individuals will only be treated as working for a company if they are employed by the company in the territory or they are otherwise directed by the company to perform duties on its behalf in the territory. ICTA 1988, Sch 25 Para 8 (5&6)

2) The **motive test** applies if the company can satisfy the Revenue that it is non UK resident for reasons other than gaining a tax advantage. That is to say that the reason for the company existing is not to divert profit away from the UK.

There are essentially two legs to this test – a transactions leg, whereby it must be shown that the transactions involving the CFC were not designed to reduce tax and second the diversion of profits leg. The recent tax case involving the Association of British Travel Agents concerned captive insurance companies and demonstrated the difficulty in passing the diversion of profits leg. (*ABTA v CIR SPC 359 (2003)).*

3) The excluded country regulations can be of great assistance where a potential CFC operates and is resident in certain territories which are not regarded as abusive. The list consists of two types of territory – those which are totally acceptable and those with certain unacceptable incentives. Essentially non local source income must not exceed 10% of a company's commercially quantified income.

9.5.1 Other exceptions

For accounting periods beginning before 1 July 2009 Para 1 of Schedule 25 ICTA 1988 gave an exemption from apportionment where an acceptable distribution policy (ADP) was followed.

This exemption was removed by FA 2009 as part of the amendment to taxation of foreign profits that we have looked at in a previous chapter.

For accounting periods beginning before 1 July 2009 to qualify for exception under this head, the company had to distribute at least 90% of its profits within 18 months of the year end. Profits in this context means equivalent UK taxable profits net of local tax in the territory of residence and net of other third party country taxes where appropriate.

There are transitional rules to deal with accounting periods that straddle 1 July 2009 and to ensure that profits that arose before 1 July 2009 can still be covered by the ADP exemption. Where a CFC has an accounting period which straddles 1 July 2009, for the purposes of the CFC rules it is to be treated as split into two separate accounting periods. FA 2009, Sch 16 Para 7

The CFC's chargeable profits and creditable tax should be apportioned between the two periods on a just and reasonable basis.

Sch 16/Para 8(1) makes it clear that the amendments do not affect the application of the ADP exemption in relation to dividends paid on or after 1 July 2009 for periods ending before that date in pursuit of an ADP. FA 2009, Sch 16 Para 8

The current rules governing how dividends are attributed to accounting periods continue to work appropriately. It does this by saying that TIOPA s59, ICTA s799(3)(c)(as was), will have effect as if the reference in it to the last period for which accounts of the CFC were made up were a reference to the first of the two deemed accounting periods provided. FA 2009 Sch 16, Para 8 (3)

Illustration 6

Gadeal Inc is a controlled foreign company which has pursued an ADP for several years. It draws up its accounts to 31 December each year. In 2009 Gadeal's taxable profits for CFC purposes are £375,000.

To apply the ADP exemption for the year to 31 December 2009 Gadeal Inc must split its accounting period into two separate periods and apportion the net chargeable profits of the whole period between them on a just and reasonable basis;

- Period 1: 6 months to 30 June with net profits of £187,500
- Period 2: 6 months to 31 December with net profits of £187,500

The ADP exemption will be available in respect of the profits arising in the earlier of these two periods.

Gadeal Inc needs to pay a dividend of at least £168,750 for Period 1 before 1 January 2011, to be able to use the ADP exemption for this period.

The ADP exemption is not available in respect of the profits apportioned to Period 2.

9.6 Consequences of being a CFC

If a company is held to be a CFC and cannot claim any of the above exemptions, then its income profits will be **apportioned** to all **UK companies** that have at least a **25%** shareholding. ICTA 1988, s.747(5)

The apportionment **only applies** to **UK companies**. Although the presence of UK individuals as shareholders can lead to a company being a CFC, it will not result in the apportionment of any profit to them. ICTA 1988, s.752

Under CTSA a company must **self assess** an apportionment and show the amounts due in the box marked s.747(4) tax on the CT600. Note that the CFC apportionment is brought in as a **tax liability** rather than as an amount of income.

Illustration 7

Happy Land Inc is owned as follows

Smart Alec Ltd (UK resident company)	30%
Mr Siegal (UK resident individual)	26%
Overseas Inc (non UK resident company)	26%
Clever Cloggs Ltd (UK resident company)	18%

Happy Land Inc is controlled by UK resident persons as we have

Smart Alec Ltd	30%
Mr Siegal	26%
Clever Cloggs Ltd	18%

Smart Alec Ltd is the only shareholder that will be subject to an apportionment. Clever Cloggs Ltd has less than a 25% shareholding and Mr Siegal is not a company.

9.7 Calculating the profits to be apportioned

ICTA 1988, s.751

The FA 2008 has made it clear that chargeable profits include income arising to trustees where a CFC is a settlor. ICTA 1988, s.747(6)(a)(b)

The profits of the CFC are to be calculated as if the company were a UK resident company. The provisions of Schedule 24 are quite detailed - the main ones to note are:

- The company is only deemed to be UK resident for the purposes of calculating the profits to be apportioned. ICTA 1988, Sch 24 Para 1

- If the company does not have a physical presence in the UK, then profits of any trade will be miscellaneous income, although calculated using trading profit rules.
-
- Dividends received from UK companies are not brought in to the profit calculations.

- The company is treated as non close. ICTA 1988, Sch 24 Para 3

- The company is treated as being neither a member of a group relief group nor a consortium. ICTA 1988, Sch 24 Para 5

- Deemed UK residence begins from the first accounting period in which an apportionment is required or when an acceptable distribution is made. This can be backdated in the case of losses.

- A claim can be made to set losses incurred in the six years prior to residence against future income. ICTA 1988, Sch 24 Para 9

- The company is treated as having made all favourable claims and elections it is entitled to. These deemed claims can be disclaimed. ICTA 1988, Sch 24 Para 4

- The company will be subject to the Forex legislation (see separate chapter) in computing its profits. It is allowed to have the currency in which the accounts are drawn up as its base currency. However, it will be locked into this currency with the exception of a change to the Euro.

- If the accounts are not drawn up in sterling, then the rules relating to functional currency apply. ICTA 1988, s.750(8)

- The company is entitled to the same capital allowances as a UK company. ICTA 1988, Sch 24 Para 10

- There are specific transfer pricing rules applying to CFCs, but generally the UK provisions apply even where two CFCs transact with each other. ICTA 1988, Sch 24 Para 20

9.8 The apportionment and creditable tax

The profits to be apportioned are calculated together with the **creditable tax** claimable. The apportionment is brought in after calculation of the company's tax on its UK profits.

Creditable tax is the **sum of**: ICTA 1988, s.751(6)

1) DTR on foreign tax paid under the normal rules. This is tax paid in the country of residence as well as in third party countries;
2) UK income tax deducted at source or charged on the CFC's income; and
3) UK corporation tax paid on the CFC's income.

Tax on CFC profits is computed at the **full rate.** The small companies rates and marginal relief are not available to CFC apportioned profits. ICTA 1988, s.747(4)

If there is effectively more than one rate of corporation tax used in calculating the tax on the UK resident company's profits i.e. over different financial years, the average rate is used.

Illustration 8

Smarty Pants Ltd, a UK company, has profits of £80,000 in the year to 31 March 2011. It has one wholly owned subsidiary, Tax Haven Ltd. Tax Haven Ltd has an accounting period ending on 28 February 2011 and has interest income of £75,000 and paid tax in Sweden of £2,000 on this income and tax in Ruritania, where it is resident, of £7,500. (The assumption is that the Swedish tax is not creditable against the Ruritanian tax).

The tax computation for Smarty Pants Ltd will show:

	£	£
TTP		80,000
UK tax at 21%		16,800
s.747(4)(a) 75,000 x 28%	21,000	
Creditable tax	(9,500)	11,500
Total UK tax bill		28,300

ICTA 1988, s.747(4)(a)

In this example all of the overseas tax is claimable in full, as it is less then 28% of the income source.

Note, as illustrated above, in determining which accounting period of Tax Haven falls to be assessed in Smarty Pants, it is the period ending within the accounting period to 31 March 2011 of Smarty Pants (i.e. to 28 February 2011). Normally the accounting periods coincide for ease of management, but there may be cash-flow benefits in having different periods.

There are provisions to ensure that a restriction of an interest deduction under the debt cap rules cannot interact with the CFC rules so as to cause the affected group to suffer double taxation. ICTA 1988, s.751AA

The new provision is an addition to the CFC rules to allow reductions in chargeable profits for certain financing income. It allows the UK company, to which the profits are to be apportioned, to apply to the Commissioners for a reduction in the chargeable profits of the CFC. If the Commissioners grant the application those profits are treated as reduced by the specified amount and the CFC's creditable taxes are accordingly reduced on a just and reasonable basis.

9.9 Reduction in chargeable profits for EEA CFCs

Where an apportionment falls to be made in respect of a CFC that has a business establishment in the EEA with individuals working in the EEA territory, a company can apply to reduce the amount of apportioned profits on a just and reasonable basis. The profits may only be reduced to the extent to which they represent net economic value which arises to those with an interest in the CFC or in the case of a group member and is created directly by qualifying work. ICTA 1988, s.751A

Net economic value doesn't include any amount arising from the reduction in tax or duty under the law of a territory.

Qualifying work is work done in any EEA territory where the CFC has a business establishment throughout the accounting period and is done in that territory by individuals working for the CFC there. ICTA 1988, s.751A

An individual is only taken to be working for a CFC if they are employed by the CFC in the territory or are otherwise directed by the company to perform duties on its behalf in the territory. ICTA 1988, s.751A(9)

9.10 Recent case law involving the CFC legislation.

a) Cadbury Schweppes plc v Commissioners of Inland Revenue C196-04

Cadbury Schweppes plc indirectly held 100 per cent of the shares of two Irish companies. The business of the Irish companies was to raise finance and to provide that finance to other group companies. They were subject to a 10 per cent tax rate under the International Financial Services Centre regime in Dublin (now phased out under the EU Code of Conduct). The UK tax authorities sought to tax Cadbury in the UK on the profits of the Irish companies.

The ECJ confirmed that the UK CFC rules restrict the freedom of establishment. However, the ECJ held that such rules can be justified as pursuing a legitimate objective of countering tax avoidance to the extent that they only counter "wholly artificial arrangements." In this regard the ECJ held that as well as considering the subjective intentions of a taxpayer (for instance the intention of obtaining a tax advantage by establishing itself in another Member State), tax authorities must also take account of objective criteria which are ascertainable by third parties (for instance the extent to which a company has genuine substance in terms of premises, staff and equipment).

The ECJ concluded that it is for the UK courts to determine whether the UK CFC rules support an interpretation which takes account of such objective criteria. The case is currently awaiting a hearing at the UK courts to determine this.

Following the ECJ decision, clauses amending the CFC rules were published in December 2006 as outlined above which provide that profits of a subsidiary resident in the EEA are not subject to attribution under the CFC rules, provided they arise from "genuine economic activity". For these purposes, genuine economic activity is restricted to activity of employees, and therefore any profits which derive from capital (investment income) or intangibles (royalty income) will not be exempt from the CFC rules.

The ECJ said that it is for the UK courts to assess whether the motive test can be interpreted as limiting the application of the CFC rules to wholly artificial arrangements intended to circumvent national tax law which leads us on to the second important recent case in this area.

b) Vodafone 2 v Revenue and Customs Commr [2009] EWCA Civ 446

In March 2000 Vodafone Group plc acquired Mannesmann AG through a wholly owned subsidiary Vodafone 2 (V2) (a UK-incorporated and UK-tax-resident company). A Luxembourg company, Vodafone Investments Luxembourg Sarl, was established as a wholly owned subsidiary of V2 to be a holding company for Mannesmann and other European companies. HMRC enquired into the tax return of V2 for the year ending 31 March 2001 and requested information to enable it to consider whether an apportionment was required in respect of V2's income under the UK CFC rules.

V2 put forward a number of arguments as to why the legislation did not apply, including the fact that the legislation constituted an unlawful restriction on V2's freedom of establishment conferred by Article 43 EC, and appealed to the Special Commissioners to issue a direction to close the enquiry. The Commissioners referred the case to the ECJ but withdrew this referral when the European Court handed down its decision in *Cadbury* on 12 September 2006. The case as stated above is currently being heard in the UK.

This case reached the Court of appeal in May 2009. The Court of Appeal reversed the High Court decision and agreed with HMRC that the CFC rules could be construed as being compatible with the decision of the ECJ in *Cadbury*, provided that the following exemption is read into the legislation at s 748(1) or (3):

'if it [that is, the CFC] is, in that accounting period, actually established in another Member State of the EEA and carried on genuine economic activities there'.

And provided that the above test is met, there should be no CFC apportionment.

On 22 July 2010 Vodafone reached agreement with the UK tax authorities with respect to the CFC tax case. Vodafone will pay £1.25bn to settle all outstanding CFC issues from 2001 to date and has also reached agreement that no further UK CFC tax liabilities will arise in the near future under current legislation.

Longer term, no CFC liabilities are expected to arise as a consequence of the likely reforms of the UK CFC regime due to the facts established in this agreement.

9.11 Schedule 26 Relief for losses

ICTA 1988, Sch 26 Para 1

If a company has profits apportioned to it then certain reliefs are available. These can be found in Schedule 26 ICTA 1988.

A claim can be made to set the following against a company's liability under s.747(4)(a):

- Losses from property business or trade loss of the current year;
- qualifying charitable donations;
- management expenses;
- group relief available to the company;
- non trade deficits on loan relationships.

If a loss is used in a Schedule 26 claim it will be used for all purposes and not be available to carry forward.

Each claim can be made for the **amount specified in the claim**. This applies to current year losses and losses from a property business which are normally all or nothing claims. ICTA 1988, Sch 26 Para 1(1)

If a company has already made a claim to use the loss it **cannot withdraw** the claim and replace it with a Schedule 26 claim - the exception being losses carried forward, as this happens automatically.

Illustration 9

In Illustration 8 assume that Smarty Pants Ltd had a non trade deficit on loan relationships of £30,000 (which would otherwise be carried forward).

Clearly it would be best for the company to set this loss against the apportioned income, as it would save tax at 28% as opposed to using it itself, and saving tax at 21%.

	£	£
TTP		80,000
Tax @ 21%		16,800
s.747A 75,000 @28%	21,000	
Less Sch 26 claim 28% x 30,000	(8,400)	
Less Creditable tax	(9,500)	3,100
Total UK tax		19,900

Note that the creditable tax comes after the Sch 26 claim. Care has to be taken to ensure that the creditable tax is not displaced and as a consequence wasted.

Example 2

Smart Move Ltd, a UK resident company, has a 100% subsidiary which is a CFC. The CFC has profits of £250,000 and creditable tax of £42,000. Smart Move Ltd has profits of £170,000 and group relief of £230,000 available from another UK subsidiary. Both companies have March year ends

You are required to calculate Smart Move Ltd's corporation tax liability assuming that the most beneficial claims are made.

9.12 Relief for gains on disposal of shares

ICTA 1988, Sch 26 Para 3

If a company has had the profits of a CFC apportioned and then makes a gain on sale of the shares, this may lead to double taxation. Schedule 26 provides relief on sale of the shares in the CFC.

The **tax paid** as a result of the **apportionment** can be treated as an **allowable deduction** in calculating the gain on disposal of the shares. The calculation of the tax deductible is performed **for each year** that there has been an apportionment (ascertaining market values each year).

ICTA 1988, Sch 26 Para 3(2)

The formula is:

$$\frac{\text{Average MV of shares disposed of in relevant period}}{\text{Average MV of total holding in relevant period}} \times \text{CT on apportioned profit}$$

ICTA 1988, Sch 26 Para 3(3)

Illustration 10

A UK resident company disposes of 35% of its 100% holding in a CFC in January 2010. Apportioned profits were £100,000 in the year to 31 March 2008 and £240,000 in the year to 31 March 2009. The shares were sold for £1,125,000. The company had bought the shares for £600,000 in June 2007. The market value of a 100% holding is £4,000,000. (Assuming market values did not change over three year period.)

We will assume that the indexation allowance from June 2007 to January 2010 is £35,067.

The capital gain on disposal will be:

	£
Proceeds	1,125,000
Cost	(600,000)
IA (assumed)	(35,067)
	489,933
Sch 26 relief (W1)	(27,337)
	462,596

(W1) The Sch 26 relief will be calculated for each year:

March 2008 UK tax £100,000 x 30% = £30,000

March 2009 UK tax £240,000 x 28% = £67,200

	£
$30,000 \times \frac{1,125,000}{4,000,000}$	8,437
$67,200 \times \frac{1,125,000}{4,000,000}$	18,900
Total	£27,337

Example 3

Wants More Ltd a UK resident company buys 100,000 shares in a CFC in December 2007 (RPI 210.9) paying £4 a share. This gives the company a 100% shareholding. In November 2009, the shares are worth £7 each. The company decides to sell 8% of its holding in December 2010 (RPI 232.10).

The following apportionments have been made in respect of the CFC

Y/e 31 December 2008	£188,000
Y/e 31 December 2009	£350,000

You are required to calculate the gain arising on the company as a result of the share disposal.

9.13 Relief when dividends are paid

ICTA 1988, Sch 26 Para 4

If a company has apportioned profit of a CFC and then later receives a dividend from the CFC there is a possibility of double taxation.

Schedule 26 provides for relief against this double taxation by treating the UK tax paid on the apportioned profit as if it was a **type of underlying tax**. It is called **Gross Attributed Tax** and often referred to as **Chapter IV tax.**

ICTA 1988, Sch 26 Para 4(3)

The relief is given for the tax assessed before any Sch 26 reliefs.

The Chapter IV tax is **added to** the calculation of **DTR** relief available on the dividend and is subject to the **normal rules** regarding relief for DTR.

To achieve this the normal DTR rules for ULT are modified as follows

- the recovery of Chapter IV tax is not dependent on a minimum 10% holding;
- the Chapter IV tax is not included in the calculation of overseas income;
- modification to the normal ULT fraction is allowed where not all the profits are apportioned to UK residents.

Illustration 11

Dodge Ltd, a UK resident company, includes CFC profits of £75,000 less creditable tax of £5,000 in its return to 31 December 2009. In the year to December 2010 it receives a dividend in January 2010 of £50,000 from the CFC, payable from the 2009 profits of the CFC. There is no WHT. The dividend does not qualify for exemption.

Tax on apportionment in 2009:

	£
CFC profits 75,000 x 28	21,000
Less creditable tax	(5,000)
	16,000

(N.B. Distributable profits of CFC = £70,000)

Tax on dividend in 2010:

Dividend – received	50,000		
ULT £5,000 x 5/7	3,571		53,571
Tax x 28%			15,000
DTR		3,571	
Chapter IV	16,000 x 50,000 / 70,000	11,429	(15,000)*
		15,000*	Nil

(*) The total taxation relief available is limited under s.42 TIOPA 2010 to the corporation tax charged on the dividend.

No further relief is available.

As we can see the presence of the Chapter IV tax can result in a restriction of the DTR. If the CFC dividend has been subject to a WHT then the company can claim **wasted relief**. Wasted relief can **never exceed the WHT** on the dividend.

Illustration 12

A UK company receives a dividend which does not qualify for exemption of £71,250 from its CFC after WHT of £3,750 has been deducted and the ULT is £12,000. The dividend was paid out of profits of £150,000 that had been apportioned to the UK company when the UK corporation tax rate was 30% together with creditable tax of £24,000.

The tax on the dividend received is:

	£	£	£
Dividend 71,250 + 3,750	75,000		
ULT	12,000		
			87,000
UK tax 28%			24,360
Less DTR			
WHT		3,750	
ULT		12,000	
Chapter IV (W1)		10,500	
		26,250	
Restricted to			(24,360)
			Nil

A claim can be made for wasted relief of £(26,250 – 24,360) = £1,890 as this is less than the WHT of £3,750.

(W1) Chapter IV tax

UK tax on profits apportioned
150,000 x 30% = £45,000 less creditable tax £24,000 = £21,000

$\frac{75,000}{150,000} \times 21,000 = 10,500$

So far we have been dealing with examples where the UK company is entitled to 100% of the CFC profits. This will not always be the case. Schedule 26 allows us to distinguish been tax profits and other profits where **less then 100%** of the CFC profits are **apportioned** to UK residents. We **modify the fraction** used in the Chapter IV calculation to merely bring in a proportionate amount of the CFC profits.

Illustration 13

A UK company owns 75% of a CFC - the rest is owned by non UK residents. In the year to 31 March 2009 the CFC has profits of £300,000 and no creditable tax. The CFC pays a dividend in April 2010 of £200,000 out of these profits. WHT of £10,000 was deducted from the dividend, which does not qualify for exemption.

The position for the UK company will be:

March 2009		
CFC Profits 300,000 x 75% x 28%		63,000
March 2011		
Dividend £200,000 x 75%		150,000
UK tax @ 28%		42,000
DTR		
WHT £10,000 x 75%	7,500	
Chapter IV (W1)	42,000	
	49,500	(42,000)
		Nil

The DTR has been restricted, thus a claim for wasted relief can also be made. The wasted relief is £49,500 less £42,000 = £7,500 as this is no more than the WHT.

(W1) $\frac{200{,}000 \times 75\%}{300{,}000 \times 75\%} = \frac{150{,}000}{225{,}000} \times 63{,}000 = £42{,}000$

Note that the relief for Chapter IV tax is **restricted if shares have been disposed of and a relief against the capital gains has been claimed.** The Chapter IV tax is reduced to take account of the relief claimed.

All the above examples show the dividend being paid after the apportionment. It is also possible to get relief where the dividend is paid before the profits are apportioned.

Example 4

Too Much Ltd owns 80% of a CFC. In the year to March 2010 profits of £150,000 were apportioned to Too Much Ltd. There was no creditable tax. In the year to March 2011 Too Much Ltd has profits of £600,000 and receives a dividend in April 2010 of £90,000 from the CFC grossed up for 7% WHT. The CFC has profits of £45,000 in the year to March 2011. Too Much Ltd has 10 subsidiaries worldwide.

You are required to calculate the tax liability of Too Much Ltd for the year to 31 March 2011. The dividends received do not qualify for exemption.

Answer 1

The corresponding UK tax is

		£
UK tax	300,000 x 28%	84,000
DTR	Restrict to £35,000 @ 28%	(9,800)
UK income tax	On UK property income	(10,000)
Corresponding UK tax (A)		64,200

The local tax paid is

		£
Local tax on profits	22%	66,000
DTR	German and UK	(25,000)
Local tax (B)		41,000

The local tax (B) is less than 75% of the UK tax (A).

Day Inc is resident in a lower tax territory even though the rate of tax of 25% would at first appear to be more than 75% of the UK tax of 28%.

Answer 2

There are three companies in the group so the limits for small profits rate are £500,000 and £100,000.

Smart Move should first use enough of the loss itself to bring its TTP down to £100,000. The CFC has creditable tax of £42,000. To avoid wasting this relief the claim for group relief should be limited to £100,000 with the balance of the group relief going against Smart Move Ltd's profits as saving tax at 21% is better then wasting the creditable tax.

	£	£
Profits		170,000
Group relief		(130,000)
TTP		40,000
Tax at 21%		8,400
s.747(4)(a) 250,000 x 28%	70,000	
Sch 26 claim 100,000 x 28%	(28,000)	
Creditable tax	(42,000)	Nil
Total		8,400

Answer 3

The gain on the disposal of shares will be

		£
Proceeds	8,000 x £7	56,000
Cost	8,000 x £4	(32,000)
IA	$\frac{232.10 - 210.9}{210.9}$ x 32,000	(3,217)
Sch 26 relief (W1)		(12,126)
		8,657

(W1)

The Sch 26 relief is calculated for each year

31 December 2008 £188,000 x 28.5% = £53,580
31 December 2009 £350,000 x 28% = £98,000

$\frac{56,000}{700,000}$ x 53,580 = £4,286

$\frac{56,000}{700,000}$ x £98,000= £7,840

Total relief £4,286 + £7,840 = £12,126

Answer 4

Too Much Ltd

	£	£
Tax on TTP		
600,000 + 90,000 x 28%		193,200
s.747 nil as CFC profits less than £50,000		
DTR (W1)	25,200	
Wasted relief (W1)	6,300	(31,500)
		161,700

(W1)

	£	£
Taxable dividend		90,000
UK tax		25,200
DTR		
WHT 90,000 x 7%	6,300	
Chapter IV (W2)	25,200	25,200
Wasted relief – amount of WHT		6,300

(W2)

Chapter IV tax

Tax paid in UK 150,000 x 28% = £42,000

Taxed profits out of which the dividend was paid £150,000

$$\frac{90{,}000}{150{,}000} \times 42{,}000 = £25{,}200$$

Note: The question gave us the figure for the amount apportioned.
Thus £150,000 = 80% of the CFC's profits.