

Clients & Friends Memo

UK Corporate Tax Reform Update

20 September 2011

While the UK Government's blue-print for corporation tax reform was put forward in June 2010, key elements of the reform programme have become much clearer during the course of the Summer of 2011. The long awaited detailed and extensive consultation documents on the reform of the UK controlled foreign companies rules and the UK Patent Box have been published, alongside a consultation on changes to the UK debt cap rules and extensive guidance on the foreign branch tax exemption which was enacted in the Finance Act 2011.

Taken together, these initiatives mark the latest developments in the Government's aim "to create the most competitive corporation tax regime in the G20".¹ The Government's priorities in the corporate tax reform programme are to broaden the UK tax base, lower corporate tax rates, and promote a more territorial approach to taxation while also creating a tax system which is stable, aligned with modern business practices and which avoids complexity where possible.

In this Clients & Friends Memorandum, we have drawn together both summaries and analysis of the four key elements of corporate tax reform during this summer: the consultation on the controlled foreign companies rules and the Patent Box, the proposed changes to the UK debt cap rules and the position which has been reached regarding the foreign branch exemption.

As the summer draws to a close, we can be confident of saying that the corporate tax reform programme has been advanced by each of these initiatives. However, we can be equally confident that much work remains to be done by the Government to ensure that changes announced can be translated into workable legislation which is both integrated across all the reformed areas of corporate taxation and which, taken as a whole, achieves the overall objective of increasing the competitiveness of the UK as an attractive jurisdiction for business.

¹ "Corporate Tax Reform: Delivering a More Competitive System", HM Treasury, 29 November 2010, paragraph 1.2.

Consultation on Controlled Foreign Companies Reform

On 30 June 2011, HM Treasury and HMRC published a consultation document (the "Consultation Document") setting out in detail their proposals for full reform of the UK controlled foreign companies ("CFC") rules.

Overview

The Consultation Document identifies the Government's aims for the revised CFC regime as being:

- to target and impose a CFC tax charge on profits artificially diverted from the UK;
- to exempt foreign profits where there is no artificial diversion of UK profits; and
- to ensure that profits arising from genuine economic activities undertaken outside the UK are not subjected to UK corporation tax.

The Consultation Document is detailed, weighing in at 110 pages, including annexes which cover certain aspects of the reform in more detail. The key proposals of the Consultation Document through which the Government's aims are to be achieved include the following:

- the CFC regime will continue to be entity based, but will impose a tax charge only on profits of a CFC which have been artificially diverted from the UK;
- the focus of the regime is on CFCs which are perceived as being the greatest risk to the UK tax base. These are CFCs with significant monetary assets, with risks and profits which are not commensurate with their underlying activities, or which hold, or have interests in, certain intellectual property ("IP");
- the introduction of a partial exemption for finance companies;
- the introduction of a new approach in respect of CFCs holding intellectual property, in particular where the relevant circumstances relate to exploitation of IP transferred out of the UK in the last six years or where the profits arising from the IP are excessive in relation to the activities undertaken; and
- the new regime will adopt a proportionate approach, ensuring that a CFC charge will only be imposed on a UK company on a proportion of profits in a CFC which have been treated as being artificially diverted from the UK.

A substantial amount of the new CFC regime rebrands the current rules in the existing CFC existing regime while refocusing on perceived areas of greatest risk to the UK tax base. Perhaps the most noteworthy example of rebranding is that the general purpose exemption in the proposed regime (which is available where no artificial diversion of profits from the UK has taken place) fulfils the same function as the motive test in the current CFC rules, but without a default presumption that profits would have arisen in the UK if the CFC had not existed. The provenance of the new regime will be helpful in assisting taxpayers and advisers through the

network of rebranded exemptions and new provisions, with a non-statutory clearance procedure being available to provide certainty in cases of difficulty or particular uncertainty.

The proposed date for the introduction of the new CFC regime will be, at the earliest, for accounting periods beginning on or after Royal Assent to the Finance Bill 2012.

Identification of a CFC

A CFC will be defined as a foreign company resident outside the UK (whether in the EU or not), directly or indirectly controlled from the UK, which, as a consequence of its non-residence, pays less tax on its profits than it would if it were subject to UK tax. This lower effective level of tax is based on the actual tax paid in the CFC's jurisdiction of residence. The definition of a CFC therefore closely follows the definition in the current CFC regime. The Government has confirmed that it intends to maintain the lower level of tax threshold at 75% of the UK corporation tax that would have been suffered if the foreign company were resident in the UK. By 2014, this will mean that if foreign tax is greater than 17.25%, the CFC rules will not apply. The test will be based on the computation of UK taxable profits.

Consideration is to be given by the Government regarding how dual resident companies which are subject to CFC charges in multiple jurisdictions and treaty non-residents will be dealt with.

The Consultation Document suggests a number of approaches to the definition of "control" for these purposes:

- a principles-based test by reference to economic rights and actual control over the assets or income of a company;
- an accounting test by reference to accounting consolidation; or
- a mechanical test including the ability, either directly or indirectly, for the company's affairs to be conducted in accordance with a UK person's wishes (broadly being very similar to the current test).

The Consultation Document proposes that the basic rules for control will be supplemented by specific rules dealing with entities such as protected cell companies and JV vehicles, as well as provisions aiming to address current difficulties arising from the definition of "control" in practice.²

² One example cited in the Consultation Document of these difficulties is the situation where UK-based creditor banks are at risk of being treated as controlling a foreign company through entitlement to assets on a winding up of a foreign debtor. Once the Government's commitment to address areas of uncertainty of this nature is taken into account, there are good arguments to resist any radical replacement of the well-understood current control test with new proposed approaches focusing on a "principles-based" identification or accounting definition of "control".

The key exemptions

A company will not constitute a CFC and will not therefore produce a UK tax charge on a UK participator in that company to the extent that the CFC qualifies for any one of the following exemptions:

- low profits exemption;
- excluded countries exemption;
- temporary period exemption;
- three territorial business exemptions;
- finance company partial exemption;
- banking exemption;
- insurance exemption; and
- general purpose exemption.

Very broadly, the exemptions are intended to exclude from the UK CFC regime those CFCs which pose a low risk to the UK Exchequer. The exemptions apply to the activities of the CFC, with any CFC charge applying to non-exempted activities.

Low profits exemption: The Consultation Document builds on the low profits exemption provision in Finance Act 2011 (which provides an interim exemption for a CFC with annual profits of up to £200,000 using an accounts based measure). The Consultation Document proposes retaining this exemption, or adopting a more flexible *de minimis* threshold. The suggestions are for either an upper profits threshold (suggested to be £500,000 with a maximum investment income component of £50,000 or 10% of total group income) or an upper profits threshold in line with the group's total group turnover (with a lower profits limit of £200,000 and an upper profits limit of £1 million).

Excluded countries exemption: As an equivalent to the "white list", this exemption would apply to CFCs located in jurisdictions with tax regimes that have broadly similar rates and tax bases to the UK. Certain requirements would govern eligibility for the exemption, including a local management condition. The exemption would be based on the CFC's jurisdiction of tax residence, although transparent entities such as US LLCs which do not have a jurisdiction of residence (and therefore do not qualify for the current exempt activities or excluded countries exemptions) will be eligible to qualify for the new excluded countries exemption. The Government has declined to introduce a general EU wide exemption.

Temporary period exemption: Following the amendments enacted in the Finance Act 2011, an exemption for up to three years will be available for potential CFCs which come under UK control as a result of third party acquisitions or group reorganisations. The exemption is more generous than the "period of grace" included in the pre-Finance Act 2011 motive test. The

exemption will be subject to an anti-avoidance rule. The current approach of offering motive test exemptions in relation to certain acquisitions will not be carried forward into the new regime.

Three territorial business exemptions (“TBEs”): Three TBEs have been proposed which aim to exempt CFCs that undertake genuine commercial activities and do not pose a significant risk of artificial diversion of UK profits. The TBEs mirror the current CFC exempt activities test, but with mechanistic parameters and numerous conditions and requirements. These are identified in the Consultation Document as being:

- *profits rate safe harbour*: this exemption would apply to a CFC which makes a low level of profits by reference to its cost base. The proposal advanced by the Government is for a single profit rate (as opposed to different sector specific rates), with a safe harbour of 10 per cent. of operating expenses (other than the cost of goods acquired for resale and related party business expenditure) being suggested. As dividends which are exempt from UK tax are excluded from the profits calculation, holding companies whose income consists mainly of dividends and whose investment income is no more than “merely incidental” should therefore be within this exemption;
- *manufacturing trades*: The Consultation Document notes that most manufacturing activity poses little risk of artificial diversion of profits from the UK. CFCs which are not involved (to any substantial degree) in activities other than manufacturing will fall within this exemption. Once within the exemption, there would be no restriction on transactions with the UK and incidental amounts of investment income would also be permissible for the manufacturing CFC. Where the manufacturing CFC uses and exploits IP in its business, the Consultation Document permits the CFC to fall within the exemption where the IP is “local IP” and where the CFC does not act as an “IP hub”. “Local IP” is further described as having being developed by the CFC’s own staff, being developed by third parties to be integral to the CFC’s trade or, where acquired, being broadly the IP which is necessary for the CFC to carry out the manufacturing activities it performs in its jurisdiction; and
- *a general exemption for commercial activities*: this exemption covers (i) trading and certain business activities between a CFC and other foreign companies (whether connected or unconnected); (ii) trading and certain business activities between a CFC and UK persons (whether connected or unconnected) where there is no arrangement in place to artificially divert profit from the UK; and (iii) trading activities relating to the exploitation of foreign IP which does not pose a significant risk to the UK tax base. These exemptions share a common set of parameters, namely an establishment requirement and a local management condition. As with the other TBEs, incidental amounts of investment income would be exempted. The interaction between the general commercial TBE and investment income of a CFC is important. The Consultation Document mentions the proposal to permit around 20 per cent. of the CFC’s business to consist of certain investment activities such as holding and managing shares and securities of non-group companies and some leasing activities. The rules for permitting merely incidental investment activity in a CFC falling within a TBE

are also proposed in such a way as to avoid the creation of a “cliff-edge” or detailed rules to quantify the level of activity.

Each of these TBEs is expressed as being “mechanical” in nature and is subject to a “local management” condition requiring the CFC to be controlled and managed by sufficient staff of the necessary expertise and seniority. The CFC would need the capacity to evaluate investment proposals and to appoint, instruct and manage sub-contractors and consultants.

Incidental finance income arising from short term working capital needed for the business will also fall within the TBEs. Intra-group finance income in excess of this will be dealt with under the finance company rules (see below). As the CFC charge will now be calculated on a mixed entity/income stream approach on a proportionate basis, it will no longer be possible to “swamp” finance income with trading income. A number of options are considered in the Consultation Document for defining incidental finance income for the TBEs and the regime generally. These included a simple fixed percentage of the CFC’s profits using a measure such as EBITDA, a simple percentage of the CFC’s gross income and a more flexible definition (at the risk of added complexity) reflecting the particular facts of the CFC’s business and recognising that some types of business may have greater short term working capital needs than others (and therefore produce more incidental finance income).

Finance company partial exemption: As already revealed in the November 2010 consultation document, the CFC regime will include a partial exemption for finance companies (“FCPE”). This is designed to apply to overseas intra-group finance income that represents the structural surplus cash reinvested within the group to the extent it exceeds amounts incidental to the CFC’s business. The assumption embedded within the FCPE is that most finance companies are wholly equity funded and, applying a deemed 1:3 debt-to-equity ratio, would give rise to a UK apportionment of 25 per cent. of the CFC’s profits. This would lead to an effective UK corporation tax rate of 5.75 per cent. on profits from overseas intra-group finance income by the financial year 2014, which would be a quarter of the UK normal corporation tax rate.

The Consultation Document states that the Government’s preferred position is for an apportionment approach focusing on the CFC’s profits and losses by means of undertaking a UK chargeable profits calculation, although the interaction with the UK debt cap rules is currently unclear. An imputation approach, focusing on the balance sheet of the CFC, and deeming any excess equity of the CFC to be a loan from the UK, does not appear to be favoured by the Government. There is also a tantalising reference in the Consultation Document to the possibility of a full exemption for overseas finance companies, although no substantial details are given.

A number of additional aspects of the FCPE are explored in the Consultation Document. These include the requirement that a CFC will need to be established and managed in its territory of residence to fall within the FCPE, notwithstanding that HMRC acknowledges that such companies are unlikely to require significant numbers of employees. A number of options governing the precise form of the FCPE are considered, together with detailed examples. The

Consultation Document proposes a simple design option for the FCPE, with three more complex alternatives. The simple option applies the FCPE to wholly equity-funded CFC's which only lend to other overseas group companies that are not themselves subject to the CFC apportionment rules. An amount of 25 per cent. of the finance CFC's profits would be apportioned to the UK under this simple option. However, many groups would not fit easily into the simple option, particularly groups which may feature intra-group finance to CFC's in respect of which a taxable apportionment is being deemed to a UK group member, hybrid-instruments or interest free loans. The other three options explained in the Consultation Document, focusing (respectively) on (i) the CFC's chargeable finance income; (ii) the CFC's chargeable finance profits; or (iii) an apportionment of chargeable finance profits are all explored with detailed illustrations but add complexity.

CFC's providing treasury management services, such as group cash pooling, are considered to be a low risk class of companies in the Consultation Document and the intention of the Government is for such companies to fall within the GPE (see below). Companies in which treasury management and finance/ structural lending are combined will only fall within the FCPE. Where a group wishes to obtain the full exemption under the GPE, it may be necessary to restructure the company to ensure that finance and treasury functions are conducted in separate companies. Similar issues arise in the context of "mixed activity companies" where trading activities are combined with financing operations such as the management of funds. The Government has received mixed responses in this area from the November 2010 consultation, and under the simplest definition of the FCPE the Government acknowledges that some restructuring may be required to ensure that financing activity of a more than merely incidental nature is carried on in a separate company in order to fall within the FCPE.

One of the most interesting sections of the Consultation Document addresses the areas which do not fall within the scope of the FCPE. The FCPE:

- will not apply to non-incidental finance income from surplus cash deposits with third parties;
- will not apply to non-incidental finance income from upstream loans by a CFC to UK connected parties unless the income arises in respect of short term loans in certain commercial situations, including where funding is provided to ameliorate insufficiencies of distributable reserves, or to comply with bank restrictions imposed by regulatory requirements or as part of a group's wholly commercial treasury management policy;
- is unlikely to apply to overseas branches of UK companies owing to the difficulty in determining the amount of finance income attributable to the branch. Restructuring may be required for groups with overseas branches wishing to use the FCPE; and
- will not be applicable to banking or insurance groups, owing to HMRC concerns that "monetary assets to different extents are intrinsic to their trade" and that separating

monetary assets which support trading from assets supporting a capital structure is highly complex³.

It will be particularly interesting to see whether there is any relaxation to the Government's position in the Consultation Document by reference to the areas where the FCPE will not apply, particularly as these areas are ones where the general purpose exemption (or, currently, the motive test) is unlikely to apply.

Insurance exemption: Specific exemptions have been proposed for CFCs conducting insurance business. The insurance exemption is sector specific and effectively replaces the current modified variant of the CFC exempt activities test as applicable to insurance companies. The proposed insurance exemption would encompass genuine overseas insurance operations (including reinsurance) and would exempt foreign to foreign intra-group insurance activity (thereby removing the current limitation on foreign to foreign connected party insurance activity). The availability of the exemption is dependent on the CFC being part of an insurance group and being engaged in the business of carrying on or effecting contracts of insurance. Basic residence, establishment and local management requirements would also need to be satisfied in line with the requirements in the three territorial business exemptions described above. In addition, a requirement will be present that for the exemption to apply, an insurance CFC will need to have business consisting of 80 per cent. insurance activities⁴, which the Government anticipates should not be problematic given the regulatory restriction on non-insurance activities by regulated insurers.

Two options are proposed in the Consultation Document for the operation of the new exemption. The first option is for a simplified exemption for CFCs carrying on overseas insurance business which do not have a "significant connection" with the UK. The Consultation Document describes this as being an exemption where a CFC has less than 50 per cent. of commissions and premiums received under contracts of insurance (including third party and intra-group business) originating from the UK and is able to pass an appropriate capitalisation test. Under this option, CFCs which cannot meet this requirement must rely on the GPE or the excluded countries exemption.

The second option is a more flexible exemption route. The intention of the Government is stated to "remove lower risk genuine overseas insurance operations without needing to consider a capitalisation test". Where an insurance CFC can demonstrate that premium and commissions from UK (third party and intra-group) and connected parties are below a certain threshold, the exemption would be available. In the event that the connected party gross trading receipts are above that threshold (but below a ceiling threshold) an appropriate

³ The same concerns militated in favour of the exclusion of regulated insurers and banks from the application for the worldwide debt cap rules in 2009.

⁴ An identical requirement is present in the other TBEs.

capitalisation test would need to be met for the exemption to be available. CFC's breaching the ceiling threshold would need to rely on the GPE or the excluded countries exemption.

Captive insurance companies owned by non-insurance groups will not be eligible under the sector specific insurance exemption and would therefore need to seek exemption through the general purpose exemption or the excluded countries exemption.

Banking Exemption: The proposals by the Government regarding a specific sector exemption for banking follow closely the current modified exempt activities tests for banking CFCs in Schedule 25 of the Taxes Act 1988. The proposal is for a banking CFC exemption to operate in a similar way to the current rules with a capitalisation test mirroring the provisions of the current capital structure test. For the banking exemption to be available, the CFC would need to meet the basic residence, establishment and local management requirements of the other TBEs, and would need to avoid being capitalised in excess of the amount of capital required to support its banking activities and regulatory requirements. The proposed capitalisation test appears to be modelled on the 15 per cent. threshold in the existing banking CFC capital structure test⁵, although the Consultation Document notes that consideration will be given to whether that limit remains appropriate given the forthcoming implementation of Basel III proposals and international regulatory developments. The gross trading receipts test in the current rules which limits income from connected parties to no more than 50 per cent. of total income will be preserved in the new regime, with the test disregarding interest income received from UK associates provided that the capitalisation test is satisfied. While the Government accepts that the more territorial shape of the new CFC regime might suggest that further scope be given to exempting income from overseas connected parties in the gross trading receipts test, it still appears to consider that this presents too high a risk to the UK tax base. Finally, banking CFCs which are unable to meet the capitalisation test will be able to attempt to access the general purpose exemption and, where available, prevent a CFC apportionment. Even where a CFC apportionment is required, the Consultation Document is careful to note (perhaps mindful of the sensitivity of the Government's relationship with the UK banking sector) that any CFC charge "would be limited to the profits which could be reasonably attributed to the 'excess' capital".

General purpose exemption ("GPE"): The Consultation Document states that the GPE "will generally be relied upon in situations where other exemptions are not available, in particular where the risk of artificial diversion of profits from the UK is high". In substance, the GPE therefore fulfils the same function as the motive test in the current CFC rules. Importantly, the GPE is consistent with the policy aim of the Government in promoting a territorial CFC regime and being proportionate in that only profits which have been "artificially diverted" from the UK will be apportioned.

⁵ Para 11(4), Schedule 25, ICTA 1988.

The GPE will exempt a CFC's profits to the extent that they are "commensurate with the CFC's own activities and have not been diverted from the UK for tax purposes". Profits which are "commensurate with the CFC's own activities" are expressed as being those profits that would, on a more likely than not basis, accrue to the CFC if it was acting under uncontrolled conditions as a separate entity. This requires a consideration of arm's-length arrangements and goes part of the way to explaining the reliance in the Consultation Document on a number of UK case authorities as justifying the new CFC regime in the context of EU law and fundamental freedoms. The factors requiring consideration will be familiar from transfer pricing methodologies: namely, is the profit achieved comparable with what an independent person would produce; and does the CFC's existing and established staff perform sufficient day-to-day active decision-making and other key functions relating to the CFC's assets and risks?

If the profits realized by the CFC are in excess of those "commensurate with the CFC's own activities", it is still possible to exempt such profits from a CFC charge under the GPE to the extent that they are *not* (i) diverted from a connected company in which they would otherwise have been subject to UK tax; or (ii) investment income that is not incidental to the CFCs activities⁶. It appears quite likely that the possibility that excessive profits, being in excess of the profits which are "commensurate with the CFC's own activities", may still fall within the GPE is the Government's attempt to follow the principles set out by the ECJ in *Cadbury Schweppes plc v Commissioners of Inland Revenue*.⁷ Just as the ECJ's decision in *Cadbury Schweppes* does not necessarily result in the penalisation of a CFC which is in receipt of excessive profits, the proposed CFC regime appears to be designed to allow such a CFC to fall within an exemption where such non-arm's length profits arise outside the UK and cannot be said to have been diverted from taxation in the UK. It remains to be seen whether this careful navigation through EU tax jurisprudence by the Government will be sufficient to prevent any future challenge against the new CFC regime under European law. Importantly, and in contrast to the current CFC regime, there is no default presumption that profits of a CFC would have arisen in the UK if the CFC did not exist⁸. In accordance with this change of approach, only profits actually diverted from the UK to avoid tax will be subject to a CFC apportionment. Where profits arise from genuine business between foreign companies within a group, the GPE exemption should apply.

In determining the identification of profits which are "commensurate with the CFC's activities", reference is made to the assets and risks which an uncontrolled CFC would be likely to own and be exposed to. Profits that accrue to these assets and risks will then constitute "commensurate profits", together with the actual profits of the CFC and will qualify for the GPE.

⁶ Non-incidental finance income is dealt with under the FCPE. Incidental investment income is dealt with under other exemptions.

⁷ *Cadbury Schweppes plc v Commissioner of Inland Revenue* [2006] STC 1908.

⁸ Under current rules, this was a difficult hurdle in the motive test. The removal of the presumption will be widely welcomed by taxpayers (*Association of British Travel Agents v IRC* [2003] STC (SCD) 194).

Assets and risk would be attributed to the CFC following the principles set out in Article 7 of the OECD Model Tax Convention and the 2010 Report on the Attribution of Profits to Permanent Establishments. Indicators of profits which had been “artificially diverted from the UK” are stated in the Consultation Document to include: (i) transaction diversion, namely a transaction giving rise to a UK deduction that would not have arisen had the transaction been at arm’s length; and (ii) diversion through the transfer of assets, such as the separation of an intangible asset, previously in the UK, from the active decision-making regarding the risks inherent in the asset ownership. In this context, a number of structures used to avoid the CFC rules in recent years (such as those involving discretionary trusts established in groups, and dual partnerships) are likely to be untenable in their current form. It is interesting to note, however, that the Consultation Document has not proposed that an indicator of “artificial diversion” is a structure, or part of a structure, which serves no or little express discernable commercial purpose.

The Consultation Document includes a number of examples illustrating the application of the GPE. Through these, and the commentary in the Consultation Document, it is clear that the Government appears to regard the GPE as a last resort (relevant to “high risk” activities, such as where a CFC’s profits are incompatible with its asset profile), although the complexity of the other CFC exemptions may tempt groups to consider eligibility for the GPE as a precursor to a detailed examination of other exemptions⁹. It is also possible that the GPE may be regarded as a “safety-net”, particularly where other exemptions are only marginally failed (or may arguably be failed) or where other income is only partially exempt (as under the FCPE).

Foreign Branches

The exemptions in the proposed CFC regime will extend to foreign branches of UK companies. In this regard, the Government aims to align the tax treatment of foreign subsidiary CFCs with foreign branches which have opted-in to the exempt foreign branch regime introduced in the Finance Act 2011.

The alignment and application of the CFC exemptions will only apply to foreign branches of UK companies which have opted-into the Finance Act 2011 foreign branch exemption regime.

The Consultation Document proposes a mechanical approach to the alignment of the CFC regime with the Finance Act 2011 foreign branch exemption. When a company elects into the Finance Act 2011 foreign branch exemption, it will be required to consider whether any of its branches are subject to a lower level of tax and whether those branches fall within any of the CFC exemptions. In the event that a CFC exemption is available, the branch profits remain exempt. Where no CFC exemption is available, the branch profits (or an appropriate proportion

⁹ Indeed, this concern was articulated at a public open day on the Consultation Document held on 8 July 2011.

of them) will remain chargeable to UK tax, although credit relief will be available for any foreign tax paid on profits which are subject to UK tax.

The Government proposes that foreign branches will be eligible for both the insurance and banking sector specific CFC exemptions, although detailed work will be necessary to ensure the capitalisation tests in the sector specific exemptions are practicable. However, the Consultation Document does not propose to make the FCPE available to overseas branches owing to difficulties in determining the amount of finance income attributable to a foreign branch.

Intellectual Property, CFCs and the Consultation Document

As noted in the November 2010 Consultation Document, the Government is concerned to protect the UK tax base against risks associated with the use and exploitation of IP. The Government does not consider that exit taxes (which may be vulnerable to challenges under EU law) and transfer pricing rules would be sufficient deterrent to prevent the artificial diversion of profits relating to IP from the UK.

Accordingly, the Government's approach in the Consultation Document is to focus attention on the application of the territorial business exemptions on "high risk situations".

Generally, the TBEs are expected to be used to exempt CFCs involved in the exploitation of IP that does not pose a significant risk to the UK tax base. The following activities should therefore be exempted:

- IP income that is related to the holding and exploitation of foreign IP which has not been transferred from the UK, and which does not have significant economic connection with the UK;
- local IP that is integral to a genuine overseas manufacturing trade; and
- IP royalty income that is incidental/ancillary to the trade.

However, the proposed TBEs will generally not apply in the following "high risk situations" (in which case the GPE would need to be considered in turn to prevent a CFC charge arising on non-commensurate profit diverted from the UK):

- where the CFC is engaged to a substantial extent in activities relating to the exploitation of IP which has been transferred out of the UK within the last six years (or before this if the IP transfer has given rise in the last two years to a UK tax charge by way of CFC apportionment);
- the CFC exploits IP and more than 50 per cent. of the CFC's business expenditure relating to IP is with related parties in the UK or more than 20 per cent. of the CFC's gross income involving the exploitation of IP originates from the UK; and

- where more than incidental amounts of the CFC's gross income are attributable to the passive ownership of IP (i.e. an IP money box).

The Consultation Document contains a list of factors to consider in determining whether the profits arising in a CFC following the transfer to it of UK IP are artificially diverted. These include:

- a lack of genuine commercial substance in the transferee;
- UK IP is transferred without the transfer of the functions needed to continue to develop/exploit the IP;
- significant sales in the UK;
- the UK sub-group forecasts show reduced profitability post-transfer of the IP;
- value-adding activities connected with the IP are performed in the UK rather than the CFC's territory of residence;
- the UK borrows to fund third party acquisitions of IP by the CFC; and
- in reference to the transfer of UK IP, the UK sub-group's ability to continue to generate income is dependent upon being able to license back the IP it has transferred overseas.

Consultation Progress

The consultation closes on 22 September 2011, with draft legislation being expected in Autumn 2011 to be introduced in Parliament in the Finance Bill 2012.

Commentary

Building on the HM Treasury and HMRC consultation document published in November 2010, one of the striking features of the Consultation Document is how closely many of the detailed provisions of the regime appear to be aligned with the current CFC regime. This may be helpful in that the entity by entity approach, the definition of "control" and a number of the rebranded exemptions from CFC apportionments will be familiar to UK groups and their advisers (in substance, if not completely in form). The more novel features of the proposed regime, such as the FCPE, have not changed materially since the consultation document published in November 2010, and offer a pragmatic solution for the difficulties of UK based groups planning effectively for intra-group financing while retaining the generous interest deduction regime for UK group members regardless of the source and destination of funding.

Against these advantages, there are nevertheless some difficulties with the proposed CFC regime. Taken as a whole, the new regime still appears less flexible and less benign than some other CFC regimes in the EU, most notably in jurisdictions competing with the UK as the European holding company jurisdiction of first choice. Significant restructuring may be required by some groups on the introduction of the new regime, particularly in the area of offshore

financing arrangements, although it is to be hoped that these such restructurings will be a one-off cost and inconvenience. While the features of the new CFC regime may just be sufficient to achieve one of the Government's policy objectives, namely of discouraging corporate inversion and outward migration from the UK, it is less clear whether the Consultation Document does quite enough to tip the balance in favour of inward investors into Europe choosing the UK as a suitable location for business. If the proposals are viewed in a jaundiced light, several features of the new regime can be seen in the context of defensive changes by the Government. For example, the change to tax only the proportion of a CFC's profits which have been artificially diverted from the UK may be seen in the light of a mechanism to counteract fairly common "swamping" arrangements (in which a genuine foreign trading subsidiary is flooded with passive income) as opposed to a change being made merely to accord to EU compatibility and principles of fairness.

These reservations aside, it is perhaps unfair to condemn the Government's proposals out of hand. The Consultation Document attempts to respond to modern business practices and financing techniques in several areas. The territorial approach of the new regime (when compared with the current regime) also sits comfortably with other recent UK corporation tax reforms such as the dividend exemption in 2009 and the branch profits exemption in 2011.

In this context, much of the success of the new CFC regime will depend not only on the final drafting of the legislation but also on the way in which the various reformed regimes interact and form a coherent and comprehensible regime acceptable to the UK business community. This requirement is accepted by the Government, with a recent statement by the Exchequer Secretary to HM Treasury focusing on the need to minimise complexity in the network of exemptions in the proposed CFC regime and to ensure that the reforms encourage previously migrated groups to return to the UK.¹⁰

Taxation of profits arising from overseas branches of UK tax-resident companies

We reported last summer on the Government's consultation on reforming the taxation of profits arising from overseas branches of UK tax-resident companies, which was launched on 27 July 2010. Following the publication of the initial discussion document, and a number of working group meetings, draft legislation was published on 9 December 2010, and revised further upon inclusion in the Finance (No.3) Bill 2011 which was published on 31 March 2011. After some amendment at committee stage, the new elective regime became law on 19 July 2011, sooner than originally expected, under Finance Act 2011, section 48 and Schedule 13. Revised draft guidance on the rules was published by HMRC on 22 July 2011. Accordingly, the new territorial corporation tax landscape is now largely in place, albeit that we will have to wait until

¹⁰ "CFC Reform: Creating the Right Conditions for Growth", David Gauke MP, Exchequer Secretary to HM Treasury, Tax Journal 9 September 2011.

next year for the final word on the boundaries of the new controlled foreign companies rules (which are expected to impact on the corresponding CFC protections which currently apply to the new regime).

The salient features of the new regime for overseas branch profits are as follows:

- *Election to exempt branch profits and losses.* A UK tax resident company may irrevocably elect that profits and losses of its overseas branches are not to be taken into account in calculating its liability to corporation tax. This will still require UK tax resident companies to prepare worldwide profits calculations. The exemption operates by an adjustment being made to the worldwide profit calculations so that exempted profits and losses are left out of account. The adjustment is arrived at by aggregating branch profits and losses for all branches in overseas territories. However, a further election may be made to stream profits and losses within branches of specified territories and this is expected to be utilised by UK resident companies which are disproportionately affected in relation to certain branches by the transitional rules regarding branch losses (as to which see below).
- *Allocations of profits and losses to the overseas branch.* At an early stage it became clear that the allocation of profits and losses to overseas branches would be made on the basis of the applicable double taxation treaty so the final form of the rules should come as no surprise. Profits are therefore allocated to each overseas branch in the same way as they would be allocated for the purposes of claiming overseas tax credit (assuming a branch is profitable and no exemption election has been made). Losses are allocated in the same way. Where overseas tax is not calculated by reference to branch profits, it is to be assumed for the purposes of the branch exemption that profits would be allocated as if overseas tax was calculated by reference to the branch profits. Where there is no double tax treaty, the allocation of profits and losses is to be made on the basis of the allocation which would have resulted from provisions of the OECD Model Double Tax Convention. Note that the treaty based attribution of profits means that profits and losses from air transport and shipping do not fall within the exemption.
- *Chargeable gains and losses also exempt.* Chargeable gains and losses on assets which are relevant to the calculation of the branch profits and losses are also included in the adjustment to worldwide profits (so that a gain may be increased by excluding a branch loss or a loss may be increased by excluding a branch gain). Separate provision is made for gains and losses on immovable property which has been used for the purposes of the branch business. The value of assets transferred on a no gain no loss basis must also be adjusted to reflect the element of a gain or loss attributable to the overseas branch. This may result in an uplift of the base cost to reflect the exempt gain attributable to the overseas branch or a decrease to the extent that there is an exempt loss.
- *Branch losses – deferral of exemption.* Special rules apply where the business of the overseas branch has given rise to a cumulative net income loss in sequential accounting periods ending in the six years prior to the end of the accounting period in which the exemption election is made. The net income loss over this period is termed the “total

opening negative amount". The adjustment to the worldwide profits of the company is then effectively deferred until a mandatory set-off of the future profits of the branch against the total opening negative amount extinguishes the total opening negative amount. This is to ensure that profits are not immediately exempted where the company has benefited from the use of losses within the last six years on its non-branch profits. A further election can be made by the company to "stream" the total opening negative amount for a particular overseas territory. This has the effect of deferring the exemption in relation to territories where streaming is elected until the opening negative amount (calculated by reference to the branches in each territory to which streaming applies) is reduced to nil. The opening negative amount falling outside the streaming election (and therefore not allocated to any particular territory) is reduced in the same way across all the remaining branches. A transfer of an overseas branch business to a connected company may result in a compensating adjustment being made (in respect of any total opening negative amount) to the worldwide profits adjustment of the transferee. The total opening negative amount of the transferor is reduced accordingly. This is to prevent companies circumventing the deferral rules.

- *Capital allowances.* Capital allowances which could be claimed in relation to assets provided for the purposes of an overseas branch are to be made automatically. This is to minimise the adjustment which is made to the worldwide profits of the company. It is also assumed that the company will make any necessary claims and elections in the overseas territory which have the effect of reducing the overseas branch profits or increasing the overseas branch losses for the purposes of making the worldwide profits adjustment required by the exemption.
- *Employee share schemes.* Reliefs available under Parts 2 and 3 of Part 12 of the Corporation Tax Act 2009 for acquisitions of shares and share options by employees are to be taken into account when calculating the worldwide profits adjustment referable to the overseas branches to the extent that they relate to the business of an overseas branch.
- *Exclusions.* Profits and losses from certain specified types of business do not fall within the scope of the exemption. These include:
 - basic life assurance and general annuity business. An adjustment may be made, subject to certain assumptions, in respect of other life assurance business or gross roll-up business provided that no increase in the value of non-linked assets is taken into account when calculating the adjustment;
 - plant and machinery leasing, where capital allowances have been claimed by the lessor company (or an affiliate);
 - transactions between UK tax residents and the overseas branch which give rise to an obligation on the UK tax resident to withhold income tax at source (this does not apply to banks unless the arrangements have a main purpose of tax avoidance);
 - branch business of small companies where the branch is not in a "full treaty territory" (i.e. territories with treaties containing a non-discrimination provision). This essentially mirrors the corresponding exemption in respect of dividends received by small companies,

although it appears that the branch business can be taken into account when determining whether a company is “small” or not (which potentially makes the branch exemption more generous in these circumstances).

- *Anti-diversion rule.* Where the amount of tax paid in the overseas territory (on income profits only) is less than 75 per cent. of the amount of corporation tax which would otherwise have been payable in relation to the branch’s income profits, the general rule is that no adjustment is to be made to the worldwide profit calculation in respect of that branch’s income profits. This has the effect of excluding the branch’s income profits (but not its losses) from the scope of the exemption. The exclusion does not apply, however, if the income profits are less than £200,000 (on an annual basis) or where the “motive test” is met. The motive test mirrors the current test under the controlled foreign companies rules, and applies where (i) the reduction of tax was minimal or was not one of the main purposes (with the reduction of tax being measured by reference to what would have been the tax result in the absence of the relevant transactions) and (ii) the reduction of tax by diversion of profits from the UK was not a main reason for carrying on business through the overseas branch. In line with the new ability to apply for a reduction in a CFC apportionment, the motive test is not “all or nothing” and there is a just and reasonable apportionment to ensure that only profits from transactions which achieve a reduction in UK tax (“tainted transactions”) are excluded from the exemption. Existing branches are grandfathered in respect of the limb (ii) of the motive test (as described above) provided that the gross income of the branch does not increase by more than 10 per cent. in the first 12 months, there is no major change in the nature or the conduct of the branch business and no asset or business of the branch was previously owned or carried on by a controlled foreign company.

The draft guidance also sets out HMRC’s non-statutory clearance procedure in respect of acquisitions. According to the guidance, limb (ii) of the motive test will also be regarded as met in circumstances where a newly acquired subsidiary becomes UK tax resident and retains an overseas branch. A “period of grace”, similar to the former non-statutory clearance for CFCs, will be given by HMRC in respect of the first full accounting period following the acquisition. This represents just one of the inconsistencies between the overseas branch exemption and the current CFC rules which now have a wider, statutory, three year exemption in analogous circumstances.

- *Consequential amendments.* Certain consequential amendments have been made to other provisions of the tax code to ensure consistency. For instance:
 - the overseas branch profits exemption will result in amounts allocated to branches not qualifying as financing income amounts and financing expense amounts for the purposes of the worldwide debt cap;
 - the manufactured dividends rules have been amended with the broad effect that manufactured dividends paid by exempt overseas branches should generally not now be subject to UK withholding (with a corresponding amendment to the reverse charge

provisions to remove the obligation to account for income tax where the manufactured dividend is received by an exempt overseas branch); and

- the exemption from withholding income tax in respect of interest paid on advances from banks under section 879(1) of Income Tax Act 2007 has been amended to include situations where the interest is received by the exempt overseas branch of a bank.
- *Commencement.* Once the election is made, the regime will apply to the next accounting period of the company based on the objective expectation of when that accounting period will begin. HMRC expects, in its draft guidance, that this will be based on the company's traditional accounting date. Where the next accounting period does not begin at the time originally anticipated, the accounting period is deemed to be split for the purposes of the rules.

Now that the new regime is in force, taxpayers and tax practitioners will need to determine the circumstances in which it will be beneficial to make an exemption election (and whether to make streaming elections). The forward looking nature of this decision means that it will not be an exact science. In terms of compliance, the exemption will at least mean that taxpayers will not need to track overseas tax for the purposes of their double tax relief computations. However, the creation of the alternative regime for foreign branch profits does in itself add to the complexity of the UK's tax code and will therefore present challenges.

Inconsistencies between the new rules and the dividend exemption (when combined with the CFC rules) also remain and may, therefore, prove to be traps for unwary taxpayers or be exploited. However, if the experience of the worldwide debt cap is anything to go by, it does seem that the Government is more prepared to listen to particular concerns which may arise than it has been in the past.

Finally, it is of course to be welcomed that the UK now has a territorial principle at the heart of its corporate tax base whether a business is held as a separate entity or established as a branch.

Consultation on the Patent Box

As part of the 2009 Pre-Budget Report, the government announced that it intended to introduce a lower rate of corporation tax (10 per cent.) for profits attributable to patents with effect from April 2013. This has been generally referred to in the UK as the "Patent Box". On 29 November 2010, the Government published further information regarding its plans for the reform of the taxation of innovation and IP in a consultation document. That consultation document set out the government's proposals for the Patent Box, including that the regime would be optional, would apply to income from patents first commercialised after 29 November 2010 and that it would apply to royalties from patents, income from patent licensing and income which is "embedded" in patented products.

On 10 June 2011, the Government published a further consultation document entitled “**Consultation on the Patent Box**”, which sets out extensive details of the Patent Box, following closely many of the features announced in November 2010. Draft legislation is expected in autumn 2011, with the Government planning to include the Patent Box regime in Finance Bill 2012.

Overview

In brief, all UK corporation tax paying businesses will be eligible to elect for a 10 per cent. corporation tax rate to apply to a proportion of their trading profits from 1 April 2013 provided they actively hold a qualifying patent or certain other qualifying IP comparable to patents (such as regulatory data protection and certain plant variety rights) and receive income related to that patent or IP.

All UK corporation tax paying businesses will be able to opt for the Patent Box to apply to their trading profits. A company may opt out at any time (in which case no further calculation of patent box losses will be needed), but a company will generally not be able to opt back in for five years after opting out.

Scope

Only patents granted by the UK Intellectual Property Office (“**IPO**”) and the European patent Office (“**EPO**”) come within the scope of the Patent Box. The Government has stated that it will consider including patents granted by the national patent offices of some other EU member states into the regime if the pre-approval examination process is comparable to those granted by the IPO or EPO. This is, however, a narrower scope to other regimes in Europe, such as the Dutch “Innovation Box”. Equally disappointing is that patents granted in a non-EU jurisdiction which are approved through a process not materially less demanding than that of the UK are not included in the Patent Box. The Patent Box will not, therefore, apply to holders of US software patents. This seems to be at odds with the Government’s stated policy of encouraging innovation, and may be seen by some as an opportunity lost. It is also uncertain whether the proposed EU Community Patent will be included as a qualifying patent, although it would be very surprising (not least from the perspective of European law) if such a patent was excluded.

The Patent Box will, however, cover worldwide income that UK businesses earn from the particular IPO or EPO patent. Supplementary protection certificates (which extend the protection afforded by qualifying patents), data protection rights and plant variety rights will also give entitlement to benefit from the Patent Box regime. However, trade marks and copyright will not be included in the Patent Box, the stated reason being that such rights have a “weaker or more variable link to high-tech activity” and lack a parallel process of independent scrutiny commensurate to a patent.

Legal ownership or exclusive licence required

The Patent Box will only be accessible by a company which is the legal owner of a patent or the holder of an exclusive licence to exploit a patent commercially. A licence can be limited by field or territory, provided that it still results in effective market exclusivity. Mere beneficial or economic ownership of a patent would, by itself, be insufficient to result in the Patent Box being applicable to income deriving from such ownership. The Government has confirmed that Patent Box will extend to patents developed under joint venture and cost-sharing arrangements. It may be necessary for some groups to look again at their patent ownership and licensing arrangements once the draft legislation in this area is published.

A requirement will be placed on the company opting into the Patent Box regime being actively involved in patent development and not merely being a passive recipient of income from holding patents. This requirement of being “actively involved” is construed in the context of remaining actively involved in decisions concerning the exploitation of the patent (including the management of risks associated with the patent) and performing significant activity to develop the patented invention or its application. Further consideration may be required in this area as it is not clear from the June 2011 consultation document how the Government will deal with genuine innovation which, owing to the particular design of the patented innovation, needs little further development. Any sub-contracting of R&D activity should be permissible, but caution will need to be exercised by the patent owner/exclusive licensee to ensure that it can demonstrate that it has continued to manage the risks associated with the project.

Intra-group patent transfers should not result in Patent Box ineligibility, although no similar rule currently is proposed by the Government for transfers between participants in joint ventures or partnerships. In addition, some care will be needed in respect of patent development which has been undertaken in conjunction with unconnected companies. In these circumstances, the Government has proposed introducing a threshold on the group’s expenses associated with the development of the patent which must be exceeded in order for the patent profits to be considered as arising within the Patent Box regime. In this regard a “cliff-edge” applies in respect of work undertaken by group members in collaboration with an unrelated, unaffiliated third party; the eligibility test will only be satisfied if the group companies’ expenses associated with developing the patent exceed the expenses threshold (or, under an alternative suggested by the Government, can reasonably be termed “significant”). Such a “cliff-edge” effect will generally be unwelcome, and could in extreme circumstances precipitate tax-driven arrangements to attempt to ensure that the “cliff-edge” effect is not operative.

Qualifying income

The proposals for identifying the amounts of qualifying income within the Patent Box mainly focus on income arising from products, rather than attempting to identify income deriving from the exploitation of particular patents. The rationale is driven by the assumption that it is easier to separate income from product lines as such information should be readily accessible from accounting records.

- *Included income:* The following types of income will qualify for the Patent Box regime:
- royalties or licence fees for use of an invention covered by a currently valid qualifying patent, whether or not the licensee uses the invention in an industrial process or incorporates it into patented products that the licensee sells;
- income from the sale of products incorporating a currently valid qualifying patent where the incorporation of the invention is genuinely commercial, and not merely undertaken to bring the product into the Patent Box regime;
- income from selling spare parts for a qualifying product;
- income from the licensing of a bundle of intangible assets that are genuinely related and licensed as a single product, although it is possible that the detailed rules in this areas may introduce anti-avoidance provisions to protect boundary issues and prevent manipulation;
- compensation and damages paid by third parties for infringing a qualifying patent;
- income from the sale of patents, thereby incentivising small companies lacking the scale of operations required to fully commercialise a new product in-house to locate their patent development in the UK; and
- income before a patent is granted. The proposal is for a company to claim Patent Box benefits for income arising between the patent application and the date of grant for a period of up to four years prior to the date of the patent. The additional benefit will be available in the accounting period when the patent is granted.

Certain income will, however, be excluded from the Patent Box regime:

- income from products made by exploitation of a patented process will not be included in the Patent Box. The Government considers that this would extend the regime to income from a wide variety of generic goods and commodities in circumstances where the profits are not directly associated with the patent or with technical innovation. Companies generating income from industrial processes can use the “divisionalisation” rules in the Patent Box regime (see further, below) to impute an arm’s length royalty for the use of that patent and this income, in turn, will be qualifying income within the Patent Box;
- service income will not be included in the Patent Box. The rationale stated by the Government for this exclusion is that the provision of services is not covered by patent protection under UK law. Where a service provider pays a royalty for use of a patent on an arm’s length basis, the patent owner will be able to use the “divisionalisation” rules (see further, below);
- income arising from financial arrangements, including interest, interest equivalents, income from financial assets, and any other type of finance income will not qualify; and
- income or profits within the North Sea ring fence regime will not qualify for the Patent Box.

The Government raised the question in the June 2011 consultation document of whether a motive test, to be used on a case-by-case basis, may be an alternative way of identifying a

composite tangible or intangible product. Where the various conditions for the inclusion of income into the Patent Box are not determinative, some form of a motive test would appear to be helpful as a residual criteria of income qualification.

Calculating Patent Box profits

The reduced 10 per cent. tax rate in the Patent Box is applicable to the net profit attributed to patents, not to gross income. The calculation of the Patent Box profits uses a formulaic approach in place of requiring an arm's length valuation of each patent individually. The broad aim of the formula is to achieve a "residual profit split" to identify and value patent profits. While this is a recognised transfer pricing methodology, the mechanics of the computation are complex and consist of three steps:

Step One: A determination is made of the company's corporation tax profit that is attributable to qualifying income within the Patent Box. The proposal is for taxable, not accounting profit, to be used as a starting point with suitable adjustments to exclude R&D tax credit enhancement and to exclude interest receipts and financing expenses owing to the difficulty of attributing finance costs to a specific patent income stream.¹¹ The remaining profit and expenses are then apportioned on a pro-rata basis according to the proportion of total trading income which is qualifying income within the Patent Box. Where the allocation of profits and expenses by this method produces anomalies, the Government has proposed that in certain situations the pro-rata basis apportionment can be replaced with apportionment of expenses and profits separately to suitable "divisions" of the company. In some circumstances, such "divisionalisation" would be mandatory, such as where a pro-rata basis apportionment would produce excessive Patent Box profits (thereby leading to a lower, overall corporation tax liability). Companies will have the option of defining divisions and applying the "residual profit split" separately to each division, such as where profit margins in different business areas are materially different.

Application on a whole-company or "divisionalisation" basis must be consistent, with a company being prohibited to change divisions or opt-into and opt-out-of "divisionalisation" on a year-by-year basis. This restriction is generally in line with the restrictions to prevent companies manipulating the elective nature of the Patent Box generally.¹² Changes to the divisionalisation will only be permitted where they "affect a genuine long term change in the company's commercial activities". "Divisionalisation" is likely to require that companies computing Patent Box profits on this basis will need to deploy additional computational resources. The logical requirement that each division would be required to produce a

¹¹ While generally accepted accounting practice forms a very material component of computing a company's corporation tax profit, the use of corporation tax profits to compute the reduced 10 per cent. tax rate in the Patent Box will produce a different quantum of "profit" for use in the three-step calculation of Patent Box profits.

¹² Companies will not be able to opt back into the Patent Box regime for five years after opting out.

separate corporation tax computation, including a separate divisional transfer pricing evaluation, is likely to create materially more administration and complexity to the profit calculation.

Step Two: A calculation is made of the “residual profit” created by the patent or IP. This is achieved by deducting a simple fixed percentage return on routine (non-patent related) activities from the corporation tax profit attributed to qualifying income within the Patent Box. The proposal is to compute the amount of routine profit through a cost-plus transfer pricing methodology, with certain expenses being excluded from the mark-up calculation. These non-routine expenses will include the cost of licence fees paid to use patents, inventory costs (such as the cost of raw materials and goods purchased for resale), and routine profit associated with third-party outsourced functions. The remaining routine costs are then marked up at a fixed rate of 15 per cent. Some commentators have noted that the 15 per cent. mark up is a fairly arbitrary figure which may dissuade UK companies from carrying out integral, but routine and excluded, R&D activities themselves. The cost of outsourced activities may not include such a high mark up. Further refinement in this area is therefore anticipated when draft legislation is produced this Autumn.

Step Three: Finally, identification is made of how much of the residual profit on a qualifying product is attributable to the patent (and closely related IP), and how much is attributable to non-patent assets (such as other forms of IP including valuable brands). The proposal is for the relevant company to distinguish between “patent” expenses (R&D expenditure, costs of patent filing, renewal and protection) and “brand” expenses (marketing, selling, promotion, advertising, expenses relating to trademark development and protection). Where the resulting costs ratio is “not supported by business”, the consultation document proposes apportionment of the qualifying residual profit by “identifying the relative contribution of the brand and qualifying patents to the success of the product”. Such a broad apportionment is to be achieved through “any reasonable method”, although the ultimate pragmatism of that approach sits perhaps slightly uncomfortably with such a detailed formulaic process for computing Patent Box profits through the three-steps process in the first place.

Any Patent Box losses (which would result in the company paying more corporation tax, through being unable to utilise the 10 per cent. Patent Box tax rate for a greater amount of qualifying income following Patent Box loss deduction) will not be taken into account in computing the company’s current year profits chargeable to corporation tax. Patent Box losses will be effectively ring-fenced and must be carried forward against profits in later periods until the losses are exhausted, with the possibility of Patent Box losses being set against Patent Box profits in other group companies. The overall result would appear to create a total Patent Box tax deduction regardless of the number of group companies holding group patents. Finally, the Government has proposed that “pre-commercialisation” expenses should be taken into account when considering net patent profits, thereby ensuring that the 10 per cent. Patent Box rate applies to the overall profit attributable to the patent. The intention in respect of the allocation of pre-commercialisation expenses appears to be to avoid manipulation of expenses in the

computation of Patent Box profits and to encourage companies to create products that are profitable across their lifecycle.

A number of concerns arise regarding the Government's proposals for the calculation of Patent Box profits. These concerns originate from the inherent difficulties of determining the boundaries of income streams in practice. It may not be easy to distinguish an apportionment of qualifying (patent) profit and non-qualifying (non-patent) profit in Step One. This difficulty follows from the challenge of determining which products incorporate qualifying patents, and the proportion of profits relating to such patents. "Divisionalisation" is one route to ascertain such an apportionment, but this seems likely to involve significant computational effort and management resources. Identifying a "routine return" at Step Three is likely to be similarly challenging, not least because the separation of "brand" profits from "patent profits" is neither straightforward nor an exact science. Furthermore, it is far from clear whether a number of the principles underpinning the Government's approach in this area are unimpeachable. For example, it is not clear that in all cases £100 of "brand" expenditure will generate the same profit return as £100 of "patent" or associated R&D expenditure. Circumstances where a company's brand value derives to a large extent from innovative patented products are likely to be particularly challenging under the Government's proposals. In these situations, the default position of using "any reasonable method" in Step Three may well be the only practical way forward, despite being both unsatisfying from a definitional approach and however much it appears to run counter to the detailed formulaic approach in the Government's proposals.

Additional Features of the Patent Box

Computations: The headline rate of 10 per cent. within the Patent Box will be achieved by allowing companies to claim an additional tax deduction when calculating the level of profits taxable at the normal rate of corporation tax. This deduction will give the same tax result as if the 10 per cent. rate for the Patent Box had been directly applicable. The amount of the corporation tax deduction will be computed using the following formula:

$$\text{Total Patent Box profits} \times \frac{\text{Main CT Rate less Patent Box rate}}{\text{Main CT rate}}$$

Where the small profits rate of corporation tax applies, that rate will replace the main rate in the calculation.

Commencement and "phasing-in" of regime: The Patent Box regime will apply to profits arising after 1 April 2013. Where a company's accounting period straddles 1 April 2013, the proposals is for the company to access the Patent Box in relation to those profits which arose after 1 April 2013. The Government proposes "phasing-in" the benefit of the Patent Box regime over the first five years of operation. Accordingly, in the 2013/14 financial year, 60 per cent of the full benefit of the Patent Box will be available, with an additional 10 per cent. being available in each subsequent financial year. The full benefit of 100 per cent. of the Patent Box will be available in the 2017/18.

Patent eligibility and “commercialisation”: Following the announcements made in the November 2010 consultation document, the Patent Box regime will apply to all patents first commercialised after 29 November 2010, although the Government accepts that “commercialisation” needs clarification as the date of initial commercialisation may be hard to identify in a number of circumstances.

Double tax relief: Double taxation relief for withholding tax suffered on royalties will continue to be available up to the lower of the overseas tax suffered and the UK tax payable on profits deriving from the licensed assets after taking into account the Patent Box deduction into account. Relief for overseas tax paid on the profits of a non-exempt overseas foreign branch will also continue to be available up to the lower of (i) the tax paid overseas; and (ii) the final UK tax payable on branch profits.

Transfer pricing: The Patent Box will apply on a company-by-company basis, rather than on the basis of UK consolidated results. To prevent tax avoidance, all companies claiming Patent Box benefits must comply with the transfer pricing regime in their transactions with associated companies. However, difficulties are likely to be present where smaller companies are exempted from applying the transfer pricing rules. The Government has announced in the consultation document that it will consider allowing HMRC to require normally exempt companies to apply UK transfer pricing rules, but limit the requirement to “cases of clear tax avoidance through the artificial manipulation of profits between associated companies”.

Anti-avoidance rules: The inclusion of targeted anti-avoidance rules in the Patent Box regime is being considered by the Government in specific areas such as: (i) the inclusion of patented inventions in products which are not functionally interdependent for a main purpose of securing that income from the sale of a product will qualify for the regime if it would not otherwise have qualified; and (ii) the artificial manipulation of income or expenses to obtain tax deduction for expenses at full rate while income is taxed at the 10 per cent. Patent Box rate.

Clearances: HMRC will operate its regular non-statutory clearance system in respect of the Patent Box regime. Areas of complexity or uncertainty relating to the definition and identification of “brand” profits, the pricing of royalty income streams under the “divisionalisation” approach, what constitutes “actively holding” a patent and the determination of residual profit generally are all likely to be areas of uncertainty that will benefit from the clearance arrangements to be offered by HMRC.

Consultation on Potential Debt Cap Changes for Finance Bill 2012

HMRC has begun an informal consultation on possible further amendments to the worldwide debt cap. The worldwide debt cap rules disallow a specified amount of financing deductions of large, non-exempt groups where the UK corporation tax payers of the group have net debt amounts which, when aggregated, exceed 75 per cent. of the gross debt of the consolidated worldwide group.

The legislation was originally introduced by the Finance Act 2009, Schedule 15 and subsequently rewritten to the Taxation (International and Other Provisions) Act 2010. It has since been amended by the Finance (No.3) Act 2010, Schedule 5. However, difficulties with the legislation remain.

The *de minimis* affecting the “total disallowed amount” has given rise to practical concerns that affect all taxpayers within the debt cap to a greater or lesser degree. The amount of the financing deduction disallowance imposed by the rules (known as the “total disallowed amount”) represents the excess of the “tested expense amount” over the “available amount”. The “tested expense amount” is, in substance, the sum of the net financing expense of each UK corporation tax paying group member which has a net financing expense. The “available amount” is the gross financing expense of the worldwide group. In calculating the “tested expense amount” a *de minimis* rule applies to the effect that net financing expenses of a company are not taken into account if they amount to less than £500,000. While this may have the effect of reducing the excess of the tested expense amount over the available amount (and therefore reducing the total disallowed amount) in some groups, the *de minimis* may work against groups in some situations. This is because the £500,000 *de minimis* limit also applies to the net financing income calculation for each UK corporation tax payer in the group. These net financing income amounts are aggregated to find the “tested income amount” but are not taken into account if they fall below the £500,000 *de minimis* threshold. The tested income amount, in turn, has the effect of absorbing some of the effect of the disallowance as the tested income amount will be left out of account for corporation tax purposes to the extent that the total disallowed amount can be set against the tested income amount. For a group of companies, the constituent members of which are near to the £500,000 threshold, the effect of the threshold could be quite onerous. For example, the net financing deductions of the UK corporation tax paying net debtor companies may all be just over £500,000 and the net financing income for the UK corporation tax paying net creditor companies may be just under £500,000 in each case. This may result in a total disallowed amount in respect of the net financing deductions but no compensating adjustment for the net financing income amounts for the other companies. The problem is apparently having a disproportionate impact on some groups, consisting exclusively of UK companies, which was not the original intention of the legislation.

The solution proposed by HMRC is that groups should be able to elect out of the *de minimis* provisions. While it is expected that this will largely ease the problem, HMRC are contemplating an irrevocable election and this will necessarily require an element of speculation as to the future financing needs of the group.

Additional aspects of the rules which are being consulted upon include:

- *Asymmetries involving partnerships.* Very broadly, the available amount is calculated by reference to amounts disclosed in the consolidated financial statements of the group. The available amount calculation has already been amended to require an adjustment to be made to substitute an amount based on a partnership’s profit sharing ratio in the calculation

of the available amount for the amounts disclosed as partnership liabilities in the financial statements which would otherwise have been used. However, where a partnership is owned as to 80 per cent. by the worldwide group, and that partnership lends to a partner which is a member of the worldwide group, an asymmetry in the rules remains. The loan will be ignored as a result of the consolidation of the partnership with the worldwide group but the interest payable to the minority partners will still be taken into account for the purpose of calculating the tested expense amount. HMRC propose to remedy this situation by requiring a similar adjustment to the available amount calculation for borrowing from a consolidated partnership as for lending by such a partnership. The alternative solution put forward by HMRC is that the available amount should be calculated by reference to loan relationship debits instead of under the specific categories of financing expense currently identified;

- *Functional currency.* It is not made expressly clear in the legislation that amounts not otherwise disclosed in the financial statements should be translated into Sterling (where that is not the functional currency) at the average exchange rate for the period of account of the worldwide group. HMRC is consulting on whether to make its understanding express;
- *Mergers and takeovers.* Another gap between the debt cap provisions and the accounting treatment has been identified in respect of merger and takeover situations. The measurement of the 75 per cent. "gateway" test under the legislation relies on a split accounting period treatment where companies join or leave a group. HMRC recognises that in merger or takeover situations, the periods of account yielding the results disclosed in the consolidated financial statements may not reflect the periods of account to which the rules are deemed to apply. HMRC's view is that the provisions dealing with non-existent financial statements cover this situation adequately and its current preferred intention is that these situations should be clarified by guidance;
- *Pension scheme contributions.* HMRC have identified that the worldwide debt cap creates a mismatch in respect of certain pension arrangements which utilise partnership or SPV structures to hold income producing assets of the group. In these structures, it is possible to achieve a deduction in respect of the discount of the current market value of the liability owed to the pension scheme from the total amount of payments which are due to be made over the life of the arrangements. While this amount will be included in the "financing expense amount" of the relevant company, the pension liabilities will be consolidated at group level and will therefore not be recognised in the available amount calculation. This may lead to a greater disallowance. HMRC has not proposed a solution to this issue and makes the rather discouraging observation that it is already consulting on the unintended tax relief which may arise from these structures;
- *Available amount constituent amounts.* The available amount is made up of certain specific categories of finance expenses (e.g. interest and amortisation of discounts) whereas the calculation of the tested expense amount includes all loan relationship debits and credits (except those relating to impairment losses, exchange losses and as a result of related transactions). This has been identified as being an administrative burden on groups consisting exclusively of UK companies which, under the current rules, have to separate out the amounts relating to the specific categories of the available amount from their loan

relationships computation. HMRC’s proposed solution is to include all loan relationship debits within the available amount calculation; and

- *IFRS 10, IFRS 11 and IFRS 12.* HMRC are consulting generally on the effect of changes to these accounting standards affecting consolidated financial statements, accounting for joint arrangements and disclosure of interests in other entities, respectively.

Legislation is expected to be brought forward in Finance Bill 2012 to correct these anomalies to the extent deemed necessary.

Judging by past experience, further changes may well be needed to the debt cap rules as more inconsistencies come to light. In addition to the fact that the worldwide debt cap legislation is in itself highly technical, there is an underlying tension which follows from the use of amounts disclosed in group accounts alongside the amounts taken into account for UK corporation tax purposes. HMRC is, at least, being seen to be listening to instances where perceived unfairness arises.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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