

**EXPLANATORY MEMORANDUM TO
THE CONTROLLED FOREIGN COMPANIES (EXCLUDED BANKING
BUSINESS PROFITS) REGULATIONS 2012**

2012 No. 3041

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 provide an exclusion from a Controlled Foreign Company (CFC) charge under Part 9A of the Taxation (International and Other Provisions) Act 2010 ("TIOPA 2010").

2.2 The exclusion applies in relation to Chapter 6 of Part 9A of those CFC rules, which imposes a CFC charge in relation to finance trading companies, including banks, based on the level of capital held by those companies.

2.3 The general condition within the primary legislation refers to how much capital it would be reasonable for an independent company to hold. These regulations offer an alternative "safe harbour" for banks, based on a comparison between the capital held by the CFC and the capital held by the banking group of which the CFC is a member.

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

3.1 None

4. Legislative Context

4.1 New CFC legislation was enacted by Part 9A of TIOPA 2010. This is commonly known as CFC reform and was introduced by the 2012 Finance Act. The legislation will, in certain circumstances, impose a CFC charge in respect of overseas companies which are controlled from the UK and in which a UK resident company has a specified interest. Such overseas companies are referred to as Controlled Foreign Companies.

4.2 There are specific rules in Chapter 6 of Part 9A which refer to the level of capital held by CFCs, including banks, which are in receipt of trading finance profits. Chapter 6 includes a general test of the level of capitalisation for all such companies. However, the legislation also makes specific provision for making regulations which can apply to CFCs carrying on banking activity. This power is set out at Section 371FD Part 9A TIOPA 2010, and provides that if the conditions of such regulations are met, no CFC charge will arise in

respect of the banking profits of that CFC. The making of these regulations is the first use of this power.

4.3 These regulations include a number of conditions which, if met, will mean that no Chapter 6 CFC charge will arise in respect of the banking profits of the CFC.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 Although the new CFC regime is essentially anti-avoidance legislation which aims to prevent the diversion of UK profits to low tax territories, the reform of the CFC rules is also intended to improve the UK's international tax competitiveness, whilst retaining adequate protection of the UK tax base.

7.2 Within the new CFC regime, the purpose of Chapter 6 is to ensure that UK groups do not place excessive levels of capital in trading finance CFCs, as such activity would allow the diversion of profits from the UK. The general approach of Chapter 6, as indicated at paragraph 4 above, is to consider whether the CFC has an appropriate level of capital for its commercial activities – or, alternatively, whether it has been provided with excess capital from the UK. These regulations offer an alternative approach to that issue by providing a more mechanical approach for banks, based on a comparison of the group level of capital with the level of capital in the banking CFC. This comparison involves a relatively straightforward calculation for banking groups because they are required to calculate their levels of capital for regulatory purposes.

8. Consultation outcome

8.1 A consultation document on CFC reform was published in June 2011, and subsequent representations on CFC reform have been extensive.

8.2 As part of the consultation process HMRC and HM Treasury have engaged in substantial and detailed discussions with the banking industry, through representative bodies, working groups and discussions with individual banks.

8.3 These regulations were published in draft for the purposes of consultation with interested parties between 22nd October and 19th November 2012. There were three written responses to the draft regulations, and in

addition HMRC officials discussed the regulations with a working party of the BBA (British Banking Association).

8.4 The outcome of the consultation was that several points of clarification were identified, and the regulations have been amended where appropriate to take account of the points raised. Other issues relating to the practical application of the regulations will be dealt with in HMRC guidance.

8.5 Only one substantive change arose as a result of consultation, which was the removal of an anti-avoidance condition within Regulation 4. All representations pointed out that this condition had a very similar effect to, but was more difficult to apply than, the average capital ratio condition in Regulation 4(3). As a result of consultation, that second anti-avoidance condition has now been removed from the regulations.

8.6 The short consultation period was in line with the Tax Consultation Framework guidance for secondary legislation of this type, which is of limited scope and application. Detailed responses were received from interested parties, and the regulations have been amended to reflect the issues raised by those responses.

9. Guidance

9.1 Draft guidance will be written for the HMRC International Manual and published on the HMRC website.

9.2 There are also explanatory notes for the primary legislation.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible for those already claiming exemption under the current CFC regime. These regulations are intended to reduce the compliance burden of the new CFC regime for banking groups, by providing a mechanical calculation as an alternative to the more general consideration of capital levels required by the primary legislation.

10.2 The impact on the public sector is nil.

10.3 A Tax Information and Impact Note covering this instrument was published on 21st March 2012 alongside the draft Schedule to the Finance Act 2012 and is available on the HMRC website at <http://www.hmrc.gov.uk/thelibrary/tiins.htm> . It remains an accurate summary of the impacts that apply to this instrument.”

11. Regulating small business

11.1 The CFC legislation applies to small business. However, it is mainly large groups who have CFCs as part of their group structure. Thus, in

practice, these regulations will apply mainly to large banking groups and will not affect small business.

12. Monitoring & review

12.1 HMRC will keep these Regulations under review to ensure that they meet the policy objectives set out in section 7.

13. Contact

13.1 Mark Bryan at HMRC Tel: 020 7147 2684 or email: mark.bryan@hmrc.gsi.gov.uk can answer any queries regarding the instrument.