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

Meeting date: 22 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
- Sarah Fahy, Sony

HMT/ HMRC:

- Carol Johnson, HMT(Chair)
- Katie MacInnes, HMT
- Caroline Newell, HMRC
- Mike Hogan, HMRC
- Bob Fisher, HMRC

Apologies:

- Andrew Page, HMRC

1. Minutes of previous meeting

The minutes were agreed subject to minor additions.

2. Consultation responses

HMT/HMRC went through some of the main themes from responses. The opt-in basis for exemption had generally been welcomed as had the application to all countries and the inclusion of chargeable gains. The main criticisms were around the transitional and anti-diversion rules. Although respondents could see the need for these rules, it was felt that the current design was a disincentive to opting in to exemption. It was agreed that the changes to the transitional and anti-diversion rules discussed at the 2 February meeting sufficiently addressed the issues raised on these aspects during the consultation. As discussed at the 2 February meeting, some respondents had been disappointed that UK loss relief with claw-back had not been provided for.

Several respondents had expressed the view that the restriction on exemption for the branches of small companies to full-treaty territories should be relaxed. However HMT/HMRC still believed that this restriction was needed to limit risks in relation to personal income, in line with the treatment of foreign subsidiaries. The number of treaties that were not full treaties was relatively small.

It had also been suggested that chargeable gains of close companies should benefit from exemption, subject to an adaptation of s13 TCGA 92. However HMT/HMRC still believed that this approach was not practicable. The impact of the exclusion could be reviewed at a later date.

It had been suggested that the exclusion in relation to investment companies might infringe state aid rules and a small number of respondents had requested that the exclusion be removed. HMT/HMRC were satisfied that there was no state aid infringement, but had looked again at the need for this exclusion. The anti-diversion rule was expected to apply in most investment company situations and the exclusion provided a 'backstop' for this. There were not thought to be many situations where the activity of such companies overseas would be defined as a permanent establishment, although the possibility was not ruled out.

On the question of whether an election for exemption should be revocable on a change of company ownership HMT/HMRC saw a number of issues that would need to be legislated for to manage an exit from exemption. Their current view was that the additional complexity was not justified, and the current regime offered enough flexibility where this is a change of ownership. WG members agreed, making the points that the assets of a company could be acquired rather than the company, or the assets of a branch could be transferred. Also, the benefit or otherwise of exemption was thought to depend mainly on the type of business, so the number of situations where revocation would be desirable following a change of ownership were probably limited. The point was made that structuring around a company's election would be more difficult in a regulated business. However, the WG felt that the approach taken by HMT/HMRC in this area was satisfactory.

The specification of the 2010 OECD Model Tax Convention in the draft legislation without an automatic update to subsequent versions had been questioned. HMT/HMRC felt that automatically following updates would increase administrative burdens for business and HMRC. It was agreed it might be better to provide for powers to substitute a later version if necessary, with amendment to the primary legislation, in line with the approach taken with the transfer pricing legislation.

There had been comments on the need for a rule in relation to the minimisation of profits. HMT/HMRC were developing a rule similar to the suggestion in the documents released in December.

Some respondents had questioned whether any OECD authorised approach for capital attribution should be acceptable. HMT/HMRC believed it was appropriate to specify the approach for UK companies, as had been done in the draft legislation, subject to the provisions of treaties in place. WG members had no disagreement with this.

A further point on the transitional rule had been that 'small' losses should be disregarded. HMT/HMRC reported that there had been some discussion on this but achieving substantial reductions in compliance burdens would carry an unacceptable Exchequer cost.

HMT/HMRC mentioned there had been a number of other suggestions to improve the draft legislation, which were being considered. It might not be possible to publish proposed amendments / additions to the December draft at the end of February as anticipated, but HMT/HMRC were aiming to share them with business when they were available.

3. Capital allowances

HMRC outlined three main Capital Allowance (CA) policy objectives in relation to the protection of the Exchequer following Foreign Branch Exemption:

- To ensure that profits of a UK company which remain chargeable to UK tax are not reduced by any CAs in respect of any activities of the company's exempt foreign branches.

- Where, after an election, part of the company's activity and / or part or all of the use of an asset switches to the exempt branch, to ensure that the same consequences arise in relation to this transfer as arise if an asset ceases to be used for a particular CA qualifying activity.

- HMRC recognised the desirability of avoiding market valuations on the transition to exemption where possible. It was not proposed to recoup any excess past CAs where the only impact has been on branch profits i.e. where the asset has only been used in the branch. However excess past relief (over and above economic depreciation) obtained against the profits of the company's residual activity (i.e. activity, such as UK activity, outside the scope of branch exemption) should be recouped.

The most straightforward approach to achieving these objectives would be to treat foreign branch activity within the scope of exemption as a separate activity, for CA purposes, once an election for branch exemption starts to apply. Where a trade is carried on across the UK and a foreign branch (or branches) the activity would be split with two separate pools of expenditure.

The third objective could be achieved by triggering a CA disposal event at market value – working either through adjustments to the unrelieved expenditure in CA pools, or, if necessary, through balancing charges (or balancing allowances).

This would not be needed for assets which have only ever been used in foreign branches as the general transitional rules should be sufficient. Past CAs will have been taken into account in calculating branch profits, and will only have impacted on the company's other (i.e. UK) profits to the extent that the branch may have made losses. These assets could therefore start in the separate branch CAs pool at their notional tax written down value (WDV).

A market valuation would be needed where there are assets used for branch activity at the time when an election for exemption starts to apply, in respect of which the company has previously claimed (or is treated as having claimed) CAs against UK profits of the activity. This would include where the asset has previously been used by the company for an activity carried on both in the UK and the foreign branch. For these assets, the application of a normal market value CA disposal event was proposed, to adjust CAs given up to the point at which branch exemption starts.

As well as ensuring an appropriate CA treatment for any such assets, this would also deal with any potential risk of companies using assets in the UK for a period and obtaining generous CAs, before switching their use to a foreign branch which then becomes exempt. Commercial circumstances in which this could be done might be limited but potential risk to the Exchequer could be significant if the rules created a particular tax incentive for manipulation.

It was proposed that the period to look back to check the use of such assets might follow the six years from the transitional rule. The limited number of cases to which the rule would apply might be further narrowed down by excluding assets which were transferred to a foreign branch before a certain cut off date.

More generally on CAs HMT/HMRC proposed to specify that for the purposes of calculating the relevant amount of branch profits or losses under the branch exemption legislation, CAs should be automatically taken into account, without any need to make a claim, and without any option to "disclaim" branch allowances. This would make the position clear in relation to the interaction with the anti-diversion rule, and in any other circumstances when branch profits could cease to be exempt, ensuring that CAs in respect of exempt branch activity cannot be "saved up" for potential future use in reducing profits chargeable to UK tax.

WG were concerned by the potential difficulty of establishing the WDV of assets from current worldwide pools. It was agreed that some sort of 'just and reasonable' basis would have to apply. Although book values could not provide an alternative basis in the legislation, in practice details from the books might be used to arrive at the WDV of the assets in the branch pool on transition to exemption.

Some WG members were concerned by the proposal that CAs should be automatically taken into account, without any option to "disclaim". It was suggested that there should be similar flexibility as within the credit regime. HMT/HMRC saw this as problematic in relation to the operation of the anti-diversion rule which could be mitigated by saving up allowances. There would also have to be a way to identify which assets related to specific branches, although it was probably not necessary to legislate for this.

More fundamentally some WG members questioned the need to continue to calculate CAs for exempt branches when they would be cancelled out anyway. Issues relating to the anti-diversion rule might be addressed in a more pragmatic way, if and when they arose. Now that a proportionate approach to the transaction leg was anticipated any profits charged to UK CT would not be significantly affected by CAs in most cases. On the other hand HMT/HMRC pointed out that the other leg of the motive test could take all of a branch's profits out of exemption and assets being transferred to the UK after a period of use in an exempt branch would be an issue. Additionally the application of the lower level of tax test required the calculation of the appropriate amount for CAs.

WG suggested that transfers of assets from an exempt branch back to the UK would not be very common, and might be dealt with by a market value or a WDV based on recomputed notional writing down allowances.

WG also had some concerns with the practicalities of tracking asset use, even going back for a limited number of years. In particular smaller assets would not be identifiable and it was proposed from WG that a de-minimis value should be specified to limit the compliance burden. HMT/HMRC would consider that suggestion.

4. Leasing

HMT/HMRC outlined a proposal to ensure that there would not be a significant risk of tax loss resulting from the transfer of leases to exempt branches once the major part of CAs had been claimed in the UK and taxable profits began to arise. All such transferred leasing activity would be excluded from the scope of exemption. WG members did not raise any points on this.

5. Avoidance risks

The scope of the anti-diversion rule had been one the biggest topics for business in consultation responses. However HMT/HMRC felt that the main concerns were addressed by the proposals discussed at the 2 February meeting and there was agreement on this from WG members.

HMT/HMRC discussed with the group the merits of a more general approach to anti avoidance, either as an alternative or a supplement, to the proposals in the draft legislation – for example, a rule aimed at schemes or arrangements with a main purpose of exploiting the branch exemption provisions (which could operate in a similar way to rules in relation to the dividend exemption).

WG's view was that the current approach, relying on a self-assessment through the motive test that the anti-diversion rule did not apply, would be more effective than one requiring the consideration of whether the rule did apply. It was noted by WG that early work was in progress on the feasibility of a General Anti-Avoidance Rule (GAAR) and there would be unease around introducing what might be seen as a 'mini-GAAR' at this time. Business would be very concerned to achieve a level of certainty around the operation of any anti-avoidance rule and this seemed more likely with a targeted rule based on elements of the CFC rules.   It was also suggested that the Tax Avoidance Disclosure regime provided a 'backstop'.

HMT/HMRC said all avoidance issues which had been discussed seemed to be caught by the existing anti-diversion rule. The 'one-way bet' opportunity from revoking the election before the filing date had been discussed at the 14 January meeting and was being addressed. WG members were not aware of other specific areas of risk beyond those already considered.

6. AOB

A question was raised from WG as to how consultation would be handled in respect of changes to the regime at FB 2012. No decisions had been made on this yet but it was thought this would be within the work on CFC reform, perhaps dealt with in a separate Chapter.

HMT/HMRC referred to the discussion at the 2 February meeting on withholding tax and use of a reverse charge mechanism. Following from that discussion an alternative means to prevent an opportunity to circumvent withholding tax requirements was under consideration.

This could be achieved by making an adjustment to the relevant profits or relevant losses amount for the branch to which the payment is made. This adjustment would increase the CT charge on the company by an amount equivalent to the income tax charge that would previously have applied. Credit relief would be available against the CT resulting from this adjustment. This seemed preferable in terms of the issues around set off of income tax paid and potential double taxation mentioned at the previous meeting.

HMT/HMRC thanked the WG members for their participation through the consultation process and for all their help in developing branch exemption.