Analysis

Have changes to the UK's CFC rules created thousands of 'surprise' CFCs?

Speed read

The apparent policy intention of the amendment to the controlled foreign companies (CFCs) 'control' test, which came into effect on 1 January 2019, was to bring the UK rules into compliance with Council Directive (EU) 2016/1164, also known as the EU Anti-Tax Avoidance Directive (ATAD). However, the actual amendment seems to go much further than is required by ATAD: it appears that *many* more companies fall within the definition of a CFC than would have fallen within the pre January 2019 UK rules combined with the basic ATAD 'control' rules – a potentially unpalatable and unexpected outcome for taxpayers, advisers and compliance firms alike.

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Policy background to the measure

The government's statement at the time of the law change provided that: 'The policy objective of this measure is to make sure the UK CFC rules continue to discourage potential tax planning by large multinational groups. The changes will comply with Council Directive (EU) 2016/1164, also known as the EU Anti-Tax Avoidance Directive (ATAD).'

The statement went on:

'The current UK CFC measure of control takes into account interests held by UK resident associates or related parties of a chargeable company. The UK CFC control rules, which are set out in chapter 18, part 9A TIOPA 2010, will be amended so that any interests held by associated enterprises, wherever they are resident, are taken into account when assessing control.

'This change will make sure all associated enterprises are taken into account when assessing control. This is in line with Article 7(1)(b) of ATAD which defines control by reference to whether a taxpayer, either alone or together with its associated enterprises, controls an entity by reference to capital interests, voting rights or entitlement to profits.'

The aggregation of the interests of non-UK resident 'associated persons' (as defined by ATAD) with those of relevant UK resident companies, when assessing the control of a foreign company, was already a material widening of the UK's CFC rules. Up to that point, the relevant UK rules only took into account the interests of *UK resident* persons when assessing whether the control threshold was crossed. Before 1 January 2019, one (generally) needed over 50% of the votes or equity value of the foreign company to be in UK hands for a company to be a CFC.

The implication from government statements such as that above was that the intention was to amend the CFC rules so as to bring them into line with ATAD, with no indication that the resulting legislation would be materially wider than required by ATAD – and, as a result, *far* wider than the pre-existing UK rules.

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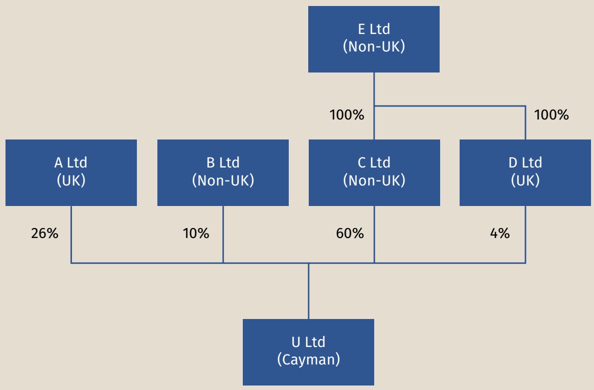
Recap of the relevant ATAD rules

Example 1: Associated enterprises of an entity



Under article 1 of ATAD, associated enterprises of an entity (such as D Ltd in example 1) would broadly include:

- entities in which D Ltd has at least a 25% interest in the capital, votes or profits;
- persons having at least a 25% interest in D Ltd, as above; and
- persons in a 25% group with D Ltd.

As such, E Ltd, C Ltd and U Ltd in example 1 would each be associated with D Ltd. Applying the ATAD CFC definition in article 7(1), U Ltd would therefore be a UK CFC because 64% of U Ltd's capital, votes and profits are held by D Ltd (the UK taxpayer) and its associated enterprises. (U Ltd would not have been a CFC under the pre 1 January 2019 UK rules as, broadly, only 30% of its equity is in the hands of UK resident companies.)

The general ATAD test for associated persons is relatively broad, in that the threshold for association is only 25%, but it can also be regarded as relatively narrow, as it only regards persons as associated where they are materially linked by capital/votes/profits. Importantly, the test does not deem, for example, all the partners in a limited partnership to be associated, or deem companies that 'act together' in relation to another company to be associated with each other or the other company.

It also seems reasonable to read the ATAD CFC rule (article 7) as requiring a member state to treat an entity as a CFC for a charge *on a relevant taxpayer* when the taxpayer *itself*, together with its associated enterprises (wherever resident) has, broadly, a direct or indirect interest of 50% or more in a non-resident company. In example 1, this would mean that the UK is required to treat U Ltd as a CFC for *D Ltd's* tax purposes, but is not required to do so for *A Ltd's* tax purposes.

The breadth of the UK implementing rules

(All statutory references are to TIOPA unless otherwise provided.)

In contrast, the post 1 January 2019 UK CFC rules would regard U Ltd in example 1 as a CFC for the tax purposes of both D Ltd and A Ltd. This is consistent with the general position under the UK's pre-existing CFC rules; i.e. where a company is a CFC, it will be regarded as one for any 'chargeable company' and not just UK companies that (together with its relevant associates) have a controlling interest. While this may not be a surprising result in the context of the UK regime, our view is that it would have been possible for HMRC to have proposed a narrower extension to our CFC rules (i.e. in line with the position outlined in the paragraph above), while still complying with the ATAD requirements.

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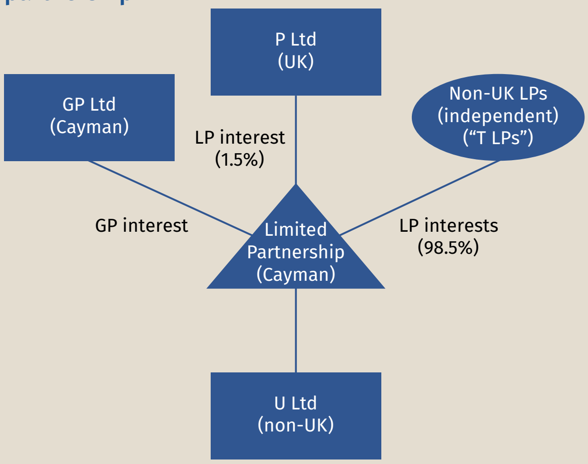
The more problematic result of the drafting is that the new rules seem to require the attribution to a UK company of the rights of a far broader group of non-UK resident persons than the 25% 'associated enterprises' required by ATAD.

Section 371RG(2) (read with s 371RG(1)) is clearly intended to encapsulate the ATAD 'associated enterprises' concept. However, s 371RG(1), when read with s 371RG(3), effectively brings in a whole raft of new relevant associated enterprises through the back door. The inclusion of the '50% investment' test in s 259ND adds an additional 'control' type test (supplementary to the existing s 371RB 'legal and economic control'), which has its own (broad) set of 'acting together' attribution rules (s 259ND(6) onwards).

The result of this appears to be that the rights and interests of non-UK resident entities, with no economic/voting links to a UK company, can be attributed to the UK company in determining whether it 'alone' has a 50% investment in a non-UK resident company for the purposes of the s 371RG(1) CFC test. We have included some illustrative examples of this point below.

In these examples (and this article more generally), we have focused on the preliminary question of whether more non-UK resident companies fall within the definition of CFC than perhaps was intended. Of course, once this CFC definition threshold is crossed, it is not certain that a CFC charge will arise under the UK rules, as further analysis would be needed to determine, for example, whether any UK company is a 'chargeable company', whether any of the 'gateways' would be relevant and whether an exemption might apply.

Example 2: Company controlled by a Cayman limited partnership



Result under pre 1 January 2019 UK rules combined with ATAD rules: not a CFC

The pre-existing definition of CFC in the UK rules was at s 371AA(3) as supplemented by Chapter 18 (see s 371AA(6)). In order to be a CFC, U Ltd in example 2 would have needed either to be controlled by a UK resident person or persons, or fall within the 40% (joint venture) rules in s 371RC or the accounting control rule in s 371RE (neither of which would be relevant here).

P Ltd (the only UK resident person having an interest in U Ltd) would not have satisfied the control test in s 371RB, even when read with the pre-existing attribution rights in s 371RD. If any of the other partners had been UK resident, their rights would have been attributed to P Ltd because of the operation of s 371RD(3)(c) and CTA 2010 s 1122(7). (All the rights of UK persons could potentially also have been aggregated pursuant to s 371RB(7) – so if more than 50% of the partners were UK residents, the control threshold would also have been met.) However, on the facts depicted above (with only 1.5% of the economics actually held by a UK resident person), U Ltd would not have been a CFC.

The position would not change by overlaying the actual ATAD CFC rules, as P Ltd has no 'associated enterprises' within the ATAD definition whose rights would be attributed to P Ltd.

Result under UK 1 January 2019 rules: a CFC

However, the combined effect of the extension to the CFC definition in s 371RG(1), the 'acting together' rules in ss 259ND(6) and (7)(d), and the partnership rule in s 259NE seems to mean that U Ltd in example 2 will now be a CFC.

Section 259ND(7)(d) appears to attribute the rights of all the limited partners in the Cayman LP (depicted as T LPs) to P Ltd in the context of determining whether P Ltd 'alone' crosses the 50% investment threshold in s 371RG(1). This is because it seems reasonable to say that the general partner of the limited partnership manages all of the limited partners' rights in relation to U Ltd (and, in an investment funds context, there may be a third party fund manager who does so). The exception from this deeming effect in s 259ND(8) relating to collective investment schemes may, on first sight, appear useful – but it only operates to prevent investors in *separate* collective investment schemes sharing the same manager/GP being deemed to act together.

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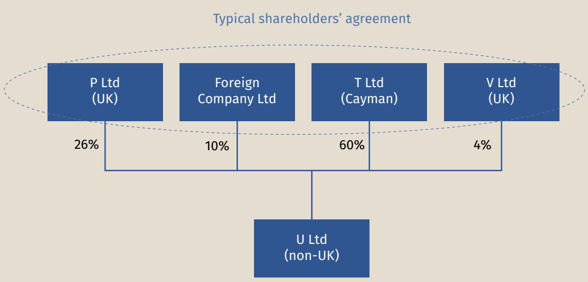
We also note that it seems that P Ltd may also be a 'chargeable company' within s 371BD(1)(b), despite only having a very small minority interest in U Ltd – far below the general 25% threshold. This is because, in determining whether the 25% profit apportionment threshold in s 371BD (chargeable companies) is reached, one needs to aggregate the amount of profit apportioned to P Ltd alone (1.5%) and the amount apportioned under step 3 to 'relevant persons who are connected or associated with' P Ltd. Each of the partners (whether UK resident or not) would be regarded as 'relevant persons' for the purposes of the apportionment of the CFC's profits in step 3 in s 371BC(1), as each holds a 'relevant interest in a CFC' (see the definition of 'interest in a company' in s 371VH and Chapter 15: 'Relevant interests in a CFC').

Section 371VF provides that CTA 2010 s 1122 applies to determine the meaning of 'connected' for the purposes of s 371BD(1)(b). CTA 2010 s 1122(6) provides that all partners in a partnership are considered to be connected to each other (except in relation to genuine acquisitions and disposals of assets of the partnership, which does not seem to assist here). It seems that the result of this is that 100% of the profits of U Ltd would be apportioned to P Ltd or to persons connected with P Ltd (i.e. all the other partners) and so P Ltd would be a chargeable company in relation to U Ltd.

Example 3: Company whose shareholders have entered into a shareholders' agreement



Result under UK 1 January 2019 rules

The application of the relatively broadly worded s 259ND(7)(c)(ii) in the context of the 50% investment test also seems to us to materially widen the scope of the attribution rules. In example 3, it seems reasonable to suppose that P Ltd and T Ltd could be regarded as 'party to an arrangement that relates to the exercise of any of T Ltd's rights in relation to U Ltd'. One can imagine this might often be the case where the parties have entered into a shareholders' agreement; for example, if the parties have agreed that a 75% threshold is required for certain shareholder resolutions that, under the general corporate law of U Ltd's jurisdiction, would typically have a 50% threshold.

Does this mean that all of T Ltd's rights in U Ltd would be attributed to P Ltd (and, in fact, to V Ltd, which only holds 4%) in determining whether P Ltd has a 50% investment in U Ltd? If so, U Ltd would be a CFC within the meaning of s 371RG(1) and P Ltd would be a chargeable company in relation to U Ltd under s 371BD.

We leave open the question of whether V Ltd would also be a chargeable company in relation to U Ltd. At first sight, at least, it seems it should not be. CTA 2010 s 1122 includes an 'acting together' test at s 1122(4) which would be relevant in determining whether the other shareholders in U Ltd are considered to be 'connected to' V Ltd for the purposes of the 25% threshold test in s 371BD. However, the 'acting together' concept in CTA 2010 s 1122 is not defined in a prescriptive manner (in contrast to s 259ND(7)) and so may well allow for a more favourable interpretation when applying the facts of this case.

> HMRC seems to agree that s 371RG gives rise to these outcomes, though it is not clear to us that this was intended as a matter of policy

Concluding remarks

We have exchanged correspondence with HMRC highlighting these points, and HMRC seems to agree that s 371RG gives rise to the outcomes described above, though it is not clear to us that this was intended as a matter of policy.

We note that CTA 2010 s 1122(4) (the 'acting together' test in s 1122) is specifically disregarded when applying the existing attribution tests in s 371RD. We would have expected s 259ND(6) to be similarly disregarded in the interpretation of the 25% and 50% investment conditions in s 371RG(3), so that the rules more closely tracked the ATAD requirements.

The application of the 'acting together' rules in s 259ND when applying the 25% investment test in the context of s 371RG(2) may also give rise to some potentially unexpected results, but, frankly, we are too exhausted from the analysis above to consider this in any real depth! ■

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