



HM TREASURY



HM Revenue
& Customs

Controlled Foreign Company (CFC)

an update

January 2012



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1

Introduction

1.1 On 6 December 2011 the Government published the document *Controlled Foreign Company (CFC) Reform - response to consultation* which set out how the proposals for CFC reform had developed in the light of the consultation over the summer and autumn. Draft legislation for most of the new CFC rules was published at the same time. This document covers the initial feedback received on the proposals and draft legislation and how the Government intends to respond. It also sets out further proposals on the finance company rules, the application of the CFC rules to exempt foreign branches, the temporary period of exemption, commencement provisions and further details on how the new rules will apply to the financial sector.

1.2 The draft legislation has now been updated to include the rules applicable to exempt foreign branches and amended rules for the treatment of finance profits. The remainder of the draft legislation is as originally published and therefore does not yet reflect either the further changes discussed later in this note or any other feedback received during consultation. Annex A provides a guide to the additional draft legislation that is being published today.

1.3 Engagement with interested parties since December continues to be very helpful. The Government is keen that all interested parties continue to engage throughout the consultation period and beyond to ensure the best possible outcome when the rules are introduced in Finance Bill 2012.

Feedback since December

1.4 The document *Controlled Foreign Company (CFC) reform: response to consultation* published in December was well received - it has been generally acknowledged that the detailed policy proposals achieve the Government's objectives for CFC reform, and that a number of important changes have been made since the June 2011 consultation document. However, many respondents feel that, although the legislation achieves the right result, the compliance burdens in getting there are excessive. These concerns have been raised in respect of the current legislative form of the Gateway in particular.

1.5 The Government recognises that ensuring that the Gateway operates as intended is key to achieving the objectives of CFC reform. The intention is to ensure that groups and their foreign subsidiaries can more readily identify whether or not they are within the scope of the rules. In response to this feedback the Government is considering proposals to achieve this, including developing the Gateway to provide clear entry conditions which work on a qualitative basis and allow groups to be able to assess, in a straightforward manner, that a foreign subsidiary is outside the scope of the rules. This will avoid the need for companies to carry out the calculations required in the current Gateway legislation, except where there is a reasonable probability that a charge will arise. The IP working group is now focusing specifically on the Gateway, and revised draft legislation on the Gateway will be shared with business when it is available.

1.6 Other issues on which specific feedback has been received include the complexity of the excluded territories exemption and the scope of the targeted anti-avoidance rules (TAARs). Officials are in discussion with businesses and advisers on these issues.

1.7 The deadline for responses to the consultation is 10 February 2012. While recognising that this is a much shorter period than is generally available, it would nevertheless be useful to receive comments on the legislation published today by the deadline. However, should this not be possible given the timescales, comments should be submitted as soon as possible after that date.

2

Finance profits

2.1 The partial exemption rules provide an effective rate of tax of 5.75 per cent (by 2014) on finance profits from overseas intra-group financing. This is intended as a competitive and pragmatic approach by the Government to the issues raised by the fungibility of monetary assets, avoiding the need for complex tracing rules.

2.2 In the document published in December the Government confirmed that the case for full exemption in limited circumstances was being given further consideration, bearing in mind the need to deliver an affordable regime.

2.3 The Government has identified two circumstances in which full exemption will be offered for profits to which the finance company rules apply. Firstly, the total CFC charge arising from partially exempt loan relationships will be limited to the aggregate net borrowing costs (calculated before taking account of any CFC charge) of the UK members of the group. Secondly, the finance profits arising from a loan which is made without reliance on wider group funds (for example as a consequence of a share for share exchange or a rights issue) will also be exempt.

2.4 In addition, in accordance with the Government's aim of targeting the rules on artificial diversion of UK profits, a loan which 'pulls up' foreign external debt to the UK with the purpose of creating a UK tax deduction will be excluded from the definition of loans that qualify for full or partial exemption. This is intended to be a carefully targeted restriction will not affect entitlement to partial exemption for loans made by a CFC for reasons other than the tax-driven replacement of existing foreign external debt.

2.5 The expectation is that the treatment of the majority of loans that fall within the finance company rules will be unaffected by either full exemption or the restriction. The Government considers that, in general, businesses will take advantage of the partial exemption, which will remain a pragmatic and competitive approach to intra-group financing.

2.6 These proposals are reflected in the further draft legislation and are described in more detail in Annex A. The Government welcomes views on this set of proposals.

2.7 Due to the need to maintain affordability of the reform, the Government will not be offering transitional rules for non-trading finance profits.

Application of the finance company rules to regulated financial traders

2.8 The proposals published in December noted that because monetary assets are intrinsic to the trade of regulated financial entities, loans to or from regulated entities would be treated as non-qualifying loans for the purposes of partial exemption. To ensure greater alignment of the treatment of financial traders with non-financial groups, this restriction has been refined. Loans within financial groups may be qualifying for the purposes of full and partial exemption to the extent that they are not funded by UK banks or insurance companies. Details of how this is achieved by the updated draft legislation are included in Annex A. The capitalisation test will be amended to ensure consistent treatment of partially exempt loans. The details of this amendment and the impact of the ultimate debtor rule on financial traders are currently being considered with the affected businesses.

3

Other updates

Application of the CFC rules to exempt foreign permanent establishments

3.1 *Controlled Foreign Company (CFC) Reform -response to consultation*, which the Government published in December, identified the interaction between the new CFC rules and the exemption for profits attributable to a foreign permanent establishment (or branch).

3.2 The anti-diversion rule in the current foreign branch exemption legislation will be repealed and replaced by rules that have the same scope in relation to a foreign branch as the new CFC rules have in relation to a foreign subsidiary.

3.3 Where an exempt foreign branch has investment income, exemption of this income will be limited to that which is effectively connected to a trade or overseas property business. This means that exemption will not be available for pure finance branches. A number of other minor changes have also been made to the foreign branch exemption legislation. Further details on the legislation can be found in Annex A.

Capitalisation safe harbours

3.4 Following consultation with the banking and insurance sectors, safe harbours have been developed which can be applied instead of the arms length capitalisation test. These safe harbours, in combination with the arms length capitalisation test, will ensure that the UK Exchequer is protected while minimising compliance burdens.

3.5 Discussions are continuing with both the insurance and banking sectors, but current proposals are for the insurance safe harbour to be set at between 200 and 250 per cent of minimum regulatory capital. The proposed banking safe harbour limit is the greater of a 12.5 per cent Tier 1 capital ratio and the level of Tier 1 capital that the FSA would require the bank to hold if it were regulated in the UK, plus a 2 per cent buffer.

3.6 Draft regulations will be published in due course.

Offshore funds

3.7 The Government is aware that the draft legislation may not give the right result in all situations for offshore funds, including those held by life insurance companies, and is in discussion with the sector on this issue.

Temporary period of exemption

3.8 The December document made clear that while it remains the Government's intention to offer a time limited exemption as part of the new CFC rules, further work on the scope of such an exemption was necessary. This work has focused on the need to ensure that any time limited exemption works in a way that is consistent with the new rules, in particular the gateway and other exemptions.

3.9 A key aim of the existing temporary period of exemption (TPE) in Finance Act 2011 is to reduce and facilitate the compliance burden associated with the acquisition by a UK group of a number of foreign subsidiaries, or a move to the UK by a non-UK group. However, given the more territorial approach taken by the new CFC rules, including the work described above to

improve the gateway, there will be a reduction in compliance burdens that aims to benefit all those potentially subject to the rules. But the Government recognises that providing a period for foreign subsidiaries brought within the CFC rules to restructure their affairs before the CFC rules apply may still be helpful in certain circumstances.

3.10 The Government proposes to introduce an initial period of 12 months during which a foreign subsidiary would be exempted from the CFC rules, but with that exemption being subject to the CFC undertaking any restructuring necessary so that no CFC charge arises for subsequent periods. If this condition is not met, then the general CFC rules, including the gateway and exemptions, will apply. It is proposed that the exemption will be available in similar circumstances to those in which the existing TPE applies, typically where a UK group acquires one or more foreign subsidiaries or where a non-UK group moves to the UK.

3.11 The 12 month period would run from the date of the event leading to the company becoming subject to the CFC rules, for example the date of the CFC's acquisition or the date of movement of its parent to the UK. It is also proposed to allow an extension of this 12 month period where it can be shown that the CFC could not reasonably have completed the restructuring necessary to ensure that no CFC charge arises within the 12 month period (typically because of circumstances beyond its control). Exemption for an extended period would then depend on the CFC becoming exempt by the end of that extended period.

3.12 It is intended that a CFC that is fully exempt as a result of the TPE, or that obtains a TPE before the rules in Finance Act 2011 are repealed, will continue to be exempt until the temporary period of up to three years ends, or until any earlier termination occurs under the conditions of the TPE. At that point the new CFC rules will apply.

Commencement provisions

3.13 The working assumption has been that the new CFC rules would apply to accounting periods beginning on or after the date that Finance Bill 2012 receives Royal Assent. For groups with the most common year end, 31 December, this effectively means a start date of 1 January 2013. Against this background, the Government has been considering a number of relevant factors including interest from business in early access to the finance company rules, access to the existing TPE and the advantage of providing sufficient preparation time for business, advisers and HMRC. The Government is proposing that the new CFC rules should apply to accounting periods beginning on or after 1 January 2013. The commencement rule will operate by reference to the accounting period of the CFC rather than of the UK controlling company, which will mean that application of the new CFC rules need not be restricted by reference to the UK group's accounting date. This is subject to the exception mentioned above in respect of companies using the existing TPE, and to specific provisions which will align the commencement of CFC reform and the new life insurance regime.

A Guide to the draft legislation

A.1 This annex is a guide to updated sections of the draft legislation, including changes to the finance company rules in Chapter 17 and the exemption of profits attributed to permanent establishments in Chapter 3A of Part 2 CTA 09. Where the legislation has been changed it is underlined to allow the changes to be easily identified. The explanatory notes will be updated to take account of these and any further changes when the final draft is published on 29 March as part of the Finance Bill.

Full exemption for finance profits

A.2 Chapter 17 of the draft legislation includes partial exemption rules for qualifying loan relationships, reducing the effective CFC tax rate on intra group lending to foreign subsidiaries to one quarter of the usual CT rate. From 2014 this will be an effective rate of 5.75 per cent.

A.3 Chapter 17 has been updated and now sets out two circumstances in which profits from qualifying loan relationships will be fully exempt from the CFC charge. These are to the extent that:

- Profits are made from loans that are funded only from 'qualifying resources' (see sections 371QC and QD); and
- a CFC charge would cause the group's UK financing income to exceed its UK financing expense ('matched interest', see section 371QF).

A.4 The definition of qualifying loan relationship (section 371QH) remains for the most part unchanged, although there are some changes affecting financial groups that are described below.

Qualifying resources

A.5 Full exemption is proposed for loans that are created in a way that makes no demands upon group funds originating outside the borrowing company's territory of residence ('the relevant territory'). Qualifying resources are any of the following:

- profits derived by the lender from lending to group companies in the relevant territory;
- cash or assets derived directly or indirectly from the proceeds of an issue of shares to the group's shareholders; or
- funds obtained from shares held by the CFC that are issued by a group company that is resident in the relevant territory throughout the accounting period in which the claim is made (including the borrower itself), but only to the extent that they are directly or indirectly derived from specified sources of value within the group of companies (see below).

A.6 Funds in the third bullet above may be obtained from shares in many different ways, including a disposal of the shares, or a distribution arising on the shares. However funds are obtained from shares, to determine if the funds are qualifying resources it will be necessary to

consider the source of value in the issuing company, or if necessary beyond that company to the ultimate source of the funds. Specifically:

- if the funds are distributed, it will be necessary to consider the source of the distribution; and
- if the funds arise from a disposal of the shares then all sources of value in the issuing company need to be considered.

A.7 If the CFC making the loan derives resources from shares it holds in group companies, they are qualifying resources if they are directly or indirectly derived by the issuing company from the following sources:

- profits derived from the group's operations in the borrower's territory, excluding any profits derived from lending to or holding equity investment in group companies outside the relevant territory; or
- amounts that reflect consideration given by the group in a 'share for share exchange'.

A.8 A 'share for share exchange' above refers to a purchase of the issuing company's shares from unconnected shareholders in exchange for newly issued shares. Where a purchase is made partly for shares and partly for other consideration, or where an extraordinary dividend is paid to shareholders in connection with the share for share exchange, only a proportion of the value derived from the transaction represents qualifying resources - this proportion is referred to as Y per cent in section 371QD.

A.9 If a qualifying loan relationship is created as part of an arrangement that also leads to the creation of an amount (X) of new debt in the UK, then at least X of the resources used to create the loan will not be qualifying resources.

Establishing the Claim

A.10 As with partial exemption, a claim must be made for full exemption (see section 371QB). A claim to full exemption is therefore optional – a company with a CFC charge arising from a qualifying loan relationship may choose to claim either full or partial exemption. If full exemption is claimed then profits from a qualifying loan relationship are fully exempt to the extent that the loan is funded from qualifying resources - this proportion is referred to as X per cent in section 371QC. To the extent that it is funded from other resources the profits will potentially be fully taxable. Therefore it will be worthwhile to claim full exemption provided that at least three quarters of the funds used to create the loan are qualifying resources – in other cases partial exemption will give a more favourable outcome.

A.11 For example, if a loan is 95 per cent funded by qualifying resources and 5 per cent funded by other resources, then 95 per cent of the profits from the loan will be exempt and 5 per cent of the profits will be taxed at the full rate. From 2014 this would represent an effective tax rate of 1.15 per cent on the profits from the loan as a whole.

Example 1

A group makes an acquisition of a previously unconnected group. The shares are paid for by a combination of newly issued shares and cash, with new shares representing 95 per cent of the acquisition value.

The shares are passed to a CFC in return for shares issued by the CFC. The CFC exchanges the shares for a mixture of debt and shares in a newly created intermediate holding company resident in the same jurisdiction as the newly acquired company.

The CFC's lending in this case is funded entirely by a disposal of the newly acquired shares. These shares comprise 95 per cent qualifying resources so – as above – the effective rate of tax on the profits from this loan is 1.15 per cent.

A.12 Nothing in the full exemption rules restricts a company's entitlement to partial exemption. In any case where there are insufficient qualifying resources, the company remains entitled to partial exemption in respect of any qualifying loan relationship. Partial exemption will be the result of the claim unless the company in its claim specifies that section 371QC should take effect.

A.13 Section 371QC does not prescribe in detail all of the circumstances in which qualifying resources derived from shares may be used to create a loan. There are many ways in which value may be passed between group companies before being used to fund a loan – any route for the funding is permissible provided (or to the extent that) the claimant can establish that no other resources were used to create a loan.

A.14 A claim cannot however succeed without adequate evidence about the source of funding for a loan. Sometimes an investigation of a company's balance sheet will be of assistance in determining the source of a distribution – for example, whether it comprises pre- or post-acquisition profits. Where a loan is funded from the repayment of an earlier loan, it will be necessary to look back to the origins of the earlier loan if a full exemption claim is to be made.

Example 2

Shares are acquired by a group for cash. The acquired company has share capital and distributable reserves at the time of acquisition. A CFC becomes the acquired company's immediate holding company. After some years of trading during which profits are earned by the acquired company, some of which are distributed, the company declares a distribution to fund lending by the CFC back to the company.

The distribution is made up of 80 per cent of profit and 20 per cent of share premium. Evidence from the company's balance sheet shows that the distributed profit did not arise before the acquisition, but that the share capital consists of capital represented in the earlier acquisition.

In this case, the balance sheet evidence shows that the distributed profit arose while the company was owned by the group in its current territory of residence. These are qualifying resources. The share capital formed part of the purchase price of the shares in the acquisition and so are not qualifying resources. 80 per cent of the profits from this loan relationship are fully exempt and 20 per cent are fully taxable, giving an effective tax rate of 4.6 per cent.

Matched Interest

A.15 A CFC charge made in respect of finance profits is included in the 'finance income amounts' of the chargeable company for the purposes of Part 7 TIOPA (the worldwide debt cap) – see new section 314A TIOPA in Part 3 of the draft legislation. Any such charge may increase the 'tested income amount' or reduce the 'tested expense amount' for the UK part of the chargeable company's group for debt cap purposes.

A.16 The matched interest rule in section 371QF reduces any CFC charge made in respect of qualifying loan relationship profits (referred to as 'leftover profits', being the non-exempt part of any such profits) if the tested income amount for the group exceeds the tested expense amount for the group, or would do so following the CFC charge arising from leftover profits. In this way this matched interest rule prevents a CFC charge made in respect of qualifying loan relationship profits from creating or increasing a surplus of net financing income over net financing deductions in the UK part of the CFC's group.

A.17 If the tested income amount exceeds the tested expense amount before any CFC charge is made in the CFC's group in respect of leftover profits, then all CFC charges made in respect of qualifying loan relationships are reduced to nil.

A.18 If the tested income amount would exceed the tested expense amount as a result of CFC charges made in the CFC's group in respect of leftover profits, then a proportion of each such CFC charge is made exempt throughout the whole group. The proportion is calculated by reference to a formula that depends upon the impact of these CFC charges on the tested expense amount and the tested income amount:

- E = The amount by which the tested income amount would **exceed** the tested expense amount as a result of the CFC charges
- I = The amount by which the tested income amount is **increased** by the CFC charges
- R = The amount by which the tested expense amount is **reduced** by the CFC charges

A.19 The proportion by which each CFC charge made in respect of leftover profits is reduced is given by the formula:

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

A.20 The result of making this proportion exempt is to cause the tested expense amount to be exactly equal to the tested income amount.

A.21 The matched interest rule will be of particular benefit to groups that have little or no interest expense in the UK. For those groups there can be little or no CFC charge in respect of qualifying loan relationship profits.

A.22 The matched interest rule is considered after any claim to partial or full exemption – it considers the effect on the debt cap amounts of a CFC charge that would arise after taking account of everything other than the matched interest rule itself.

A.23 The worldwide debt cap does not apply to small or medium sized groups or to groups that are principally financial groups. Companies in these types of groups can claim exemption under the matched interest rule. However, irrespective of the overall nature of the group, finance income and expense is disregarded if it is received or paid by a bank or insurance company.

Qualifying loan relationships – restriction

A.24 Section 371QH(9) prevents a loan relationship from qualifying for either full or partial exemption if it is paid as part of an arrangement to “pull up” foreign external debt to the UK. The restriction applies where:

- the CFC’s loan is mainly used, directly or indirectly, to repay an existing external loan of the ultimate borrower;
- the CFC has received capital investment directly or indirectly from a connected UK company for the purpose of making the loan and
- the main purpose or one of the main purposes of the arrangements described above is to obtain a UK tax advantage.

A.25 This rule therefore applies only in narrow circumstances in which a CFC’s loan replaces existing foreign external funding and therefore serves no new funding purpose. It also applies only where the purpose and effect of the arrangements is to create a UK tax advantage through interest deductions to fund the equity investment in the CFC.

Qualifying loan relationships – financial companies

A.26 The draft legislation makes some changes to the definition of a qualifying loan relationship in section 371QH. A loan cannot be a qualifying loan relationship to the extent that it is derived directly or indirectly from capital investment made by a UK resident bank or insurance company, or by a foreign bank or insurance company that has a UK permanent establishment.

A.27 A loan made by a CFC to a foreign bank or insurance company in the same group can be a qualifying loan relationship. However, to the extent that such a loan is made fully or partially exempt from the CFC charge under a claim made by the chargeable company, there will be an impact on the Chapter 10 (over-capitalisation) position. This interaction is not included in the updated draft legislation but it is intended that the capitalisation test will be amended so that the corresponding part of the qualifying loan relationship which is fully or partially exempt will be treated as equity in the hands of the bank or insurance company for the purpose of determining whether any CFC charge arises to that company under Chapter 10.

A.28 This will only be relevant if there is a potential CFC charge on the bank or insurance company. There will not be a CFC charge if any of the entity level exemptions apply, or if there is no UK capital investment in the bank or insurance company. Additionally, a CFC charge will only arise if the result of re-characterising all or part of the loan as equity leads to the conclusion that the company is over-capitalised.

Permanent establishment (PE) exemption

A.29 An elective exemption for profits attributable to foreign permanent establishments was introduced in FA 2011. The rules are contained in Chapter 3A of Part 2 of CTA 2009. These rules are amended by Part 2 of the draft legislation, which inserts a number of new and amended provisions into Chapter 3A of Part 2 of CTA 2009. Legislative references are to CTA 2009 unless otherwise stated.

A.30 Under the current provisions exemption of PE profits is subject to an anti-diversion rule (existing section 18G). This rule currently reflects the lower level of tax test and the motive test within the current CFC rules, but not any of the other exemptions. The draft legislation makes the following changes:

- the anti-diversion rule is repealed and replaced by one that reflects all aspects of the new CFC rules;

- the scope of PE exemption is amended in relation to profits derived from investments;
- PE exemption is extended to corporate members of Lloyd's insurance market; and
- certain other relatively minor amendments are made.

Anti-diversion rule

A.31 The starting point for the anti-diversion rule (new section 18G) remains the 'adjusted relevant profits amount', which are the profits attributable to a PE excluding any chargeable gains or losses. The revised anti-diversion rule prevents part of the adjusted relevant profits from being exempt only if:

- the profits are 'diverted profits', which are defined by reference to the definition of CFC chargeable profits; and
- none of the CFC exemptions apply.

A.32 To determine if the adjusted relevant profits amount includes any diverted profits there is a two step process:

- 1 first establish whether the company with the foreign PE (referred to as 'Company X') has any profits that would be CFC chargeable profits if it were not UK resident;
- 2 then establish whether any of these profits are attributed to the PE.

A.33 To determine whether one of the CFC exemptions apply it is necessary to assume that the PE is a subsidiary of Company X that is resident in the PE territory (new section 18H). Certain other secondary assumptions are listed in new section 18H(3).

A.34 Some of the entity level CFC exemptions refer to accounting profits. Because the adjusted relevant profits amount is already known in the case of PE exemption, and also because of the uncertain nature of PE accounts, these references to accounting profits are disregarded for PE exemption purposes, and the exemptions are applied on the basis of adjusted relevant profits.

Profits from investment business

A.35 The nature of the current anti-diversion rule is such that (unless transitional arrangements apply) little or no non-trade investment profit will qualify for exemption. The changes to the PE exemption will allow profits that are incidental to a trade or property business to qualify for exemption to the same extent as those amounts are excluded from the CFC charge (section 18CB).

A.36 If there are finance profits in excess of the allowed incidental amounts, they may qualify for full or partial exemption in the same way as applies to a CFC. This aspect of the rules is not yet reflected in the draft legislation.

A.37 It is unlikely that investment profits will be attributed to a PE unless the PE carries on a trade or a property business, but to put this matter beyond doubt and to give a clear limit on the scope of PE exemption, investment profits will qualify for exemption only if they arise from assets that are effectively connected with a trade or overseas property business carried on by the CFC (section 18CB(2)). This applies to both investment income and gains.

Lloyd's underwriters

A.38 Profits arising from a foreign PE are exempt to the extent that they would otherwise be attributed to the PE for the purpose of establishing entitlement to credit relief in respect of any foreign tax. A corporate member of Lloyd's obtains credit relief in accordance with regulations

that apply without any requirement to attribute profits to a foreign PE. This means that no profits of a Lloyd's corporate member will qualify for PE exemption.

A.39 To remedy this position, the draft legislation amends the PE exemption legislation so that the relevant profits or losses amount of a Lloyd's corporate member is calculated as if the Lloyd's credit relief regulations did not exist (see new section 227CFA 1994 in Part 2 of the draft legislation). This allows PE exemption to be calculated for a Lloyd's corporate member on the same basis as applies for any other company.

A.40 PE exemption applies to the profits arising from underwriting years that begin after the date the company elects for PE exemption to apply, together with investment income that is attributed to those years in accordance with Lloyd's rules and practice.

Minor amendments

A.41 Some other minor improvements are made to the PE exemption legislation:

- at present an election for section 18A must be made in an accounting period of the company. A change to section 18F allows an election to be made before a company's first accounting period; and
- a balancing adjustment is required for transfers of plant and machinery to a PE. New section 15(2B) CAA 2001 in Part 2 of the legislation switches this rule off in the case where the transfer occurs due to the transfer of a lease and the profits from the lease excluded from PE exemption in accordance with section 18C(3).

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