



# CFC Proposed Reforms - Impact on IP Rich Groups

## Introduction

The Government's long awaited proposals on the reform of the United Kingdom's controlled foreign company ("CFC") rules were finally published in a Discussion Document on 26 January 2010. This represents the second part of the Government's reform of foreign profits, the first part of which introduced, in the Finance Act 2009, a welcome exemption from tax for foreign dividends received by UK companies.

In general, the current CFC rules are aimed at attributing, to a UK corporate shareholder, profits of a UK controlled foreign company and subjecting such profits to UK tax where the foreign company is subject to a lower level of foreign tax. The current regime is subject to a number of exemptions. Given the complexity of the current rules and issues regarding their compliance with EU law, reform of the rules has been a priority for the Government and the subject of substantial consultation.

However, the ongoing uncertainty over the outcome of the proposed CFC reform has led to a significant number of UK headed groups, such as Shire Pharmaceuticals, WPP, UBM and Henderson Group, moving their headquarters from the UK to territories without a CFC regime (such as Ireland). It is questionable whether the Government's latest proposals for the CFC rules will allay the concerns of UK headed groups, particularly those holding valuable intellectual property ("IP") interests.

On a positive note, the Government's stated aim is to seek to avoid only the artificial diversion of profits from the UK and not to tax profits genuinely earned in overseas subsidiaries (including, in this context, profits derived from companies involved in the active management of their IP). However, the perceived scope for the diversion of IP income from the UK has led to specific proposals, which could result in greater exposure to UK taxation for UK headed groups with passively held IP in foreign companies and for UK companies wishing to transfer their IP offshore.

There still remains considerable uncertainty as to the application of the proposals. Further clarity is to be provided in more detailed proposals and draft legislation to be published later this year. The final proposals are intended to be enacted in Finance Act 2011. However, we recommend that UK companies with significant IP assets within their group should review their current IP holdings and group structure now and monitor future developments in order to ensure that they are not disadvantaged by future reforms to the CFC rules. Such groups may also wish to make representations in response to the questions raised by the Discussion Document.

## Overview

In the Discussion Document, the Government maintains its commitment to making the UK an attractive place to invest and do business. The good news is that the Government has listened to responses of business and the proposals do not involve a wholesale move to impose an income basis of taxing CFC profits. The policy aim is to target only profits that are artificially diverted away from the UK rather than those genuinely earned in overseas subsidiaries. Moreover, capital gains should remain outside the scope of the CFC rules, subject to the application of anti-avoidance rules.

The new regime proposed would maintain a territorial approach to taxation. It would primarily apply on an entity basis to companies that operate in jurisdictions which do not have similar statutory rates to the UK nor a similar basis for determining tax liabilities. Like the current system, there would be certain exemptions available to avoid the application of the CFC rules.

However, in those areas where the Government perceives a significant risk of artificial diversion of profits (such as profits from the exploitation of IP through the artificial movement of IP to low tax jurisdictions), the regime provides a hybrid approach such that income streams could be separately identified and taxed differently.

## Actively Managed IP Companies

Consistent with the stated aim of not targetting profits that are genuinely earned in overseas subsidiaries, there is a welcome proposal that those companies that carry on sufficient IP management activity offshore with no (or minimal) UK involvement should be exempt from the application of the CFC rules.

### Characteristics of Active Management

The difficulty is in identifying what will constitute sufficient management activity by the offshore IP company to avoid the application of the new CFC rules. The Discussion Document suggests a characteristics based test with consideration given to whether the necessary quality and expertise is held within the overseas company to manage the IP. There is a recognition that such characteristics will depend on the type of IP, that IP companies can outsource some of their activities and that not all activities typically involved in exploiting IP need to be present to meet the active management test. These activities identified in the Document include:

- development of IP through research and development and incurring the expense of such development;
- obtaining legal protection for IP and taking the risk of any infringement;
- evaluating, analysing and developing the IP;
- negotiating and entering into IP agreements; and
- directing and monitoring advertising and marketing of IP.

The Discussion Document suggests that if the IP company does not actually have the expertise necessary to control and manage all parts of its business itself or to outsource those functions to third parties, the IP company will be viewed as requiring group support. Whilst the position under the CFC rules is unclear if the support were to come from outside the UK, the clear implication is that where there is any UK involvement in the management of the IP, full CFC exemption would not be available and different elements of income of the IP company could be attributed back to the UK.

## Passive Foreign IP Companies

The Government considers that the passive holding of IP provides particular opportunities to divert profits from the UK. The suggested approach in this case is an income based approach to the attribution of profits. The Government is seeking comments in this area, but has identified that an erosion to the UK tax base could arise where an offshore IP company has been funded by an inappropriate mix of equity and debt from the UK. A particular concern is where a UK parent has borrowed moneys itself (or uses the group's cash reserves) to provide equity funding to an overseas IP company and the IP company has used the moneys to fund its acquisition of IP or its activities. The proposal in this case would be to exempt the underlying profits of the IP company from UK tax but to instead impute a taxable interest return to the UK parent in respect of its equity investment in the IP company.

The Discussion Document indicates that further consideration is to be given to situations where royalty receipts of the overseas IP company are received from the UK. Whilst the Document is unclear, the implication would seem to be that further thought needs to be given to the interaction of these rules with the UK transfer pricing rules.

## Sale of IP Offshore

A key area of concern relates to proposals dealing with the transfer offshore of IP located in the UK. The Government considers that the current exit tax provisions and transfer pricing rules may be insufficient to prevent the loss of tax revenues where the value of the IP is difficult to measure. It is proposed that an additional tax charge (similar to a commercial earn out) should apply where the value of the IP transferred is difficult to calculate (presumably because it is in the development or pre-commercialisation stage) and the value of the IP significantly increases after its transfer from the UK. In this case, an additional tax charge would apply in limited circumstances and for a finite period.

Although the Government is seeking representations in formulating a workable and commercially equivalent solution, the concern is that such rules could give rise to additional tax charges for UK companies that wish to transfer their IP from the UK. The Government has not expressed any intention to make these rules retrospective and companies should, therefore, be looking to undertake any planning before the introduction of new legislation.

## Conclusions

We recommend that groups with significant IP interests or UK companies with IP in development consider now how best to structure their holdings and develop their IP assets so that they are prepared when future legislation is introduced in this area.

In this context, consideration should also be given to other areas which are relevant to IP holding companies. Indeed, the Discussion Document acknowledges that the interaction of the proposed CFC rules with the transfer pricing rules and the proposed Patent Box regime (which proposes, from April 2013, a reduced rate of UK corporation tax to income from patents) is an area which will need further clarification.

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