

Foreign profits: active finance meeting 11 September 2007

External attendees

Mary Gilchrist	HSBC
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Points mentioned/views expressed

Summary

The meeting discussed the practical issues arising from the operation of sub part F and in particular the substantial compliance burden it created. Business therefore felt that this was not an appropriate route to adopt; what was required was an improvement on the present CFC regime and recognition of the way that business now operated.

Business felt as interest is interest it was necessary to look more to the commercial rationale as a distinguishing feature in any CC regime; wholly mechanical tests were distortive and should be avoided; and ideally entities subject to supervision by a regulator should be carved out. It was accepted though that this raised some definitional issues, including group complications.

One other possible way forward discussed was to identify the location (staff/premises) of the customer facing activity generating the income and recognise this as income for the relevant entity/jurisdiction but accept the commercial need to streamline functions into centres of excellence and allow recharging for accordingly but possibly with a cap on the amount of profit that could be moved cross border as a result. Any such cap would need a commercial override.

Points noted during discussion

- discussed history and approach of US subpart F active financing exemption
- Subpart F exemption applies two tests – the entity (is it active bank, financing or insurance entity) and each item of income (is it active financing or insurance income) – and imposes limitations on cross border income and profit shifting, and seeks to distinguish good and bad income
- problems experienced by US practitioners from subpart F active financing exemption, and in particular in taking view on materiality of actions by third parties, in context of requirement that entity (the

Controlled Foreign Company (CFC)) must undertake all necessary activities to derive active financing or insurance income itself in home country

- tax rules inconsistent with business practice – stringent activity thresholds in US active financing exemption can compel companies to incur extra operating costs to satisfy tax requirements because extra costs are less than additional tax that would be incurred – hence businesses are being forced to conduct activities in a manner that is inefficient and suboptimal
- subpart F active financing exemption imposes heavy compliance and due diligence burdens to determine whether entity and items of income qualify for exemption; must file a detailed annual information return for each CFC
- it is most unlikely that existing reporting requirements, regulatory or other, would provide the level of detail anticipated for the CC analysis
- current UK CFC regime does not reflect how business now works, so try to improve from current position – currently business does things that are less than optimal to ensure no problems with CFC rules
- alternative approach to have a motive test, to say why things done where
- wholly mechanical tests are distortive – commercial override (motive) is better, and fits with ECJ
- is regulated entity sufficient safeguard, although a non-regulated subsidiary of a regulated bank is different
- could have list of regulated entities (but EU implications?)
- further consideration needed to determine whether, and if so how, to address impact of bank capitalisation levels
- impossible to distinguish between good and bad interest per se – hence use motive instead
- Government concern is separation of people, capital and risk
- Several approaches available to provide sufficient safeguards. Have a tier of tests, ie use filters – could enable to move away from considering each line of income
- Could focus on nexus of capital and risk to the location of the customer, regardless of where activities are carried out. Transfer pricing policies prevent distortion.
- could focus on nexus of customer and requisite business activity.
- Businesses need to be close to customers – but prudent business practices require centralisation of some functions
- prudent business practices also require that certain functions be outsourced, hence don't want requirement that must do everything to meet test – front office should be enough
- OK to tie to 'where is the salesman', but not other things
- a quantitative test of the true location of banking activity may permit normally centralised low profit activity to be located outside the Controlled Company without causing that CC to lose its exemption
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- pragmatic approach – book income where relationship starts less X% - possibly better than anything else on table. So depends on where

banking customer relationship manager is. And regional hubs have people there

- Further consideration needed with respect to the question - -If can move credit risk to third party, why can't do within a group
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- offshore deposit takers still necessary – banks still do this for expats etc – they then upstream the money to parent, different to upstream loans which repatriate profits
- how do non UK securitisation vehicles fit
- confirmed that an exemption is intended to cover genuine third party leasing business
- financial business moving towards virtual insurance company or bank, where have things done in one country in Europe