CONTROLLED FOREIGN COMPANIES - THE FINANCE ACT 1994 CHANGES

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The controlled foreign companies ("CFC") legislation, now contained in Chapter IV Part XVII Income and Corporation Taxes Act 1988, was introduced in 1984 to counteract the use by UK companies of offshore companies for the accumulation of profits in low tax jurisdictions, the scope for which had increased following the abolition of exchange control in 1979. The Finance Act 1994 contains controversial changes to this legislation and the purpose of this article is to explain the effect of those changes and the issues which arise from them.

The basic position is that the Board of Inland Revenue may direct that the CFC legislation shall apply in respect of an accounting period where the overseas tax paid on the profits of an overseas company controlled by persons resident in the United Kingdom is less than 75% (50% prior to the Finance Act 1993) of the amount which would be due if the profits were taxed in the UK. The chargeable profits and any creditable tax of the CFC are apportioned among the persons who had an interest in the CFC at any time during the period. Any UK resident company to which, either alone or together with connected or associated persons, 10% or more of the profits of the CFC are apportioned may be assessed to corporation tax in respect of the chargeable profits apportioned to it. However, such an assessment may not be raised, if:

1. the CFC carries on exempt (broadly, commercial) activities (the "exempt activities test");

2. the CFC pursues an acceptable distribution policy;

3. 35% or more of the ordinary shares in the CFC are held by the public and quoted on a recognised stock exchange;

4. the CFC has chargeable profits not exceeding £20,000; or

5. the CFC was not established to avoid UK tax (the "motive test").

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It is difficult to assess the level of success of the CFC legislation in countering tax avoidance. It is likely that any increase in UK tax yield as a result of the CFC rules has derived not from amounts assessed on UK shareholders under apportionment directions, but from tax on dividends actually received in the UK, because a substantial number of groups have avoided the levying of assessments on their UK companies by ensuring that their CFCs pursue an acceptable distribution policy.

Prior to the changes introduced by the November 1993 Budget, a non-trading CFC pursued an acceptable distribution policy if it distributed at least 90% of its "available profits", i.e., profits legally available for distribution as shown in the CFC's accounts in accordance with the law to which it was subject, less capital gains. For a trading CFC, the required distribution percentage was reduced to 50% However, because the test was based on accounting profit under local rules, it was possible to satisfy the acceptable distribution test by distributing considerably less than would have been required had the test been by reference to a percentage of profits for UK tax purposes. For example, a CFC investing in a deep discount security might under local law recognise the income on an accruals basis over the life of the security. However, for UK tax purposes, the discount would only be taxed in the final period. By distributing the (low) accounting profit in the final period, the CFC regime would be avoided. In earlier periods, the company would have had no UK chargeable profits and therefore the CFC rules would not have applied because of the test in (d) above. The Finance Act changes are designed to curtail this.

The Finance Act amendments

The major change to the CFC legislation is the amendment of the acceptable distribution test for non-trading CFCs. A non-trading CFC will not pursue an acceptable distribution policy for accounting periods ending on or after 30th November 1993, unless it distributes at least 90% of its chargeable profits (computed as if it were UK resident) less capital gains and any creditable foreign tax. For trading CFCs the test will remain distribution of 50% of accounting profits less capital gains. Chargeable profits will, in many cases, be higher than local accounting profits as they will not take into account compulsory provisions, write-downs and reserves required under the company law or accounting practice of the jurisdiction in which the CFC is situated, since such items would not be allowable deductions in the UK. A non-trading CFC may therefore be unable to pursue an acceptable distribution policy in the future as this would involve distributing profits in excess of those legally available for distribution in the relevant foreign jurisdiction.

In order, in part, to mitigate the new rules for non-trading CFCs the Finance Act relaxes the rule that dividends paid to satisfy the acceptable distribution policy for an accounting period must be made out of the profits of that period. The provisions are obscurely worded, but their effect appears to be that, if a CFC has distributed all its profits available for distribution for the current accounting period, but has not distributed 90% of chargeable profits less capital gains, for an unbroken chain of earlier periods then distributions paid in those periods (to the extent that they exceeded the required distribution standard for that period) can now be notionally added to distributions for the current period in calculating whether the new 90% test is satisfied. This will only be possible if the CFC has distributed all of its profits available for distribution for such earlier period or, if the CFC is not wholly owned by UK residents, the appropriate proportion of such profits. The chain will be broken by any period in which the acceptable distribution test is not satisfied.

For both trading and non-trading CFCs the Finance Act introduces detailed rules to clarify the identification of the amount of dividends to be treated as paid for an accounting period. If a dividend is paid for a period entirely within an accounting period, it is treated as paid for that accounting period. If it is paid for a period which straddles two or more accounting periods, the dividend is treated as if it were a number of separate dividends, one in respect of each relevant accounting period, and the actual dividend is apportioned, presumably on a time basis, to determine the amount of each separate dividend. For this purpose, "accounting period" is the period prescribed by s.751 ICTA 1988 and may not be the period for which the company actually makes up its accounts.

Retrospective effect

The Finance Act provisions have been heavily criticised. The retrospective nature of the change has been criticised in representations by, among others, the Institute of Taxation and the Law Society. An amendment which would have applied the change to accounting periods beginning (rather than ending) on or after 30th November 1993 was withdrawn when the clause was discussed in Standing Committee A after Stephen Dorrell gave an assurance that it would be open to any CFC to prepare accounts to immediately before Budget Day if it wished. He gave a further assurance that the Revenue would be prepared to accept, as a basis for assessment to tax, informal accounts prepared to such date without requiring the full statutory return that might be required in the relevant foreign jurisdiction. Although Stephen Dorrell stated that a company which prepared accounts "to 30th November 1993" could enjoy the law as it was before Budget Day for all that accounting period, it should be noted that the Finance Act states that the changes will apply to accounting periods ending "on or after 30th November 1993". Such accounts should therefore be prepared for the period ending on 29th November 1993.

Under paragraph 3 Schedule 25 ICTA 1988, the Inland Revenue already have power to use taxable profits as the basis for the acceptable distribution policy test for an accounting period of less than twelve months. An assurance was given when the legislation was introduced that paragraph 3 would only be invoked where the accounting period has been terminated early to manipulate the company's results for the purposes of the CFC legislation. In answer to concerns expressed, the Inland Revenue have indicated that splitting an accounting period bridging Budget Day into periods before and after Budget Day as a result of the Budget change would not, of itself, be regarded as manipulation for this purpose, although paragraph 3 could be invoked if there was then also manipulation which removed the profits from charge to tax. Stephen Dorrell repeated this assurance in the discussions in Standing Committee A.

Other criticisms

The changes have been criticised by professional bodies as going far beyond the changes required to counteract the exploitation of mismatches mentioned in the Budget Press Release. As mentioned above, certain CFCs will be unable to pursue an acceptable distribution policy, even though they do not store up economic profit offshore, as local company law and accounting practice will prevent them from distributing amounts equivalent to 90% of their chargeable profits. Hitherto UK companies have had the assurance that no assessment can be made on them under the CFC legislation provided that 90% of accounting profits are distributed, a test which, in most cases, was relatively straightforward to meet. Under the new regime, a UK tax computation will have to be prepared for each non-trading CFC, which will impose a considerable administrative burden on UK shareholders.

Much of the debate in the past few months has centred on the purpose of the CFC legislation and conflicting positions have been taken by multinational groups and their advisers on the one hand and the Government on the other.

The argument put forward by the former is that the purpose of the CFC legislation is to prevent the accumulation of economic profits in tax havens and the diversion of such profits from the UK. It is argued that accounting profits based on the accountancy rules of the relevant overseas jurisdiction will correspond more closely to economic profit than profit computed according to UK tax rules, which may have a distorting effect due to the fact that the CFC is not a UK resident company. The Government's argument is that the purpose of the CFC legislation is to tax overseas profits as though they were earned in the UK.

This contrast in view was highlighted in the debate in Standing Committee A. Michael Stern MP introduced amendments which would have had the result of continuing to use accounting profits as a basis for the acceptable distribution policy test, but with certain modifications to counter the particular abuses which the Government wished to counter. For example, in certain circumstances it would be necessary to show, not only that an acceptable distribution had been made in a particular accounting period, but also that at least 90% of the total available profits had been distributed for the preceding ten years. This would appear to have been intended to counteract the deep discount based arrangement referred to above but would not have been successful in so doing because profits in accounting periods in which chargeable profits did not exceed £20,000 would have been left out of account in calculating total available profits. The amendments also provided that a test of 90% of chargeable profits for the relevant period would apply, but only where in any period the available profits of a non-trading CFC amounted to less than 85% of the chargeable profits, because available profits were distorted as a result of a depreciatory transaction, or an intra-group transfer of assets, or were less than they would have been had available profits been determined in accordance with accounting principles acceptable to the Inland Revenue. This amendment would have prevented the use of provisions, reserves and deductions significantly in excess of those permissible under UK accounting procedure to reduce the CFC's accounting profits, but would, in many cases, have prevented a CFC from failing to meet the acceptable distribution test due to less substantial mismatches between taxable and accounting profits.

In response Stephen Dorrell argued that the position must be looked at from the starting point that, if a UK resident company were to hold the underlying asset directly (rather than through a CFC in which, for example, a write-down takes place), the write-down would not be allowable for UK tax; the insertion of a CFC should not be allowed to create a write-down for UK tax that would not be allowable if the underlying asset were held directly. He argued that the amendments to the CFC legislation would not force companies to pay dividends which would be illegal under local company law, but merely provided that, if they did not make distributions at this level, assessments would be levied on UK shareholders direct. In that event, the tax liability would rest on the United Kingdom parent, where it would have fallen if the CFC had never been established. Stephen Dorrell further argued that any company with a commercial purpose is exempt from the rules and its shareholders cannot be assessed to UK tax on undistributed profits even if the company does not pursue an acceptable distribution policy. With the assurance that the CFC legislation would not apply to companies engaged in a genuinely commercial activity, Mr Stern withdrew his amendments.

In making this argument, Stephen Dorrell was referring to the "exempt activities" and "motive" tests mentioned above, satisfaction of which will also exclude a company from the operation of the CFC legislation. In practice, however, not every commercial activity is covered by the exempt activities test and the motive test is subjective and few businesses are prepared to rely on its application. In consequence, the effect of the Finance Act changes appears to be that CFC directions may be made, even in cases where there is no storing up of economic profit, where a company cannot legally distribute sufficient to meet the new test. In its Finance Act representations the Institute of Taxation requested clarification as to whether the Inland Revenue were considering revising the scope of the motive test to prevent the application of the new regime to such cases where there is no tax avoidance motive.

It was suggested in the Standing Committee debate that the Government had proposed some form of consultation in order to make the new CFC legislation workable. This seems in keeping with a recent trend towards harsh legislation mitigated by concession and informal Inland Revenue practice and is not conducive to legal certainty.