Part IIIB: Foreign branch taxation

1 Introduction

1.1 At the Budget, the Government announced its intention to make company taxation more territorial and to bring forward proposals in Finance Bill 2011 to reform the taxation of foreign branches in line with this. Broadly, a foreign branch is established by a UK company if it carries on part of its trade in another jurisdiction without establishing a separate trading subsidiary company there.

1.2 Following the Budget announcement, the Government published a discussion document in July setting out a number of options as to how reform of foreign branch taxation could best be achieved.[1]

Principles for reform

1.3 In pursuing this reform the Government will apply the principles set out in the Corporate Tax Road Map.

1.4 A key objective of reform to foreign branch taxation is to improve the overall competitiveness of the UK tax system.

1.5 In contrast to the current rules for foreign branch taxation, dividend income from the foreign subsidiaries of a UK parent company is generally exempt from UK corporation tax (CT), following a change to the rules in 2009. As a result of this, exempting foreign branch profits will ensure greater alignment between the taxation of foreign branches and foreign subsidiaries.

Consultation to date

1.6 The consultation is being conducted in line with the principles outlined in the document *Tax policy making: a new approach* published alongside the Budget. This document sets out three stages for policy development:

- Stage 1 – set out objectives and identify options;
- Stage 2 – determine the best option and develop a framework for implementation, including detailed policy design; and
- Stage 3 – draft legislation to effect the proposed change

1.7 The next chapter includes the Government's detailed proposals for reforming foreign branch taxation, which completes stage 2 of the process. The Government will shortly publish draft legislation, which is stage 3 of the process. The purpose of the next stage of consultation is to seek views on the draft legislation and the implementation of the proposals.

[1] *Foreign branch taxation: a discussion document,* HM Treasury, 27 July 2010.
http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm
More precisely, the reform is to the taxation of foreign permanent establishments.

Next steps

1.8 The Government welcomes responses by 9 February 2011 in order to allow drafting changes to be made in advance of Finance Bill 2011. Details on how to respond are provided at the end of the next chapter. Draft legislation and an Explanatory Note will shortly be published.

1.9 The Government will also shortly publish draft guidance on the rules preventing artificial diversion of profits to exempt branches, together with some more detailed questions on the draft legislation.[2]

1.10 Details of the Government's wider engagement strategy for corporate tax reform, including consultation and working groups, are given in Chapter 5 of the Corporate Tax Road Map. The existing foreign branch taxation working group will continue to meet, to support the Government in developing final legislation.

[2] The draft guidance and questions will be available at http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm

2 Reforms to foreign branch taxation

2.1 This chapter sets out the main issues considered in the previous discussion document, a summary of the responses of interested parties to the document and the proposals which the Government is taking forward. At the end of the chapter there are some questions for interested parties on the proposals.

Issues considered in the discussion document

2.2 Under the present rules, UK companies are subject to CT on the profits of their foreign branches, with credit given for foreign tax paid on the same profits, in order to relieve double taxation. In cases where the foreign tax paid is less than the UK tax, then the company must pay a "top up" of UK tax, while under an exemption regime there would be no such tax. In addition, exempting foreign branch profits will ensure greater alignment between the taxation of foreign branches and foreign subsidiaries, following the introduction in 2009 of an exemption for dividend income from foreign subsidiaries.

2.3 The discussion document presented a number of options regarding the possible scope of a foreign branch exemption regime. Issues included:

- the basis for foreign branch exemption
- exemption for chargeable gains
- whether exemption should apply to air transport and shipping
- how the new regime should prevent artificial diversion of profits
- whether the scope of exemption should extend to countries with which the UK does not have a double taxation agreement

The discussion document also included several options to relieve losses incurred in foreign branches. Issues included:

- maintaining loss relief to various extents, either coupled with a profits exemption or as part of an elective regime
- mechanisms for the reclaim of any relief previously provided ("claw-back") in respect of branch losses once the branch moves into profit
- a transitional rule for losses carried forward that are derived from branch business, the subsequent profits of which become exempt from UK tax as a result of any change to the regime for taxing foreign branches of UK companies

Responses of interested parties to the discussion document

2.4 Responses to the discussion document focused on large businesses, and consultation to date has indicated that the reforms will not have a significant impact on small businesses.

2.5 A number of respondents regarded an elective exemption regime as the best approach to ensuring a competitive regime for all sectors. In particular, businesses currently making use of loss relief for foreign branch activity as part of their business model were generally in favour of an elective regime, and many were concerned that the alternative option of providing loss relief with claw-back alongside exemption could be complex. However, a number of other respondents preferred the latter option, as it would provide some extra benefit to generally profitable companies making unexpected losses.

2.6 On the issue of how to define the basis of exemption there were mixed views, with a slight overall preference among respondents for a treaty basis. A further option for defining the basis of exemption was put forward at the working group, which was to define those profits subject to CT – in effect, those arising from the UK 'permanent establishment' of the company – rather than those exempt from CT. However, discussions with businesses indicated that the unfamiliarity of this approach could make compliance more difficult for some businesses.

2.7 There was a strong message from many respondents that extending exemption to all countries and territories is important for the competitiveness of the new regime.

2.8 Exempting chargeable gains was generally felt to be less important for competitiveness than, for example, extending exemption to all countries and territories, but useful for businesses nonetheless. Respondents noted that exempting gains would achieve better alignment between taxation of branches and subsidiaries.

2.9 No concerns were raised over the Government's proposal not to extend exemption where the taxing rights of a branch territory are restricted by other treaty provisions such as a shipping, inland waterways transport and air transport article of a tax treaty.

2.10 Regarding the transitional rule, a number of respondents had concerns that the rule could introduce complexity into the regime. There was a mixture of views as to which of the options for a transitional rule provided in the discussion document was preferable.

The Government's proposals for reforming foreign branch taxation

2.11 The following section outlines the Government's proposals for reform. Further details will be provided in the Explanatory Note and draft legislation to be published shortly.

2.12 The Government proposes an **opt-in exemption regime** for foreign branch taxation. Companies within the exemption regime will not receive relief in respect of the foreign branch losses. This has a number of advantages over the alternative of exempting profits for all companies while giving some loss relief, including:

- consistency with the principle of providing loss relief only where profits are also taxed, as is the case for foreign subsidiaries;
- avoiding the need to introduce artificial "claw-back" of loss relief within an exemption regime; and
- continuity of treatment for companies choosing to remain in the current regime.

2.13 The election will be irrevocable, so that any company may elect for all its branches to be permanently exempt from UK CT. This means that no company will make a transition from branch exemption to worldwide taxation, making special rules to deal with such a transition unnecessary.

2.14 The opt-in exemption regime will apply to foreign branch trading profits and to investment income that is effectively connected to the branch.

2.15 Exempt profits will be defined by reference to individual treaties. For branches in territories where there is no treaty, the measure of exempt profits will be determined by the OECD model treaty.

2.16 The Government will extend the opt-in exemption regime for large and medium companies to **all countries and territories**, including those with which the UK has no tax treaty. The Government notes that this goes beyond the foreign branch exemption regimes of many other countries.

2.17 As indicated in the July discussion document, the Government will not extend exemption to non-treaty branches of small companies, because of the risk of loss of tax through diversion of personal income. This is in line with the treatment of foreign subsidiaries.

2.18 The Government proposes to extend exemption to **chargeable gains** by reference to the relevant treaty, or to the model treaty. That part of the gain which is (or was) taxable in accordance with the treaty will be exempt from CT. For example, if the host state taxes a gain arising on immovable property in the branch territory, that gain would be fully exempt from CT.

2.19 There will be a **transitional rule** as part of the exemption regime, because exemption would otherwise prevent the claw-back of relief already given for foreign branch losses, potentially resulting in significant costs for the Exchequer. When a company opts into exemption, the company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding 6 years have been matched by profits, except in the case of very large losses. Further details are provided in the Annex.

2.20 As a consequence of the EU Solvency II directive, the Government is working with industry to develop a new basis of taxation for **life insurance** companies from 2013 onwards. The Government will consult closely with industry on potential reform of foreign branch taxation in respect of life insurance companies and on when any such reform would be implemented.

Interaction with CFC regime and commencement

2.21 The Government will introduce the new regime for foreign branch taxation in Finance Bill 2011, and plans to make the new regime available for accounting periods commencing on or after a specified date in 2011.

2.22 Rules are needed to protect the UK tax base against the **artificial diversion of profits**. The Government proposes that, where a company opts in to the branch exemption regime, each of its branches will potentially be subject to anti-diversion rules. If a branch does not comply with the anti-diversion rule in any year, then the profits arising from that branch in the year will be subject to CT, with credit for foreign tax given in the usual way.

2.23 There is a question as to what form the anti-diversion rules should take. The Government will provide the same protection against artificial diversion of profits as applies to foreign subsidiaries. However, extending the current CFC regime to branches raises some significant challenges:

- the whole of the CFC regime will be reformed in 2012, so 2011 legislation applying existing rules to foreign branches will be repealed and replaced a year later; and
- because the current CFC rules apply on an entity basis, they do not form a natural test of branch income.

2.24 The full reforms to the CFC regime in 2012 will include changes to update protection in respect of foreign branches. Before then, for the first year of the new exemption regime there will be a CFC-type regime introduced for foreign branches with more limited carve-outs. This will reduce the length and complexity of temporary anti-diversion provisions in Finance Bill 2011, while allowing businesses the opportunity to benefit from branch exemption. Further details are provided in Annex A.

Questions for interested parties

How well does the draft legislation (to be published shortly on the HM Treasury website) put into effect the policy proposals set out above?

How could the legislation be improved?

What else should it include?

Do you agree that new regime should be available for accounting periods commencing on or after a specified date in 2011?

How to respond

2.25 Responses and enquiries should be sent to:

Carol Johnson
Room 2/E1
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Alternatively, please email: carol.johnson@hmtreasury.gsi.gov.uk

Further information may be found at:

http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm

Telephone enquiries: 0207 270 6032

Confidentiality disclosure

2.26 Information provided in response to this document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

2.27 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarding as binding on HM Treasury or HM Revenue & Customs (HMRC).

2.28 HM Treasury and HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Technical note on reforms to foreign branch taxation

A.1 In broad terms, the Government proposes to provide companies with the option of exemption from CT for foreign branch profits, irrespective of the branch territory, subject to the same protection against artificial diversion of profits as applies to foreign subsidiaries.

Opt-in mechanism

A.2 Every UK-resident company will be able to make an irrevocable election for all of its foreign branches to be exempt from CT. The profit or loss arising in each foreign branch will then be deducted from the UK company's worldwide profit calculation to give a net amount that is subject to CT.

A.3 Branch exemption will prevent relief being given for branch losses, and so the regime will be optional. The election will cover only the company making the election, but will apply to all present and future branches of that company.

Transitional rule

A.4 A transitional rule will be applied when a company opts in to the branch exemption regime. Under this rule a company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding 6 years have been matched by profits (except in the case of very large losses, as explained below in paragraph A.7). This will help ensure the reforms are affordable, by preserving the Exchequer's ability to mitigate the cost of loss relief already given in respect of foreign branches. At the same time, the 6 year time limit will help manage compliance burdens.

A.5 When a loss arises in a foreign branch it is currently relievable against the overall profits of the company in the UK. At the same time the overseas territory usually allows the losses to be carried forward to be set against future profits to give relief from local taxation. This gives a lesser amount of foreign tax to be relieved against UK tax on the branch profits and therefore mitigates the cost to the Exchequer of the UK loss relief.

A.6 The transitional rule will defer entry into exemption to allow this recovery of value following loss relief to continue. It will look back to see what losses have arisen in foreign branches and whether those losses, taken together in aggregate, have subsequently been matched by foreign branch profits. If not, the commencement of exemption for the company opting in will be delayed until they are.

A.7 The rule will be based on a calculation of losses over this period that would have been carried forward by branches if they had been separate entities (the notional "carry forward") and a corresponding amount of profit will be taxed (with double taxation relief available) before exemption commences. In general the transitional rule will look back for 6 years from the date at which the election into exemption is made. However, there will be an exception where very large branch losses have been made in the six years preceding the introduction of the new regime. In those circumstances, the large loss must be carried forward until the aggregate of all the losses made in the foreign branches has been matched by profits made in the foreign branches. "Very large" will mean losses over a specified amount, say £50 million.

A treaty-based approach

A.8 The Government will provide exemption for profits defined by reference to individual treaties. For branches in territories where there is no treaty, the measure of exempt profits will be determined by the OECD model treaty.

A.9 Where a UK resident company has a foreign branch in a treaty jurisdiction, the treaty requires both states to compute the profits that are attributable to the permanent establishment. The UK computation provides the measure of CT which limits the company's entitlement to credit against CT in respect of the foreign tax. With certain exceptions, branch exemption will proceed in the same way, with the existing UK measure of branch profits representing the exempt amount. Where this measure produces a loss, it will be cancelled in the calculation of the company's profits that are subject to tax.

A.10 This approach ensures that, where it applies, exemption will be a complete replacement for credit relief as a means of relieving double taxation. The approach leaves the initial computation of worldwide profits unchanged, but modifies it by exclusion of the branch profit or loss.

Chargeable gains

A.11 A company within branch exemption should prepare a computation of all its chargeable gains and losses in the same way as it currently does. It will then deduct from the total any gain, or part of a gain, attributable to an exempt branch and add back any loss, or part of a loss, so attributable.

A.12 The attribution of chargeable gains and losses to exempt branches will follow the principles of the relevant tax treaty, so that relief from double taxation will be achieved as far as possible by exemption instead of credit relief. Where no full treaty is in force the attribution will follow the principles of the updated model treaty released by the OECD in July 2010.[1] The detail of the computation will follow UK rules.

A.13 Some specific chargeable gains rules, for example on transfers of assets to a non-resident company will need to be adapted. The Government will need to consider whether anti-avoidance rules are needed in respect of chargeable gains specifically, for example in relation to transfers of assets within a group.

Investment income

A.14 Investment income will be included in the exempt profits of a branch to the extent it is 'effectively connected' to the branch. The term 'effectively connected' is used in several model treaty articles.[2] Such sources of income must be 'genuinely connected' to the business i.e. the economic ownership of the assets that generate the income should lie with the branch rather than some other part of the enterprise.

A.15 Branch exemption will not be available to a company whose business is wholly or mainly investment business, as defined in section 1218 Corporation Tax Act 2009 (CTA 2009).

A.16 Some aspects of defining trade profits, such as capital attribution, raise particular issues. These are set out below.

[1] *Model Tax Convention on Income and Capital*, OECD, 22 July 2010. http://www.oecd.org/document/37/0,3343,en_2649_33747_1913957_1_1_1_1,00.html

[2] See 10(4) (Dividends), 11(4) (Interest), 12(3) (Royalties) and 21(2) (Other Income). The term 'effectively connected' is also relevant in relation to moveable property in articles 13 and 22 (Capital Gains and Capital).

Capital attribution

A.17 The treaty approach is based on the separate entity principle. This attributes to a branch the profits that it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing independently. The principle provides for the attribution of such equity and loan capital to the branch as it would reasonably be expected to have if it were a separate entity.

A.18 The issue was discussed separately in the discussion document as it is of particular significance in the banking and insurance sectors. For banks it is fundamental to the amount of interest expense to be deducted in calculating branch profits and for insurance companies to the attribution of "free assets".

A.19 To provide clarity and limit risk regarding over-attribution to exempt branches it is intended to make some principles explicit, including:

- Attribution should follow an allocation of the company's free capital / free assets based on a factual and functional analysis that takes into account the whole of the company's business. This will include consideration of the funding structure that would be reasonably expected to support the company's business other than those parts of it carried on through its foreign branches.
- Where a tax treaty is in place the principle above will be subject to the provisions of the Business Profits article of that treaty.
- If the amounts of free capital or free assets allotted to a branch are in excess of the arm's length range, the amount attributed to the branch will be adjusted to an amount within the limits set by the arm's length range.

Minimisation of branch profits

A.20 Companies will be expected to minimise the profits that are subject to tax in the branch jurisdiction, for example by taking full advantage of the extent to which the treaty limits that territory's taxing rights.

A.21 Companies should also make claims and elections that are available to reduce the corporation tax measure of profits arising in the branch. For example, capital allowances should be claimed.

Exceptions

Air and shipping

A.22 Foreign branch exemption will not extend to international air transport and shipping as these activities are generally not taxed by the foreign jurisdiction. Article 8 of the OECD model treaty restricts taxing rights over profits made in the foreign territory to the state where the effective management of the enterprise is situated, i.e. the state of residence.

No restriction for non-treaty jurisdictions

A.23 Exemption will still apply in the case of branches in states with which the UK has no double taxation agreement, or none with a non-discrimination article. Profits of such branches will be calculated by applying the updated OECD model treaty. The risk to the Exchequer from the artificial diversion of profits to such states which charge little or no taxation on branch profits will be countered by applying CFC concepts to particular income of a company that is attributed to the branch. Adaptation of the CFC rules is discussed below.

Protection against artificial profit diversion

A.24 Profits should not be exempt to the extent that they would have been subject to a CFC apportionment, had they arisen in a foreign subsidiary. This principle ensures that branch exemption does not undermine the protection of the CT base afforded by the CFC regime.

A.25 The current CFC regime is entity-based: generally it either exempts a company or applies a tax charge to the whole of its profits. In the branch context it is necessary instead to apply CFC concepts to particular income of a company that is attributed to the branch. This means that legislation to apply CFC concepts to branch income will be relatively long and detailed.

A.26 The CFC regime will be reformed in 2012 and so 2011 legislation applying existing CFC rules to foreign branches will be repealed and replaced a year later. To reduce the length and complexity of these temporary anti-diversion provisions in Finance Bill 2011, the Government proposes to include a CFC-type regime for foreign branches, with a motive test, a lower level of taxation test and a de minimis level of profit as the available carve-outs. The temporary anti-diversion provisions in Finance Bill 2011 will extend to small companies.

A.27 The Government continues to consult on proposals for the comprehensive reform of the CFC regime in Finance Bill 2012. These reformed rules will be written so as to apply equally to both foreign subsidiaries and exempt foreign branches.

A.28 It is anticipated that further specific rules will be needed to prevent abuse of branch exemption. Particular provisions are envisaged in respect of leasing activities as well as a more general rule regarding transfers between connected companies.

Commencement

A.29 The Government intends to give effect to the legislation for accounting periods commencing on or after a specified date in 2011. Once the legislation takes effect, a company will be entitled to opt into the exemption rules, which will apply from the beginning of the next accounting period, subject to the transitional rule described above.