HMRC - INTM248200 - Alphabetic Index Of Terms Defined In Part 9A: Accounting Profits

Accounting profits of a CFC are used as a measure of the CFC’s profits for the purposes of the Excluded Territories exemption, the Low Profits exemption and the Low Profit Margin exemption.

TIOPA10/S371VC sets out what is meant by “accounting profits”. It explains that the CFC’s accounting profits for an accounting period are its pre-tax profits for the period subject to any adjustments required by TIOPA10/S371VD. Where the accounting profits are prepared for the accounting period in accordance with an acceptable accounting practice then the CFC’s pre-tax profits are to be determined based on the amounts disclosed in its financial statements, unless subsections (4) and (5) apply.

Subsection (4) applies subsection (5) if the CFC’s financial statements for the accounting period are not prepared in accordance with an acceptable accounting practice, or the CFC’s financial statements are not prepared within twelve months of the end of the CFC’s accounting period.

If subsection (5) applies to a CFC that normally prepares financial statements according to an acceptable accounting practice, its accounting profits must be based on amounts that would have been disclosed in financial statements if its usual practice had been adopted. In any other case the CFC’s profits are to be based on international accounting standards.

Subsection (6) defines what is meant by “acceptable accounting practice” for the section. It is any of the following:

international accounting standards;

UK generally accepted accounting practice; or

accounting practice which is generally accepted in the CFC’s territory of residence for the accounting period.

References in TIOPA10/S371VC to amounts disclosed in financial statements include amounts comprised in amounts so disclosed (TIOPA10/S371VC(7)). This covers a situation where an amount is disclosed in the financial statements of a CFC as part of a cumulative total or larger balance such as interest received by the CFC netted off against interest paid by the CFC.

The method for converting the CFC’s accounting profit (or amounts included in them) into sterling where they are stated in another currency is covered by TIOPA10/S371VC(8). They should be translated to sterling using the average rate of exchange for the accounting period calculated from daily spot rates.

Adjustments to pre-tax profits

TIOPA10/S371VD provides the adjustments required to determine a CFC’s accounting profits. The computation can be summarised as follows:

In the computation above, capital profits or losses in this context means realised or unrealised profits or losses in the accounts that arise from the disposal or revaluation of assets that would be chargeable assets of the CFC for capital gains purposes if it were UK tax resident. Accordingly a CFC’s ‘accounting profits’ do not include capital profits or losses that arise on the disposal of an asset and that would fall to be treated as a chargeable gain or capital loss if the CFC were within the charge to corporation tax, nor any accruals in respect of unrealised gains or losses on say the revaluation of an asset.

Similarly, property business profits and losses mean the profits and losses included in the CFC’s accounts for the accounting period that would be the starting point for the UK tax computation of property business profits and losses under Part 4 of CTA 2009.

Accounting profits include only income items, such as foreign exchange gains which would be treated as items of income (rather than capital) if the CFC were UK resident. Additionally it only includes income if that income is included in arriving at the pre-tax profits of the CFC. Thus income that goes straight to reserves is not included nor is income that is treated as a prepayment, although it would be included if and when it is released from reserves. Depreciation will be treated as a cost of earning income profits and allowed as a deduction in arriving at accounting profits if this is how it would be treated under the generally accepted accounting practice adopted by the CFC.

Where there is more than one settlor or beneficiary of a settlement, the income accruing to the trustees is apportioned between the CFC and the other settlors or beneficiaries on a just and reasonable basis.

A partnership for these purposes includes any entity established in a territory outside of the UK that has the characteristics of a partnership and “partner” is to be read accordingly.

Trust and partnership income is included in accounting profits to prevent avoidance schemes using the entity level exemptions to shelter interest income in either trusts or partnerships as this income will not be included in the financial statements of the CFC.

The pre-tax profits arising under TIOPA10/S371VC should also be adjusted to take account of the transfer pricing rules in Part 4 of TIOPA 2010 as if the CFC’s assumed taxable total profits were being computed unless, after making the adjustment, the difference in the profits is £50,000 or under.

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Example - transfer pricing adjustment

A CFC has accounting profits of £470,000. In addition, it has made an interest free loan to a connected party of £10m. Assuming for simplicity that an arm’s length interest rate for such lending was 5%, this would suggest that, had the arrangement been at arm’s length, the CFC would have earned an additional £500,000 of profits. This would mean that the arm’s length profits of the CFC would have been £970,000. Note that no transfer pricing adjustment is required where it would be less than the limit of £50,000 (TIOPA10/S371VD(8)).