**Minutes: Taxation of foreign branches – sixth meeting of the Working Group**

**Meeting date:** 2 February 2011

**Location:** 1 Horse Guards Road, London

**WG members present:**

- Jane Wethered, BP
- Rob Gill, Chartis
- Mark Herbert, HSBC
- Mike Lomax, Standard Chartered
- Deirdre Nolan, BG
- Matt Goodwin, Catlin

**HMT/ HMRC:**

- Carol Johnson, HMT
- Katie MacInnes, HMT
- Andrew Page, HMRC (Chair)
- Mike Hogan, HMRC
- Bob Fisher, HMRC

## 1. Minutes of previous meeting

Agreed, subject to a typing error to be corrected.

## 2. Anti-diversion rules

HMT/HMRC said the two main concerns for business have been to achieve:

- greater certainty on the application of Condition B ('entity leg') of the motive test to existing activities; and
- proportionality in relation to Condition A ('transaction leg') - where under current proposals, one 'bad' transaction would result in the denial of the benefit of exemption for the whole of the branch profits.

Rather than relying on guidance / clearances to give more certainty in respect of Condition B, potential revisions to the draft clauses were now being considered. Similar issues were addressed in the 'CFC Interim Improvements' draft legislation and aspects of that could be drawn on.

An approach currently under consideration was broadly to provide that Condition B will be met where the company carried on the business of the permanent establishment through that PE for a period of 12 months before the commencement date for the PE exemption legislation, providing that 3 'safe harbour' conditions were met:

- gross income attributable to the PE for the relevant accounting period does not exceed by more than 10% the gross income attributable to the PE for the 12-month period to the start of the relevant accounting period. (Where the relevant AP is <12 months the comparison would be based on a time apportionment); and

- there has been no ‘major change’ change in the nature or conduct of the business of the PE within the meaning of S712 CTA 2010, over a defined period; and

- no asset attributable to the PE, or part of the business carried on by the PE in the relevant accounting period was previously owned, or carried on, by a company subject to a CFC apportionment.

Similarly Condition B would be met where the business carried on through the permanent establishment was carried on for a period of 12 months before the commencement date by a company which was not resident in the UK and which was under the control of the company of which the PE is a part. This would be dependent on similar provisos to the above, with the additional requirement that:

- the company which carried on the business for the 12-month period before the commencement date was not subject to a CFC apportionment.

HMT/HMRC acknowledged that the <10% increase in gross income might be exceeded in many cases where there was no UK tax reduction main reason. However this was just a pragmatic approach to providing a legislative ‘safe harbour’. Where the provisos were not all met, Condition B would be considered in the normal way. WG members agreed that using an objective measure was preferable to trying to develop a workable definition of ‘substantial change’ and that a gross income measure was preferable to one based on profits. However there were concerns about compliance costs of applying tests to a branch not currently affected by CFC rules.

WG asked why the gross income condition was considered necessary in addition to no ‘major change’. HMT/HMRC said the S712 CTA 10 definition required something well beyond ‘substantial change’ (as discussed at the 14 January meeting) and ‘major change’ could be seen as not much more than a backstop.

WG pointed out that insurance companies were constrained by regulation and could only do insurance business through a branch, so there should be no question of ‘changes’ to the business. HMT/HMRC thought this would probably be more appropriate to pick up in guidance rather than legislation.

On Condition A of the motive test, HMT/ HMRC were looking at the possibility of providing for a proportionate reduction to the adjusted relevant profits amount, with reference to any transactions that fail the condition. Part 3 of the ‘CFC Interim Improvements’ draft legislation provides for something similar where an ‘exempt period’ for an acquired company is terminated by a ‘relevant transaction’ and a similar wording (“so much … as is just and reasonable to regard as referable to – “) might be adopted.

WG members would consider these potential approaches and feed back any further thoughts and comments.

**3. Transitional Rule (TR)**

HMT/HMRC said work on drafting potential revisions to the TR was underway for several points raised in discussion with business.

- To meet concerns over the uncertainty of being able to enter the regime because of subsequent losses, it was proposed to provide for election to have

the effect of bringing a company's PEs into exemption for the next AP. Earlier PE losses would be subject to claw-back of relief with DTR. Subsequent losses would just be treated as within exemption, so would not add to the 'residual negative amount' (RNA).

- It was proposed to allow for an option to stream PE losses of a particular territory / territories. This would allow companies with a large RNA relating to losses in particular countries to benefit from exemption in respect of PEs in other countries. Profits from PEs in the streamed territory would not be included in the 'relevant profits amount' until the streamed RNA had been matched by profits from PEs in that territory.

- For insurance companies, S107 FA 2000 had effectively allowed losses of earlier periods to be taken into account in later years. It was proposed to ignore S107 in calculating the RNA.

- It was also intended to ensure that the TR would apply in cases where the business of a PE is transferred from a company outside exemption to one within it.

In discussion on these points HMT/HMRC explained that streaming would not have the same effect as branch-by-branch election in that UK relief for future losses would not be available. However this was complicated by a new proposal under consideration - to be discussed under 'loss relief'.

WG also raised the view that the TR should treat losses from PEs in low tax jurisdictions differently to take account of the different interaction of loss relief / DTR. This might be with reference to the 'lower level of tax test'. HMT/HMRC thought it would be difficult to justify a more generous rule for such PEs, but understood the point would be included in consultation representations.

**4. Loss relief**

HMT/HMRC said that not all businesses had welcomed the decision for an elective exemption regime over the alternative proposal of providing loss relief with a claw-back mechanism. Some businesses thought that the risk of stranded losses and related uncertainties would be too great for them to elect into exemption as it stood. They viewed the elective regime as less competitive than that offered in other countries, such as the Netherlands and suggested that there might also be an unintended incentive to split branch activity in high tax and low tax jurisdictions into different UK companies.

Some consultation respondents had made a proposal to address these concerns and this was under consideration by HMT/HMRC. It had been suggested that loss relief could be made available alongside profit exemption, broadly on the basis that relief could be given for trading losses in exempt foreign PEs in exceptional circumstances, subject to tightly defined claw-back provisions. The principal benefit to groups from this proposal would be the cash flow support that such loss relief could give in exceptional circumstances, but there might also be a balance sheet benefit from greater certainty on utilisation of tax losses.

There was some discussion over options for claw back. HMT/HMRC stated that claw back of a fixed amount per annum would provide greater protection to the Exchequer. WG members noted that the balance sheet benefit would be negated if claw-back was mechanically determined over a fixed period set by the legislation, as

that would be treated as a loan in the accounts, and would prefer claw-back as profits arose. A third option would claw-back as profits arose with the addition of a 'sunset clause' to guarantee full claw-back within, say, 4 years of a claim. There was debate over whether this would provide an accounting benefit as the rate of claw-back would still be determined by PE profits.

The proposition was that such relief would only apply where there had been an aggregate loss across all the exempt PEs of a group. There would inevitably be some complexity around the claw-back arrangements in order to protect against abuse – for example SPVs being set up to take advantage of one-way bet opportunities, as had been seen in other situations.

WG members were keen that any mechanism of this sort would be triggered by a claim rather than automatically, to allow businesses the choice of not claiming the loss relief and avoiding the additional complexity imposed. It was noted that as long as this was the case the proposal could only give upside benefits to business. This proposal would go beyond the policy intention of aligning the treatment between branches and subsidiaries and give asymmetric treatment to profits and losses. HMT/HMRC stressed that this proposal would need to be considered by ministers as part of the overall response to the consultation.

## 5. Withholding tax

This had been mentioned at the 14 January WG meeting as an area needing further consideration so that the obligations on UK residents to deduct income tax from certain payments to non-residents could not be sidestepped through the use of exempt branches.

HMT/HMRC said their current thinking was that existing arrangements should not be affected. For new arrangements there should be a mechanism to ensure that income tax is accounted for on payments to exempt PEs up to the level that would be withheld if the payment was to a non-resident company. This would take into account any limitations on UK taxation from the relevant article of a double taxation agreement in place, as if the PE was a company resident in the host state, as well as under S.757 ITTOIA (concerning the relevant EC directive).

As the payment would be received by a UK resident company there would be no need for a withholding mechanism, so it would work as a reverse charge. It was thought that the income tax paid would not be available to set off against the company's CT liability or against other IT the company was liable to pay. WG thought it was likely that PE host states would not recognise IT accounted for in this way for credit purposes. HMT/HMRC suggested this would be similar to the situation where a PE received a payment subject to withholding from a third country.

## 6. Life Insurance

HMT/HMRC reported that consideration was being given to whether the exclusion of profits from life insurance could be relaxed so that it just applied to basic life assurance and general annuity business (BLAGAB).

## 7. Next meeting

The next meeting was scheduled for 22 February and would concentrate on:

- capital allowances / intangibles / leasing

- consultation responses
- avoidance risks