EXPLANATORY MEMORANDUM TO

THE TAXATION (INTERNATIONAL AND OTHER PROVISIONS) ACT 2010 (AMENDMENT TO SECTION 371RE) (CONTROLLED FOREIGN COMPANIES) REGULATIONS 2014

2014 No. 3237

1. This explanatory memorandum has been prepared by HM Revenue and Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations amend a test to determine whether certain foreign companies are taken to be UK controlled for the purposes of the Controlled Foreign Companies (CFC) legislation at Part 9A of The Taxation (International and Other Provisions) Act 2010 (TIOPA). The test determines UK control using definitions taken from Financial Reporting Standard 2 (FRS 2) which has been withdrawn for accounting periods starting on or after 1 January 2015 and replaced with Financial Reporting Standard 102 (FRS 102). This Instrument amends the legislation to take account of this change.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 The CFC legislation in Part 9A of TIOPA aims to prevent the diversion of UK corporate profits to low tax territories. The rules will, in certain circumstances, impose a charge (equivalent to corporation tax) on UK resident companies in respect of overseas subsidiaries which are controlled from the UK and in which the UK resident parent company has a specified interest.

4.2 There are a number of tests to determine whether a foreign company is controlled by a UK person or persons, one of which is section 371RE. This section uses FRS 2 definitions of "parent undertaking" and "subsidiary undertaking" in determining whether a foreign company is UK controlled. As FRS 2 will be withdrawn from 1 January 2015, it is necessary to replace references to FRS 2 with FRS 102 for accounting periods starting on or after 1 January 2015 in order for the control test to continue to work. FRS 102 uses broadly the same definitions for "parent" and "subsidiary" as were previously found in FRS 2, but FRS 102 uses slightly different terminology; "parent" instead of "parent undertaking" and "subsidiary" instead of "subsidiary undertaking" and so references to these terms have been amended to reflect this.

4.3 The power at section 371RF to amend these provisions is being used for the first time and enables HM Treasury, by regulation, to amend section 371RE in order to take account of the replacement of FRS 2 with any other relevant document that replaces FRS 2 (i.e. FRS102) under subsections 371RF(1)(b) and (2)(a).

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Financial Secretary to the Treasury – David Gauke – has made the following statement regarding Human Rights:

In my view the provisions of The Taxation (International and Other Provisions) Act 2010 (Amendment to Section 371RE) (Controlled Foreign Companies) Regulations 2014 are compatible with the Convention Rights.

7. Policy background

7.1 The CFC legislation is anti-avoidance legislation, the aim of which is to prevent the diversion of UK corporate profits to low tax territories. The CFC rules were reformed in 2012 in order to move towards a more territorial approach to charging overseas profits whilst still protecting the UK's corporate tax base from erosion.

7.2 The control tests in the old CFC rules attracted significant avoidance activity from tax planners. With this in mind, when the rules were reformed in 2012, a new control test was introduced which was designed to be an overarching rule whereby if the financial results of an overseas company with a UK parent are either required to be, or are in fact, consolidated into the group accounts, the overseas company will be treated as controlled from the UK for the purposes of the CFC legislation. This is the test at section 371RE and it is an important feature of the overall regime.

7.3 The control by accounting standards test works by stating that a person controls a company when the person is the company's "parent undertaking" and the company is its "subsidiary undertaking" as defined by FRS 2. As stated above this is a test of whether the subsidiary undertaking's results would be consolidated in its parent's accounts but it applies regardless of whether the parent undertaking actually prepares, or is required to prepare, consolidated accounts or not. This is to ensure that the accounting test provisions will still apply where a parent undertaking controls a subsidiary undertaking for the purposes of FRS 2, but where the parent is exempted from preparing consolidated accounts under an exemption in FRS 2 that relates, for example, to the size of the subsidiary. Replacing the definitions found in FRS 2 with those from FRS 102 of "parent" and "subsidiary" should ensure the policy objectives set out above are met.

- Consolidation

7.4 Not applicable

8. Consultation outcome

8.1 This is a minor technical change replacing definitions used in one accounting standard with another one which gives an equivalent result. There is no change in policy and therefore consultation was not required.

9. Guidance

9.1 Guidance on the operation of the control rules, of which this instrument forms part, will be included in the wider update of the International Manual concerning the CFC legislation. This Guidance is currently published on the HMRC website.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible, as the instrument simply amends primary legislation to reflect a consequential update relating to the replacement of an accounting standard.

10.2 The impact on the public sector is nil.

10.3 A Tax Information and Impact Note has not been prepared for this Instrument as it contains no substantive changes to tax policy.

11. Regulating small business

11.1 The Regulations apply to small business in the same way as larger business. It will however be larger businesses that have CFCs as part of their group structure which will fall within the CFC legislation. No special approach for small business is therefore necessary.

12. Monitoring & review

12.1 HMRC will keep the instrument under review to ensure that it meets the policy objectives set out above in section 7.

13. Contact

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