

**1 Controlled foreign companies**

The Schedule makes provision in relation to controlled foreign companies.

## SCHEDULE

Section 1

## CONTROLLED FOREIGN COMPANIES

*Imputation of chargeable profits and creditable tax of controlled foreign companies*

- 1 (1) Section 747 of ICTA (imputation of chargeable profits and creditable tax of controlled foreign companies) is amended as follows.
  - (2) After subsection (3) insert –
    - “(3A) In the case of an apportionment to a company resident in the United Kingdom which has made an application under section 751A which has been granted, subsection (3) above has effect subject to that section.”
  - (3) After subsection (5) insert –
    - “(5A) Where the resident company has made an application under section 751A which has been granted, it shall be assumed for the purposes of subsection (5) above that –
      - (a) each of the persons who are connected or associated with the resident company has made an application under that section to the same effect, and
      - (b) all the applications have been granted.”

*Residence*

- 2 In section 749 of ICTA (residence) insert at the end –
  - “(10) For the purposes of subsection (8) and (9) above, the effect of any application under section 751A shall be disregarded.”

*Elections and designations under section 749: supplementary provisions*

- 3 In section 749A of ICTA (elections and designations under section 749: supplementary provisions) insert at the end –
  - “(9) For the purposes of this section the effect of any application under section 751A shall be disregarded.”

*Territories with a lower level of taxation*

- 4 In section 750(3) of ICTA (territories with a lower level of taxation), after the “and” at the end of paragraph (a) insert –
  - “(ab) there shall be disregarded the effect of any application under section 751A; and”.

*Reduction in chargeable profits for certain activities of EEA business establishments*

5 After section 751 of ICTA insert –

**“751A Reduction in chargeable profits for certain activities of EEA business establishments**

- (1) This section applies if –
  - (a) an apportionment under section 747(3) falls to be made as regards an accounting period (“the relevant accounting period”) of a controlled foreign company,
  - (b) throughout that period the controlled foreign company has a business establishment in an EEA territory,
  - (c) throughout that period there are individuals who work for the controlled foreign company in that territory, and
  - (d) a company resident in the United Kingdom (a “UK resident company”) has a relevant interest in the controlled foreign company in that period.
- (2) The UK resident company may make an application to the Commissioners for Her Majesty’s Revenue and Customs for the chargeable profits of the controlled foreign company for the relevant accounting period to be reduced by an amount (“the specified amount”) specified in the application (including to nil).
- (3) If the Commissioners grant the application –
  - (a) those chargeable profits are treated as reduced by the specified amount, and
  - (b) the controlled foreign company’s creditable tax (if any) for that period is treated as reduced by so much of that tax as, on a just and reasonable basis, relates to the reduction in those chargeable profits,for the purpose of applying section 747(3) to (5) for determining the sum (if any) chargeable on the UK resident company under section 747(4)(a) (but for no other purpose).
- (4) The Commissioners may grant the application only if they are satisfied that the specified amount does not exceed the amount (if any) equal to so much of those chargeable profits as can reasonably be regarded as representing the net economic value which –
  - (a) arises to the appropriate body of persons (taken as a whole), and
  - (b) is created directly by qualifying work.
- (5) For the purposes of subsection (4) “net economic value” does not include any value which derives directly or indirectly from the reduction or elimination of any liability of any person to any tax or duty imposed under the law of any territory.
- (6) For the purposes of subsection (4) “the appropriate body of persons” means –
  - (a) if the controlled foreign company is not a member of a group of companies, the controlled foreign company and the persons who have an interest in it at any time in the relevant accounting period, and

- (b) if the controlled foreign company is a member of a group of companies, all the persons falling within paragraph (a) and any other person who is a member of that group of companies,
- and for the purposes of this subsection “group of companies” means a company and any other companies of which it has control.
- (7) For the purposes of subsection (4) “qualifying work” means work which—
- (a) is done in any EEA territory in which the controlled foreign company has a business establishment throughout the relevant accounting period, and
  - (b) is done in that territory by individuals working for the controlled foreign company there.
- (8) Any reference in this section to a business establishment of a controlled foreign company in an EEA territory is to be construed in accordance with paragraph 7 of Schedule 25 (but as if the reference in that paragraph to the territory in which the company is resident were to the EEA territory).
- (9) For the purposes of this section individuals are not to be regarded as working for a company in any territory unless—
- (a) they are employed by the company in the territory, or
  - (b) they are otherwise directed by the company to perform duties on its behalf in the territory.

#### **751B Section 751A: supplementary**

- (1) An application by a company under section 751A—
- (a) must be made in such form as the HMRC Commissioners may determine,
  - (b) must be accompanied by such documents (or copies of documents) in the company’s possession or power as those Commissioners may reasonably require for the purpose of determining whether to grant the application, and
  - (c) must contain such information as those Commissioners may reasonably require for that purpose.
- (2) An application by a company under section 751A—
- (a) may be made at any time on or before the filing date (within the meaning of Schedule 18 to the Finance Act 1998) for the relevant company tax return of the company, and
  - (b) may be amended or withdrawn at any time before the application is determined by those Commissioners.
- (3) If an application by a company under section 751A is granted after the company has delivered its relevant company tax return, it has 30 days beginning with the day on which the application is granted in which to amend that return to give effect to section 751A.
- (4) The time limits otherwise applicable to an amendment of a company tax return do not prevent an amendment being made under subsection (3) above.

- (5) If the HMRC Commissioners refuse an application by a company under section 751A, the company may appeal to the Special Commissioners against the refusal.
- (6) Notice of an appeal must be given in writing to the HMRC Commissioners within 30 days after the application is refused.
- (7) On an appeal—
  - (a) if the Special Commissioners are satisfied that the relevant amount is a different amount from the amount specified in the application, they must direct the HMRC Commissioners to grant the application as if the amount specified in it were that different amount,
  - (b) if the Special Commissioners are satisfied that the relevant amount is the amount specified in the application, they must direct the HMRC Commissioners to grant the application, and
  - (c) in any other case, the Special Commissioners must confirm the refusal.
- (8) For the purposes of subsection (7) “the relevant amount” means the amount (if any) equal to so much of the chargeable profits mentioned in subsection (4) of section 751A as can reasonably be regarded as representing the value mentioned in that subsection.
- (9) Part 5 of the Management Act (appeals against assessments to tax), apart from section 50, applies in relation to an appeal under this section as it applies in relation to an appeal against an assessment to tax.
- (10) In this section “relevant company tax return”, in relation to a company, means the return for the accounting period for which—
  - (a) any sum is chargeable on the company under section 747(4)(a), or
  - (b) any sum would be so chargeable but for section 751A, in respect of the chargeable profits of the controlled foreign company for the accounting period mentioned in section 751A(1).
- (11) In this section “HMRC Commissioners” means the Commissioners for Her Majesty’s Revenue and Customs.”

#### *Interpretation*

- 6 In section 756 of ICTA (interpretation and construction of Chapter 4 of Part 17), after subsection (1) insert—
  - “(1A) In this Chapter “EEA territory”, in relation to any time, means a territory which is an EEA state at that time other than the United Kingdom.
  - (1B) But a territory is not to be regarded for the purposes of subsection (1A) above as an EEA state at any time if—
    - (a) it is not a member State at that time, and
    - (b) there are no arrangements made in relation to the territory having effect by virtue of section 173 of the Finance Act 2006 (international tax enforcement arrangements) at that time.”

*Exempt activities test*

- 7 (1) Part 2 of Schedule 25 to ICTA (supplementary provision in relation to cases where apportionment under section 747(3) does not apply: exempt activities) is amended as follows.
- (2) In paragraph 5, after sub-paragraph (1) insert –
- “(1A) Except as provided in paragraph 8 below, the provisions of this Part of this Schedule apply in relation to a company which is resident in an EEA territory in the same way as they apply in relation to a company which is resident elsewhere.”
- (3) In paragraph 8, in sub-paragraph (1), after “fulfilled” insert “in relation to a company which is not resident in an EEA territory”.
- (4) At the end of that paragraph insert –
- “(5) The condition in paragraph 6(1)(b) above shall not be regarded as fulfilled in relation to a company which is resident in an EEA territory unless there are sufficient individuals working for the company in the territory who have the competence and authority to undertake all, or substantially all, of the company’s business.
- (6) For the purposes of sub-paragraph (5) above, individuals are not to be regarded as working for a company in any territory unless –
- (a) they are employed by the company in the territory, or
- (b) they are otherwise directed by the company to perform duties on its behalf in the territory.”

*Abolition of public quotation exemption*

- 8 (1) In section 748(1) of ICTA (cases where apportionment under section 747(3) does not apply), omit paragraph (c) (together with the “or” at the end of it).
- (2) In Schedule 25 to ICTA (supplementary provision in relation to cases where apportionment under section 747(3) does not apply), omit Part 3 (the public quotation condition).

*Discovery assessments*

- 9 In paragraph 44(3) of Schedule 18 to FA 1998 (discovery assessment: situation not disclosed by return or related documents etc), in the definition of “relevant claim”, insert at the end “or an application under section 751A of the Taxes Act 1988 made by or on behalf of the company which affects the company’s tax return for the period in question”.

*Commencement*

- 10 (1) The amendments made by this Schedule have effect in relation to accounting periods of controlled foreign companies beginning on or after 6th December 2006.
- (2) In the case of an accounting period (a “straddling period”) of a controlled foreign company –
- (a) beginning before 6th December 2006, and
- (b) ending on or after that date,

the amendments made by this Schedule have effect as if, for the purposes of Chapter 4 of Part 17 of ICTA, so much of the straddling period as falls before that date, and so much of the straddling period as falls on or after that date, were separate accounting periods.

- (3) The company's chargeable profits for the straddling period, and its creditable tax (if any) for that period, are to be apportioned to the two separate accounting periods on a just and reasonable basis.
- (4) Each of the following expressions –
  - “accounting period”,
  - “chargeable profits”,
  - “controlled foreign company”, and
  - “creditable tax”,

has the same meaning in this paragraph as in Chapter 4 of Part 17 of ICTA.

**DRAFT EXPLANATORY NOTE**

**CLAUSE AND SCHEDULE: CONTROLLED FOREIGN  
COMPANIES**

1. This Clause and Schedule provides for amendments to the Controlled Foreign Company (CFC) rules in Chapter IV of Part XVII and Schedule 25 of the Income and Corporation Taxes Act (ICTA) 1988, to ensure that where a UK resident company can demonstrate that a CFC has a business establishment in another EU member state (or another EEA state with which the UK has International Tax Enforcement Arrangements), and that the CFC is undertaking genuine economic activities there, then there is a statutory mechanism to disapply the CFC rules in relation to the profits of those genuine economic activities. The Clause also provides for the repeal of the public quotation exemption from the current CFC rules.
2. In particular, the amendments will create a new procedure by which UK resident companies can apply to reduce CFC profits and creditable tax apportioned to the company under CFC rules. The amendments will do this by:-
  - Providing for a UK resident company with a relevant interest in a CFC to make an application, to HMRC, by the filing date of the UK company's relevant tax return, to disregard part or all of a CFC's chargeable profits that would otherwise be apportioned for the purposes of calculating the tax charge on the UK company under the CFC rules.
  - Stipulating that such an application can be made only if the CFC has a business establishment and individuals working for the CFC in at least one EU member state (or in another EEA state with which the UK has International Tax Enforcement Arrangements).
  - Providing that an application must be made in such form as HMRC may determine, and be accompanied by such documents

and contain such information as HMRC may reasonably require for the purpose of determining whether to grant the application.

- Providing for HMRC to grant an application if they are satisfied that the part of the CFC's chargeable profits covered by the application can reasonably be regarded as representing the net economic value that is created directly by the work of individuals working for the CFC in the relevant EEA state(s) and arises to the body of persons comprising the CFC, persons with an interest in the CFC and if the CFC is a member of a group of companies, the other group members.
  - Providing for the effect of granting such an application to be that the part of the CFC's chargeable profits covered by the application and the CFC's creditable tax that relates to that part of the CFC's profits, are treated as disregarded for the purposes of calculating the CFC charge on the UK resident company.
  - Providing for a UK resident company that has already made the relevant tax return to have a period of 30 days following the grant of an application under the new rules in which to amend its return to give effect to the application.
3. The amendments will also create a new right of appeal in respect of a refusal of an application under the new rules, and will ensure other rules work properly in the light of the changes, by:
- Providing for the applicant to be able to appeal to the Special Commissioners against refusal of their application, if the applicant gives HMRC notice of an appeal in writing within 30 days after the application is refused.
  - Providing for the Special Commissioners, on appeal, to direct HMRC to grant the application in relation to the amount that the Special Commissioners are satisfied represents so much of the CFC's chargeable profits as can reasonably be regarded as representing net economic value that is created directly by the work of individuals working for the CFC in the relevant state(s) and arises to the body of persons comprising the CFC, persons with an interest in the CFC and if the CFC is a member of a group of companies the other group members.
  - Providing for some consequential detailed amendments, including to ensure that a "relevant claim" in paragraph 44 of

Schedule 18 of FA 1998 includes an application made by, or on behalf, of a UK company, so as to ensure that the discovery assessment provisions in Schedule 18 FA 1998 operate properly in relation to tax returns based on applications granted under the new rules.

4. The amendments will also introduce a new “effectively managed” condition for the purposes of applying the exempt activities test to a CFC resident in an EU member state (or in another EEA state with which the UK has International Tax Enforcement Arrangements), by:
  - Providing for such a CFC not to be regarded as effectively managed in its territory of residence unless there are sufficient individuals working for the company in the territory who have the competence and authority to undertake all, or substantially all, of the company’s business. In all other respects, the Exempt Activities exemption applies in the same way to all CFCs, whether resident inside or outside the EEA.
5. The amendments will also abolish the public quotation exemption in the CFC rules, by:
  - Providing for the repeal of s748(1)(c) ICTA 1988.
6. The amendments include a commencement provision that:
  - Provides for all the changes to have effect in relation to all or any part of an accounting period of a CFC that falls on or after 6<sup>th</sup> December 2006; and for the CFC’s chargeable profits and creditable tax to be apportioned on a just and reasonable basis for the purposes of applying the new rules where only part of a CFC’s accounting period falls on or after that date.

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**HMRC Draft Guidance**  
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# CHANGES TO CONTROLLED FOREIGN COMPANIES RULES

Draft Guidance, 6 December 2006

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## **Introduction**

1. Finance Bill 2007 will include legislation to amend the UK controlled foreign companies (CFC) rules with effect from 6 December 2006. A draft Clause and a draft Schedule are being published alongside this draft guidance.
2. This represents the Government's response to the decision of the European Court of Justice on 12 September 2006 in the case of Cadbury Schweppes (case C-196/04). As announced, the Government nonetheless remains committed to exploring further reform relating to the taxation of foreign profits.
3. The case concerned the compatibility of CFC rules with the Freedom of Establishment provided by the EU treaty, which allows companies resident in one Member State to participate unhindered, on a stable and continuing basis, in the economic life of another Member State by the pursuit of genuine economic activities through an actual establishment in that State.
4. The ECJ decided that CFC rules pursue a legitimate aim and are compatible with European law – so long as they are not applied to the profits of genuine economic activities undertaken in an actual establishment in another Member State.
5. In such circumstances CFC rules must ensure that the parent company is “... *given an opportunity to produce evidence that a CFC is actually established [in another Member State] and that its activities are genuine*”. If it can, CFC rules must not be applied to the profits of any genuine economic activities in such a business establishment in another Member State.
6. The Government is satisfied that the UK's CFC legislation is compatible with European law as interpreted by the ECJ in *Cadbury Schweppes*. But the Government recognises that there may be circumstances at the margins where it may not be entirely clear.
7. The Government has therefore decided to amend the CFC legislation in Chapter IV of Part XVII ICTA to reflect the judgment explicitly in the rules, and to provide a clear and certain procedure for companies to produce evidence to prove the extent of a CFC's genuine economic activities undertaken in a business establishment in another Member State and establish what amount (if any) of a CFC's profits should be excluded from the CFC charge.
8. This draft guidance covers the period from 6 December 2006 onwards. HMRC will be issuing further guidance on open cases for earlier periods, such as those kept open pending the ECJ judgment.
9. This draft guidance includes some cross references (prefixed “INTM”) to existing guidance in the International Manual, available at:  
  
<http://www.hmrc.gov.uk/manuals/intmanual/index.htm>
10. Unless otherwise specified, references to legislation refer to the Income and Corporation Taxes Act 1988.

## **Overview of the new rules**

11. The CFC rules provide a number of general exemptions, where none of these are available the new rules provide an additional mechanism for excluding profits from apportionment to a UK company.
12. The new rules can apply in relation to any CFC that has individuals working for it (see paragraphs 37 & 38) in a business establishment (see paragraph 33) in another EEA state (see paragraphs 30-32). If the CFC's profits would otherwise have to be apportioned, the UK owners of the CFC may apply to HMRC (see paragraph 29) for the CFC's apportionable profits to be treated as reduced by an amount ("the specified amount" – see paragraphs 34-36) representing the "net economic value" arising to the group that is created directly by the work of those individuals (see paragraphs 15-25).
13. HMRC must grant the application providing the company's application demonstrates that the specified amount satisfies the criteria set out in the new rules. Once the UK Company's application has been granted, the CFC's chargeable profits and creditable tax are treated as reduced for the purposes of determining the UK Company's CFC charge.
14. The new rules also provide a new "effectively managed" condition in paragraph 8 of Schedule 25, for the purposes of applying the Exempt Activities exemption to a CFC resident in another EEA state.

## **"Net economic value" created directly by work in an EEA state**

15. In concluding that CFC rules are an appropriate means of tackling tax avoidance within the EU, the ECJ distinguished between:
  - a) Groups genuinely exercising their freedom to establish anywhere within the EU by (re)locating genuine economic activities to another Member State (not tax avoidance even if only done so as to benefit from low tax rates); and,
  - b) Groups diverting profits from elsewhere to a CFC in another Member State, without locating in that Member State genuine economic activity creating those profits (tax avoidance).
16. The ECJ gave broad guidance on what it meant by "genuine economic activities", which concentrated more on what they were not (e.g. activities that "do not reflect economic reality" or activities that involve "practices which have no purpose other than to escape ... tax") than what they were.
17. The distinction is in essence one between the creation of profits in another Member State and the diversion of profits to another Member State from elsewhere. And the distinction within a CFC is, in essence, between profits, that arise from labour and those that arise from capital. Profits from labour tend to be created where the activities are located. Profits from capital are mobile and have no automatic link with where the activities take place and

can be (and often are) diverted elsewhere.

18. For the purposes of the new rules, therefore, in respect of profits not already exempt because one of the existing exemptions in the rules applies, the profits identified as arising from “genuine economic activities” are those created by the labour of the individuals working for the CFC in its EEA business establishment(s).
19. Profits from capital will rarely, for these purposes, constitute profits from “genuine economic activities.” Further, activities that are entirely intra-group and, of themselves add no value to the group (e.g. intra-group lending) cannot give rise to profits of “genuine economic activities”. By definition, they simply move value from one part of the group to another.
20. The new rules achieve this (on the grant of an application under the new rules) by excluding from a CFC apportionment that part of a CFC’s chargeable profits that represents the “net economic value” to the group arising from the work carried out by the CFC’s staff in the other Member State.
21. The “net economic value” is the real economic profit to the group as a whole **created directly** by the work of individuals working for the CFC in an EEA state, after allowing for the full economic costs to the group of carrying out the work.
22. The focus is on real economic value created by the work, before any tax reduction (see draft new section 751A(5)), though once the appropriate amount has been established, a CFC can benefit from any low local tax rate applicable to that amount of the CFC’s profits.
23. The value of the work must be assessed in relation to its actual content and the competence and level of independence/authority of the person carrying out the work. For example, work that has minimal content and nominally (or notionally) relates to capital or assets placed artificially in the CFC may have some intrinsic value; however this value will be limited and very marginal when compared to the value of the profits that arise from the capital or assets. In such circumstances, the profits in the CFC largely come from the diversion of profits to it, rather than those profits being created by its work. Such diversion of profits may be achieved, for example, by placing capital or other assets, such as intangible assets, in the CFC; or by arranging for capital to accumulate in a CFC, or ownership of new intellectual property to arise in a CFC. Such profits do not constitute “net economic value” to the group created directly by the work of the staff in the CFC.
24. A useful guide is that the “net economic value” should equate to what the group would be prepared to pay to a third party to undertake the work done by staff working for the CFC in the relevant state(s), over and above the full economic costs of undertaking the work.
25. Annex 1 contains examples of the application of the new rules to different scenarios.

## **Timing**

26. The new rules will apply from 6 December, the date of PBR 2006.
27. The legislation will apply in relation to CFC accounting periods starting on or after 6 December 2006, or where an accounting period straddles that date, in relation to that part of the CFC's accounting period running from 6 December 2006.
28. Applications must be made by the filing date for the UK Company's tax return to which it is relevant.<sup>1</sup> The company can only make its return on the basis of the application once the application has been granted. If a company has made its return before the application is granted, then the company will have 30 days after the grant of the application to amend its return to take account of its effect.

## **Conditions for making an application to treat a CFC's profits as reduced**

29. A UK resident company that has a "relevant interest" (as defined in s752A) in a CFC may make an application under the new rules if the following conditions are satisfied in relation to an accounting period of the CFC:
  - i) none of the exemptions provided for in s748 applies (and so the CFC's chargeable profits and creditable tax fall to be apportioned under s747(3)); and,
  - ii) throughout the period the CFC has a business establishment in, and individuals working for it in, another EEA State (see below).

## **Geographical scope and other defined terms**

### **Geographical Scope**

30. The new rules will apply to CFCs that have a business establishment within another Member State, or another European Economic Area (EEA) State with which the UK currently has relevant legal instruments that provide appropriate procedures for collaboration and exchange of information between national tax administrations. References in this draft guidance to an EEA state are to a state meeting one or other of these criteria.
31. Currently, besides other EU Member States, the UK has International Tax Enforcement Arrangements (as defined in s173 FA 2006) with two other states in the EEA, namely Iceland and Norway. This therefore defines the

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<sup>1</sup> Until the legislation is enacted, companies can submit proposed applications to HMRC, for a view on the decision that HMRC intends to take on the application once the legislation is in force.

current geographical scope of the new rules.

32. Where a CFC has business establishments in more than one state throughout the accounting period, the scope of the company's application must be limited to the company's business establishment(s) in EEA state(s) where the CFC has individuals working for it throughout the accounting period.

#### Interpretation of "business establishment"

33. The term "business establishment" means premises, as defined in paragraph 7 of Schedule 25. Existing guidance on this term is available at [INTM205030](#).

#### "Specified amount"

34. Any application made under draft new section 751A must specify the amount by which the CFC's profits should be treated as reduced, for the purposes of determining the profits to be apportioned for the relevant accounting period.
35. The amount specified should be that part of the CFC's chargeable profits that the applicant can show represents "net economic value" to the group created directly by the work of individuals working for the CFC from a business establishment in an EEA state.
36. HMRC must grant the application if they are satisfied that the whole of the amount specified in the application satisfies the criteria (draft new section 751A(4)), so amounts should only be included in the application if the applicant is submitting full evidence with the application to demonstrate the criteria are satisfied.

#### "Individuals working for the CFC"

37. Individuals working for the CFC in a state are people employed by the CFC in that state, or people working there in essentially the same role as an employee of the CFC. This could include an employee of another group company who is seconded to take up a post in the CFC in the state, or staff provided by an employment agency to work for the CFC in the state.
38. The category of individuals working for the CFC does not include either self employed individuals, or employees of a contractor contracted to provide services for or deliver services on behalf of the CFC (the value of such work arises to the contractor). Nor does it include any people working in the CFC in the state (whether or not they are formally employees of the CFC) who are, in practice, working for, or taking directions from, another group company (for example, people based in the CFC who make transactions on the instructions of the parent company in essentially the same role as an employee of the parent company).

## **Procedures and process**

### Form, content and procedure for applications under draft new s751A

39. Applications should be made in writing, to HMRC's CFC Team at the address given at the end of Annex 2. The Commissioners of HMRC will need to review the information listed in Annex 2 in order to consider whether the CFC has a business establishment and individuals working for it in a particular EEA state, and whether the amount specified in a company's application is a part of the CFC's chargeable profits that represents net economic value created directly by the work of individuals working for the CFC in the EEA state. So, the Commissioners of HMRC would expect to receive this information in all applications.

### Corporation tax instalments

40. The Corporation Tax (Instalment Payments) Regulations 1998 require large companies to make instalment payments in relation to their tax liability, including any CFC charge. Where a UK resident company intends, or has made, an application under draft new s751A that the company expects to be granted, then the company can calculate its advance instalment payments on that basis. I.e. for this purpose the company can take account of any reduction in its CFC charge that would result from their application being granted, unless and until its application has been refused.

### Right of Appeal

41. If HMRC refuse to grant an application under draft new s751A then the applicant will have a period of 30 days from the date the application is refused to give HMRC notice in writing, if the applicant wishes to appeal to the Special Commissioners (see draft new s751B(5)-(9)).

### Discovery

42. Applications will be considered on the basis that they are true and disclose all the relevant facts. In the event that a return (or amended return) is based on an application that was granted on an incorrect basis, then a discovery assessment may be made subsequently, as provided for by paragraph 41 onwards in Schedule 18 FA 1998.

## **Exempt Activities Test**

43. The new rules also introduce a distinction in the “effectively managed” condition in paragraph 8 of Schedule 25, between CFCs resident in another EEA state and other CFCs.
44. From 6 December 2006, a CFC resident in another EEA state will only be regarded as “effectively managed” there if there are sufficient staff working for the company in the territory who have the competence and authority to undertake all, or substantially all, of the company’s business. The conditions relating to CFCs resident in other states remain unchanged.
45. In all other respects, the Exempt Activities exemption applies in the same way to all CFCs, whether resident inside or outside the EEA.

## **Invitation to comment on the draft guidance**

HMRC welcomes comments on this draft guidance.

HMRC is committed to providing guidance on new legislation that is accurate, available at the right time, and as helpful as possible to staff and customers. To help us achieve this we would welcome comments and suggestions of ways that this draft guidance could be improved. If you wish your comments to remain confidential, please indicate this clearly when writing to us.

Comments should be submitted by 28 February 2007. Please send your comments to:

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Or, if possible, by email to:  
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**“Net economic value” created directly by work – Examples**

**NOTE:** All these examples assume that the CFC is eligible for any of the exemptions available in the CFC rules.

**Example 1: Locating work in another EEA state**

A UK parent company decides to set up a CFC in another EEA state to operate a call centre providing a helpline for the group’s European customers, and an internal helpline for group staff. The CFC opens an office in the other EEA state, appoints a management team and recruits local staff to man the helplines.

The services to customers and staff are part of the group’s real business. The work directly creates value for the group by contributing to the delivery of its business.

The UK company has already decided that an appropriate way to establish the “net economic value” of the work is to apply a “cost plus” method to estimate an appropriate profit for this work (see guidance on “Centrally provided services” in [INTM464055](#)). (The UK Company can use the supporting analysis and calculations as part of the evidence submitted with an application under the new rules.)

The local tax rate applicable to the profit for the work does not affect whether an application can be made under new s751A. So, even if the cost of undertaking the work in the other EEA state is the same as it would have been in the UK, and the only reason that the work has been located abroad is because the local tax rate on the profit for the work is lower than the UK tax rate, an application can still be made.

Provided that the chargeable profits simply reflect the arm’s length provision for the work undertaken by the CFC and take account of the full economic costs of undertaking the work, then, in principle, an application covering the whole of the chargeable profits of the CFC might be granted.

**Example 2: Diverting profits to a CFC using intra-group loans**

A UK parent company decides to set up a CFC in another EEA state in order to route through it funds raised centrally through borrowings made in the UK to other group members. The funds are passed to the CFC by the UK parent in the form of equity. The CFC then passes them on to other group members, on the directions of the UK parent, in the form of interest-bearing loans. The CFC rents an office and pays two employees of a group company in the same Member State to carry out the necessary administration.

In this scenario, the income from the loans is not net economic value to the group as a whole. The loans simply transfer value from one part of the group to another. Even if there were any value, it would be attributable solely to the location of capital in the CFC and not to any work done by staff of the CFC.

No application under the new rules is likely to be granted.

**Example 3: Diverting profits to a CFC by locating intellectual property in the CFC**

A UK parent company decides to set up a CFC in another EEA state and place intellectual property in the CFC so that royalties are received there.

The CFC opens an office in the other EEA state appoints a small team of staff to undertake work involved in administering the intellectual property in the CFC and receiving the royalties.

In this scenario, little of the income from the intellectual property can be considered to constitute net economic value created directly by the individuals working for the CFC in the other EEA state. This is because the real economic value arises not from the administrative work carried out by the CFC's staff but from the legal ownership of the intellectual property by the CFC.

In this case an application is only likely to be granted if the specified amount reflected just that part of the chargeable profits that reflected an arm's length net return for the administrative work undertaken in the CFC.

**Example 4: Mixed activities**

Instead of setting up a new CFC in another EEA state in order to route through it funds raised centrally through borrowings made in the UK to other group members, as in Example 2, the UK parent company decides to do this using the CFC that is operating the European call centre as described in Example 1.

As in Example 1, the appropriate way to establish the net economic value for the work of the call-centre is to establish the profit a third party would be likely

to earn for the work. For example, it may be appropriate to use a 'cost plus' method to come up with an appropriate profit for the work.

As in Example 2 however, the income from the loans is not net economic value to the group as a whole, as the loans simple transfer value from one part of the group to another.

An application under the new rules would only be granted if the amount specified in the application was limited to the appropriate profit for the work undertaken in the call centre, as in Example 1.

#### **Example 5: Treasury operations**

A UK parent company decides to set up a CFC to undertake group treasury operations in another Member State so benefiting from a low rate of tax. The CFC has an office in the other state with sufficient competent workers with the authority to borrow on the markets, manage the group's exchange risks and on-lend the borrowed funds to group members; and they do all the work themselves in the other Member State.

The net economic value to the group that is created directly by the work in the CFC arises out of the treasury management and administration that, for example, enable the group to achieve economies of scale by borrowing on better terms than individual group companies could achieve. On third party terms, this might be rewarded with a small turn (say 25 basis points) on the interest rate to reflect the value of the work to the group and UK parent. An application can be made under the new rules, to the extent that the CFC's profits comprise or include such an amount.

An application under the new rules is likely to be granted if the amount is specified on this basis.

#### **Example 6: Captive insurance, established in two other EEA states**

A UK parent decides to set up a captive insurance CFC in another EEA state. The CFC has two agency staff in a business establishment in its territory of residence to handle administration and one employee to handle claims based in a rented office in another, different, EEA state. The UK parent has arranged for the investment activity to be outsourced from the CFC to third parties.

The administration and claims activity would be rewarded at arm's length equivalent to, say, cost plus a modest mark-up in line with the provision of such services on third party terms. Such a reward would constitute the net economic value of the activity for these purposes. None of the profits from the investment activity will represent net economic value to the group from the work of the CFC, as it is not carried out by the staff of the CFC.

An application under the new rules would only be granted if it is limited to the CFC's profits representing the net economic value of the administration and claims work that the CFC's staff do in the CFC's two business establishments in other EEA states.

**Information to be included in applications under draft new s751A**

1. Name of controlled foreign company (CFC)
2. United Kingdom Company's interest in the CFC's share and loan capital (by virtue of S749B)
3. Tax district and reference number of United Kingdom interest holders where known
4. Territory of residence of the CFC and details of branches including those in the United Kingdom.
5. Place, and for new companies, date of incorporation of the CFC
6. Confirmation that no other exemption is available to the CFC under the legislation at s748.
7. The other EEA state(s) where the CFC has a business establishment and individuals working for the CFC in the state(s).
8. A copy of the most recent accounts of the CFC (or where these have not yet been drawn up, management accounts or financial projections)
9. Actual or expected equity at the beginning and end of the CFC's accounting period
10. Details of all investments held by the CFC and actual or projected income from these during the accounting period for which the application is made
11. Details of all direct or indirect transactions between group affiliates and in particular between the United Kingdom and the CFC. This will include interest on loans (direct or indirect), royalties, payments for services, purchase or sale of goods etc.
12. Full details (including address) of the CFC's business establishment(s), the number of hours, days etc. occupied on the company's business, the size of premises, whether premises are shared, in particular with group affiliates, the amount of rent paid by the CFC etc.
13. Full details of staff working for the CFC in business establishment(s) in EEA states, including details of duties, experience, position of authority and salary.
14. Details of any outsourced business activity.
15. Full details of the business activity undertaken by the CFC. Where there is more than one business activity, details of where each activity is carried out and which individuals in each territory as detailed above at 13 are involved in carrying out each business activity.
17. Details of sources of funding for the CFC's activities, in particular sources of equity and intra-group borrowing.

18. A computation of the CFC's chargeable profits and creditable tax for the relevant accounting period.

19. The computation of how the specified **amount** was arrived at and the reasons why it is considered that this amount is a part of the CFC's chargeable profits that represents the net economic value created directly by the work of individuals working for the CFC in another EEA state where the CFC has a business establishment. Include details of the work directly carried out by individuals and how the net economic value to relevant interest holders or other members of the group was arrived at.

20. Provide a computation of the amount by which the creditable tax of the CFC for the relevant accounting period should be reduced and an explanation of why you consider this to be the correct amount on a just and reasonable basis.

Applications, or potential applications under the new rules, should be sent to:

CFC Team  
International CT  
HMRC03C/01  
100 Parliament Street  
London SW1A 2BQ  
For Attn: Mary Sharp, Team Leader

Telephone 020 7147 2656

Note: In considering applications HMRC may request further information and documentation in relation to the application, though it is thought that the above information should be sufficient in most cases.