Minutes: Taxation of foreign branches – fifth meeting of the Working Group

Meeting date: 14 January 2011

Location: 1 Horse Guards Road, London

WG members present:

- Jane Wethered, BP
- Rob Gill, Chartis
- Mark Herbert, HSBC
- Sarah Fahy, Sony
- Mike Lomax, Standard Chartered

By telephone:

- Deirdre Nolan, BG

HMT/ HMRC:

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

Apologies:

- Matt Goodwin, Catlin

Draft legislation – published 9 December

The core provisions of the draft legislation seemed to have been well received. The tight timing between the consultation period and publication of the draft Finance Bill clauses meant there were a number of areas needing some further attention.

The anti-diversion and transitional rules had been less well received. For the transitional rule the current design does not provide certainty on when exemption will be available. The anti diversion legislation as currently drafted does not fully achieve the intended outcome. The aim was that profits should not be exempt to the extent that they would have been subject to a CFC apportionment if they had arisen in a subsidiary. Suggestions as to how to get closer to this in the final legislation were invited.

Anti-diversion rules

A number of difficulties had come up in trying to adapt the CFC rules to branches. It had become clear it would not be feasible to do this for rules that were to be substantially reformed in FB 2012 and the approach adopted in the draft clauses relied heavily on the motive test. HMRC could give some certainty to businesses through one-year clearances for the entity leg of the test, but not for the transaction leg. WG members were concerned that it seemed disproportionate that a single transaction failing the transaction leg could result in denial of exemption for a branch.

It was suggested from WG that a simple purposive formulation might be more appropriate for a temporary anti-diversion rule. This might just state that exemption would be denied to a branch if as a subsidiary it would have been subject to a CFC apportionment. HMRC/HMT said this approach had been examined but considered to give rise to too much ambiguity, and the alternative was rewriting the whole of the CFC legislation - which would have been disproportionate given the interim nature of the legislation.

There had been some discussion with the Association of British Insurers on whether more certainty on the application of the motive test could be provided through guidance or whether this should be achieved through legislation. The proportionality of the transaction leg was also being considered. HMRC/HMT outlined two potential approaches that had been floated:

- Exclusion from exemption only for the specific transactions that fail the test. This might raise the question of whether the entity leg is needed.

- Grandfathering through legislation of existing permanent establishments (PEs) and subsidiaries becoming PEs, where there has been no substantial change in the business, including over the period of say 12 months before entry into exemption. This could be subject to clearance.

WG members were cautious about introducing a new term "substantial change" and suggested "major change" (for example, as defined at S.712 CTA 2010). HMRC/HMT thought this was too broad, although they were considering whether it could be modified for this purpose. There was some discussion on the nature of changes that should be caught to achieve the intention.

HMRC/HMT mentioned:

- that it may be possible to apply a proportional approach to changed activity as well as the transaction leg;
- that the transaction leg of the motive test was only failed where both the effect and main purpose of a transaction was to achieve a UK tax reduction.
- Where the motive test was not met then profits of the transaction would be taxed, but would still receive credit relief

However some WG members remained concerned with the potential compliance burden.

Financing expenses
A question arose from WG on a situation where external interest charges would be allocated to a branch which is carrying out low risk distribution activity and is rewarded by a sales commission and recovery of its costs without mark up. Whether or not the interest charged was simply cancelled

out seemed to be both a matter of presentation (to be discussed with the tax office/CRM) and a transfer pricing question (depending on whether a distributor would bear financing costs at arm's length).

Specific areas for further work:

Interaction with Debt Cap rules

Questions had arisen on the flexibility for groups to allocate the total disallowed amount against specific financing expenses and to allocate exempt financing income. HMRC/HMT said the current intention was to amend to:

- exclude from financing expenses and income for debt cap purposes any amounts brought into the S18A computation as attributable to an exempt PE;

- ensure that no amount included in the S18A computation can be specified as a disallowed finance expense amount.

Leasing

In the absence of further specific rules there could be a strong incentive for lessors to transfer leases to exempt branches around the time income exceeds available capital allowances. The intention was to address this by excluding from the S18A computation any profits and losses from leases on which profits and losses have already arisen and which have not been wholly included within a relevant profits or relevant losses amount.

Amounts excluded in this way would be subject to credit relief rules. It was recognised that this would give some computational complexity, but HMT/HMRC regarded this as manageable and proportionate given the tax avoidance risks.

Capital Allowances (CAs)

HMRC/HMT and WG members were still considering the issues around CAs and it was proposed that these should be discussed at the (7th) WG meeting on 22 February along with the closely connected issues on leasing.

Chargeable Gains (CG)

One area that might require amendment is where a UK gain arises in a different period from that in which the foreign gain was taxed. This might require an amendment of the "relevant accounting period" definition. Although there was some further work to be done on CG there was general WG consensus that the approach of 'letting the treaty take the strain' was appropriate. No specific rules were envisaged to cover issues such as mixed use or whether any alienation of a business asset had taken place. For example treaty principles were considered capable of properly limiting any advantage in transferring an asset pregnant with gain to a foreign branch.

Transitional Rule

There might be a need to tweak the draft legislation to clarify the treatment of profits / losses in the accounting period in which an election is made. There was also a question as to whether a company affected by the rule should be treated as within exemption but subject to claw back of loss relief or outside exemption. The former should allow the residual negative amount to be eroded more quickly, without being affected by subsequent losses. HMRC/HMT were also considering the suggestion that losses could be streamed in respect of particular territories so that, for example, large losses in a particular location would not defer exemption in respect of other branches. However it might be expected that in most cases the pooling of profits (with DTR) in the current draft rules would allow companies to benefit more quickly from exemption overall.

Other open points on draft legislation:
The following points were discussed and are being looked at further by HMRC:

<u>S18A</u>

- Issues arising where a treaty is within the 'full treaty' definition but does not have the OECD standard requirement in Article 7 for both territories to attribute profits to a PE.
- The need to ensure that the foreign PE amount retains the character of the profits or losses that went into it, so that each head of charge is appropriately adjusted.
- There was some consensus that S18A(9) was difficult to read without the help of an example. The intention was to ensure that chargeable gains/ losses subject to CT did not exceed the company's actual gain or loss when the amount attributable to a period of use in an exempt PE was taken into account.

<u>S18B</u>

- Subsection (2) allows a section 18A election to be revoked at any time up to the filing date for the return. This could create the risk of a "one-way-bet" e.g. involving equal and opposite financial instruments to generate profits or losses. The election in the company that records a loss could then be revoked. The revocation date should therefore be moved to the start of the accounting period.
- Some WG members asked if the right to revoke the election was really necessary. A properly advised company would only make the election when it was sure of the benefit. However HMRC/HMT thought some right of revocation should be retained if possible.
- Subsection (9) needed to be amended so that it deals with negative PE amounts, which should increase the residual negative amount.

<u>S43 TIOPA 2010</u>

- HMRC/HMT asked if the requirement at S43(7) of the draft - to assume such free assets as the PE would have in the circumstances described in subsection (2) - necessarily implied the application of the capital allocation approach required by subsection (4). Although it followed via subsection (3) it might perhaps be made more explicit.

Commencement
WG asked about current thinking on the commencement date. HMRC/HMT did not think this could be before Royal Assent for the Finance Bill. The intention had been to give reassurance that accounting periods (APs) starting in 2012 could be within exemption. WG members suggested it would be necessary to be able to properly consider the effect of the final legislation before opting any company in for an AP starting on a date in 2011, particularly if the provision on revocation was tightened. It was recognised that many groups did not have calendar year APs and that having a commencement date earlier than Royal Assent might not allow enough time for decisions to be properly considered for these groups. HMRC/HMT did not think it necessary to include any specific provisions to prevent a change of accounting date to gain earlier benefit from exemption, and WG noted that changing accounting dates for this purpose was likely to be impractical.

Withholding tax
Another issue needing further consideration was the extent to which the obligations on a UK resident paying interest to an overseas subsidiary of a UK company should be replicated where interest was payable to an exempt foreign branch. There were particular considerations in the case of banks. WG members thought that in general the same principles should apply, but there were practical difficulties in that the payer would not be aware of the status of the recipient. Furthermore, the CFC rules could apply to take a receiving branch out of exemption in a particular accounting period.

Next meetings
Further meetings are scheduled for 2 and 22 February. It was agreed that the first should concentrate on any updates on potential amendments to the current proposals, subject to specific issues from WG. The focus of the second would be CAs, avoidance and any other issues outstanding.