HM TREASURY

Foreign branch taxation:

a discussion document

July 2010

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Basic information

Subject of this consultation:	This discussion document contains options for reforming the taxation of the foreign branches of UK companies.
Scope of this consultation:	This consultation deals with the taxation of foreign branches of UK companies. The Government is not looking to reform the taxation of the UK branches of foreign companies.
Impact Assessment:	The Impact Assessment for the options set out in this discussion document can be found at: http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm
Who should read this:	The Government would like to hear the views of business, as well as the views of representative bodies and tax advisers, on the options set out in this discussion document and the questions posed.
Duration:	The consultation period for this document runs from 27 July 2010 to 15 October 2010
Responses and enquiries:	Responses and enquiries should be sent to: Alexander Harris Room 2/E1 HM Treasury 1 Horse Guards Road London SW1A 2HQ Alternatively, please email: alexander.harris@hmtreasury.gsi.gov.uk Telephone enquiries: 0207 270 6104
After the consultation:	The answers the Government receives to the questions on the proposals will assist in the development of firm proposals and draft legislation, to be published later in 2010.

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Introduction

1.1 The Government is committed to delivering a more territorial approach to corporation tax and is considering the case for exempting the profits of foreign branches (sometimes known as "permanent establishments") of UK companies. 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 The Government recognises that developments in the regulation of financial services companies have made the issue of taxing foreign branch profits a pressing matter for affected companies. At the same time, the Government is aware that the choice of regime for foreign branch taxation could have an impact on companies in other sectors, such as the oil and gas sector.

1.3 The Government is consulting on the form of an exemption regime for foreign branch profits, to enhance the UK's competitiveness and to achieve greater consistency of tax treatment between foreign branches and subsidiaries of UK companies. It will be necessary to give careful consideration to the treatment of losses incurred in foreign branches, and this discussion document includes options on this issue. The consultation will consider the impact on the UK's competitiveness for all sectors. In considering the options for a new regime, the Government will also balance a number of other factors, including simplicity, fairness and affordability.

1.4 The Government has established a working group of interested parties.[1] The working group will hold meetings over the summer and autumn to discuss the questions and options in this discussion document. Together with the written responses received to this discussion document, the working group will help inform the Government's decision on the shape of the new regime. Detailed proposals and draft legislation will then be published later in 2010. Consultation will continue over the winter, with legislation to be included in Finance Bill 2011.

1.5 The consultation is being conducted in line with the principles outlined in the document "*Tax policy making: a new approach*" published alongside the Budget.[2] The 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

This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views on the detailed policy design and the framework for implementation of the proposal.

[1] For a list of working group members, please see: http://www.hm-treasury.gov.uk/consult_taxation_of_foreign_branches.htm
[2] http://www.hm-treasury.gov.uk/junebudget_tax_policy_making.htm

1.6 Chapter 2 of this discussion document sets out the context for reform, including the principles against which the Government will assess policy options, international comparisons of branch exemption regimes and an outline of the sectors likely to be most affected by changes to the rules.

1.7 Chapter 3 sets out options and proposals for the scope of a branch exemption regime. These cover a number of issues, including:

- how the foreign branch taxation regime should prevent artificial diversion of profits
- whether exemption should apply to air transport and shipping
- how to provide Double Taxation Relief (DTR) alongside a branch exemption regime
- whether the scope of exemption should extend to countries with which the UK does not have a double taxation agreement

1.8 Chapter 4 discusses options to relieve losses incurred in foreign branches. The options to be considered include:

- 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 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

Context

Principles for reform

2.1 The Government's aim is to create the most competitive corporate tax system in the G20. In the Budget, the Chancellor announced immediate action to restore the UK's competitiveness, including a phased reduction in the main rate of corporation tax to 24 per cent. The wider corporate tax system will affect business perceptions of competitiveness and businesses will have a range of priorities. The Government is discussing enhancing the UK's competitiveness further with business before it sets out more detail on its overall approach to reform in the autumn.

2.2 As part of its commitment on competitiveness, the Government plans to deliver a more territorial approach to company taxation. In the context of the taxation of foreign branches, greater territoriality would be achieved by moving to an exemption regime, so that foreign branch profits were not subject to UK corporation tax.

2.3 This would also achieve greater consistency of tax treatment between foreign branches and subsidiaries of UK companies. Under the present rules, UK companies are subject to corporation tax on the profits of their foreign branches, with DTR given for the 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 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.

2.4 The Government is also committed to achieving fairness and simplicity in the tax system, and will assess the options for reform in the context of these principles.

International comparisons

2.5 A number of countries, including the United States and Japan, tax foreign branch profits but provide DTR for foreign tax paid on the same profits, as the UK currently does. A number of other counties have exemption regimes for foreign branches, including France, Germany and the Netherlands. There are some significant differences between these exemption regimes, as outlined below.

France

2.6 The standard basis for taxation of French companies with foreign branches is a branch exemption regime. This means that a foreign branch of a French company pays no French tax on its profits and gets no relief against French tax for any losses. However, a French company can elect instead to be taxed on its worldwide income. Where an election is made and accepted, a French company can set off any foreign branch losses against other (French, not foreign) profits, and other domestic losses against any foreign branch profits.

Germany

2.7 The foreign branch profits of German companies are taxable in principle under German legislation. However, German tax treaties generally provide exemption, overriding the German taxing rights. Where the profits are exempt, loss relief is not available.

Netherlands

2.8 As in the case of Germany, the foreign branch profits of Dutch companies are taxable in principle but these taxing rights are generally overridden by individual tax treaties, which provide exemption for branch profits. Alongside profits exemption, Dutch companies can set foreign losses incurred by a branch against the head office profits. However, this loss relief is "clawed back" by the Dutch tax system, so any later profits are taxed up to the amount of foreign losses previously set against head office profits.

Affected sectors

2.9 It is considered that relatively few UK businesses operate outside the UK through foreign branches. Those businesses that do make significant use of branches tend to be large companies in the following sectors:

- Oil and gas exploration is often conducted through foreign branches. This can be for a number of reasons, including legal and contractual obligations and filing requirements. Exploration activity routinely makes losses in its early stages, and there is a significant risk that an exploration project will not lead to a successful outcome. These characteristics make loss relief for foreign branch activity particularly important for the sector.
- Banks often conduct business through foreign branches. Again, this can be for a number of regulatory and commercial reasons, especially efficient allocation of capital.
- Insurance companies currently make use of foreign branches and subsidiaries. Developments in prudential regulation have made the regime for foreign branch taxation a pressing issue for insurers. The Solvency II regime will modernise and consolidate prudential regulation for insurers across the EEA. This new, much more harmonised solvency regime is one factor leading many insurers to consider using branch structures where they have previously operated through subsidiaries.

2.10 The Government is aware that the regime for foreign branch taxation is a particularly important issue for multinational enterprises in these sectors. Nevertheless, the Government welcomes views on the options in this discussion document from all sectors. The Government is aware that changes to the regime for foreign branch taxation may also impact on a limited number of small companies and welcomes views on how changes to the rules would affect small companies.

Affordability

2.11 The UK faces a very challenging fiscal position, and the Budget announced urgent action to eliminate the bulk of the structural deficit through plans for additional consolidation of £40 billion per year by 2014-15. In this context, affordability and relative value for money are key considerations when considering options to improve competitiveness.

Scope of exemption

3.1 This chapter describes options on the scope of the profits that could be exempted from corporation tax. There are a number of key policy questions around this issue, including how the foreign branch taxation regime should treat chargeable gains, whether exemption should apply to air transport and shipping and how the regime should work in the case of small companies. These are dealt with in the later sections of this chapter.

3.2 There are also important questions as to how best to design an exemption regime to enhance the UK's competitiveness consistent with simplicity, fairness and affordability. Key among these questions is how to define the profits that will become exempt from corporation tax if branch exemption is introduced. The next section deals with this issue, with further detail provided at Annex A.

Quantification of branch profits

Basis of calculation

3.3 The first question is how to define the profits that will become exempt from corporation tax if branch exemption is introduced. The Government has identified two broad alternatives for the way that the profits of a foreign branch may be identified.

Option A

- One option is to identify foreign branch profits on the basis of how these are calculated under the UK's double tax treaties. Under current rules the UK gives credit for the foreign tax paid on the profits of a foreign branch of a UK company against the corporation tax due on the same profits, in order to relieve double taxation. The profits are defined by the business profits article of the relevant treaty. It would be possible to design branch exemption in a similar way.[1]

Option B

- An alternative option is to identify foreign branch profits as defined under existing legislation for UK branches of foreign companies. This legislation determines the profits of a foreign company that are subject to corporation tax because they arise from a branch in the UK. This legislation could be adapted for exempting the profits of a foreign branch of a UK company.

3.4 These two alternatives are quite similar, because the legislation for taxing UK branches (Option B) is based on OECD principles for determining branch profits, and these same principles also form the basis for the UK's tax treaties (Option A). However, there are some differences that, though typically small in terms of the amount of profits and so the tax involved, are important in determining how simple an exemption regime could be.

[1] The exempt branch income would then be the same income as currently determines the limit on credit relief. This is the amount of income referred to in section 42 Taxation (International and Other Provisions) Act 2010 (TIOPA)

3.5 Double tax treaties are all based on OECD principles but vary in their detailed terms, with a few quite significant departures from the standard model. Option B would ignore these variations and determine the exempt amount by reference to the legislation based on the OECD model treaty. This would lead to some mismatches between the profit that is exempt from UK corporation tax and the amount that, in accordance with the relevant treaty, is taxed in the jurisdiction where the foreign branch is situated. These mismatches would lead to the possibility either of double taxation or double non-taxation of the foreign branch profits.

3.6 A feature of Option A is that any dispute about the scope of exemption for profits arising from a branch in a treaty location may become linked to a dispute about the taxing rights of that other location. This type of dispute would normally be resolved through the treaty mutual agreement procedure. It is not clear whether or not this might cause problems in practice and the Government invites views on this matter.

3.7 The Government is committed to achieving fairness and simplicity in the tax system. Option A may have some simplicity benefits over Option B, but these will need to be considered alongside any impact on dispute resolution procedures. Option B potentially has fairness impacts, to the extent that mismatches between different ways of measuring branch profits could lead to double taxation or non-taxation.

Questions

- In the case of Option A (an exemption based on treaties), to what extent do you see difficulties arising from disputes with other jurisdictions about the scope of exemption?
- Which of Option A and Option B do you prefer, and why?

Capital attribution

3.8 Capital attribution is part of the process for determining the amount of interest expense that a branch of a financial company (a bank or insurance company) may deduct from its branch profits, whether these are defined under Option A or B.

3.9 Under the capital allocation approach, the relevant share of the total assets of the financial institution as a whole, weighted for risk according to regulatory requirements, is attributed to the branch.

3.10 The thin capitalisation approach is based on the principle that the capital to be attributed to a branch should be comparable to that which would be held by a host country resident financial company of a similar size, and conducting a similar type of business, to the branch.

Questions

- What method do you consider to be most appropriate for attributing capital to the foreign branches of banks, and why?
- What method do you consider to be most appropriate for attributing capital to the foreign branches of insurers, and why?

Chargeable gains

3.11 Corporation tax profits consist of both income and gains. An exemption regime for foreign branch income could be accompanied by an exemption for chargeable gains arising from assets used by a branch, as per the exemption regimes of France, Germany and the Netherlands. This would be consistent with delivering a more territorial approach to corporation tax. On the other

hand, exempting chargeable gains on foreign branch assets would lead to some issues that could add complexity:

- Foreign branch assets are currently within the scope of chargeable gains legislation. If exemption were introduced the Government would need to consider a transitional rule to retain taxing rights over accrued but unrealised gains on these assets.
- Many assets (including intangible assets) might be used partly by a branch and partly by the headquarters or other branches, giving rise to apportionment issues.
- It would be necessary to consider amendments to the rules that allow intra-group transfers of assets, otherwise assets could be allocated to a branch immediately before a sale in order to escape taxation on the gain.

Question

- If assets used by a foreign branch were made exempt from chargeable gains, what would be the administrative and compliance impacts?

Shipping and air transport

3.12 As a general principle, shipping and air transport profits are taxed in the state of residence. As a result, the shipping and air transport sectors are generally exempted from taxation in the territories of their foreign branches under the terms of almost all of the UK's tax treaties and other specific agreements. It would not be appropriate to give these sectors exemption from UK tax in respect of their foreign branch profits, as this would mean they would no longer pay tax on those profits. This denial of exemption for shipping and air transport would be consistent with the branch exemption regimes adopted by Germany and the Netherlands, for example. The Government therefore proposes that where the taxing rights of the branch territory are restricted by other treaty provisions such as a shipping, inland waterways transport and air transport article of a tax treaty, the profits of the foreign branch would not be made exempt.

Preventing artificial diversion of UK profits to exempted branches

3.13 It would be necessary to put in place protection against the artificial diversion of profits to an exempt foreign branch equivalent to the defences for subsidiary companies. These elements of branch exemption would need to be taken forward alongside the Controlled Foreign Companies (CFC) review to help ensure consistency across the corporation tax regime. The Government recognises the need for a proportionate approach to the issue of artificial diversion of profits in order to minimise compliance costs.

3.14 The CFC regime is the principal protection against the artificial diversion of UK profits to a foreign subsidiary. The Government recognises that CFC reform is a key priority for multinationals. It is currently reforming the rules to make them more competitive while providing long term stability and adequate protection of the UK tax base.

3.15 Whatever the nature of the future CFC regime, the Government's view is that profits that would have been subject to a CFC apportionment in a foreign subsidiary should not be exempt in a foreign branch. This might be achieved in one of three ways:

Option C

- There could be a limitation on the scope of exemption defined by reference to the CFC legislation (i.e. exemption would not be available to an extent determined by reference to the CFC rules on the assumption that the branch were a foreign subsidiary).

Option D

- An anti-avoidance rule specific to branch exemption might apply in a way that reflects CFC principles, but does not apply them directly.

Option E

- The CFC rules could apply to the foreign branch of a UK company as if the branch were a foreign subsidiary.

3.16 A practical difference between the options is the order in which the rules are applied. Under Option C or D, the CFC rules (or rules equivalent to them) would determine whether a branch qualified for exemption; if a foreign branch were disqualified from exemption, then the current tax-with-credit regime would apply for that branch. Under Option E, profits would be made exempt under branch exemption but would then become subject to a CFC apportionment in the same company, which could be complicated to apply in practice. On the other hand, it is possible that apportionment could more closely target profits that have been artificially diverted.

3.17 Each approach would require the application of anti-avoidance rules to a foreign branch that are in keeping with the CFC regime. Full reform of the CFC regime will take place in 2012, whereas foreign branch reform will be introduced in 2011, so initially branch exemption legislation will refer to current CFC rules as amended by the 2011 interim amendments. Branch exemption legislation may need to be updated subsequently, to reflect the final CFC regime.

Question

- Is limiting the scope of exemption defined by reference to the CFC rules, or rules equivalent to them (Option C, Option D) a simpler approach than applying the CFC rules to a UK company with a foreign branch as if the branch were a foreign subsidiary (Option E)?

3.18 For distribution exemption the CFC regime is supplemented by some targeted anti-avoidance rules. The Government will need to consider further whether any such additional protection may be necessary in the case of branch exemption.

Branches in non-treaty territories

3.19 The UK has a very wide network of double tax treaties, with comprehensive bilateral agreements in force with 116 countries and territories. This provides significant benefits in terms of competitiveness. All of the UK's modern tax treaties are based broadly on the OECD model treaty.

3.20 In respect of subsidiaries, distribution exemption is given to medium sized or large companies irrespective of whether the paying company is in a treaty jurisdiction. For small companies, however, exemption is given only for distributions from treaty locations.

3.21 In deciding whether or not to extend exemption beyond the UK's treaty network, the Government will consider how this would affect competitiveness, balanced with the need to protect Exchequer revenues by preventing the artificial diversion of profit and any compliance costs this could involve. The risk to the Exchequer associated with branch exemption would be reduced by retaining taxation of branches in non-treaty territories, which include many zero or

very low tax jurisdictions. The Government will consider whether retaining the current rules for branches in these territories would be an appropriate safeguard against artificial diversion of profit.

3.22 If a tax-with-credit regime were retained for branches in non-treaty territories, then there would continue to be "top up" tax (see paragraph 2.3) for those branches. This would reduce the cost to the Government of an exemption regime.

3.23 If instead exemption were extended to non-treaty territories, then under Option A (an exemption based on treaties), this could be achieved by applying the business profits article of the OECD model treaty, reflecting the new text of that article in the 2010 update. Under Option B, the profits to be exempted would be defined under existing legislation for UK branches of foreign companies, just as the exempted profits of branches in treaty territories would be.

Question

- What impact do you consider that limiting the scope of a foreign branch profits exemption to treaty territories would have on UK competitiveness?

Small companies

3.24 As described above at paragraph 2.9, the regime for foreign branch taxation is an important issue for a number of multinationals. Most small companies do not have foreign branches, but the Government is aware that changes to the regime for foreign branch taxation may impact on a limited number of small companies. The Government seeks views from small companies that currently make (or plan to make) use of branch structures, on how changes to the rules would affect them.

Question

- How would small companies be affected by the options in this discussion document?

Preventing diversion of UK profits in the case of small companies

3.25 A small proportion of small companies have foreign branches, with many of these held for commercial reasons. While anti-avoidance rules for a branch profits exemption need to be considered for all companies, it may be appropriate to vary the rules according to the size of the company. This is the case for the distribution exemption, for example.

3.26 The CFC regime is of less relevance to small companies than to larger companies, and so, as with distribution exemption, it seems appropriate instead to apply a generic anti-avoidance condition in the case of small companies. This could help provide a lighter touch regime for these companies, minimising compliance costs.

3.27 As noted above, there is an open point as to whether branch exemption would be extended to branches in non-treaty territories irrespective of company size. Because of the risk of loss of tax through diversion of personal income into a tax haven branch of a small company, it is unlikely that exemption would be extended to a non-treaty branch of a small company.

Question

- In the case of a profits exemption for small companies, would a generic anti-avoidance rule be a more appropriate way to protect Exchequer revenues than a reference to the CFC rules?

Double taxation relief

Treaty relief

3.28 For the most part an exemption would prevent foreign branch profits from being doubly taxed. However, as noted above, if exemption is fixed by reference to UK legislation (Option B) then the possibility of double taxation remains in cases where exempt profits are less than the measure of branch income under the treaty. Credit rules would be needed in such a case.

3.29 Exemption of branch profits in treaty territories under Option A would remove the need for DTR, as there would be no UK tax on any profits covered under the treaty. The same would be true for branch profits in non-treaty territories if exemption were based on the OECD model treaty. As a result, under Option A the Government could get rid of the current DTR rules, except where foreign branch profits are taxed due to specific provision in the corporation tax rules denying exemption (for example by reference to the CFC rules). As well as preventing double taxation, this approach would prevent double non-taxation from occurring between the UK and a treaty partner.

3.30 Foreign tax paid in respect of exempt branch profits would of course not be available for relief by way of either credit or deduction.

Unilateral relief

3.31 The UK currently gives unilateral relief to prevent double taxation on income arising in non-treaty locations. The Government's view is that where profits were eligible for branch exemption, this would entirely displace the need for DTR in respect of taxes paid in non-treaty jurisdictions. Unilateral relief would therefore be given only where branch exemption is not available, where foreign tax is paid by deduction from income taxable in the UK, or (exceptionally) on profits underlying taxable dividends.

Loss relief

4.1 An across the board exemption for foreign branch profits would also prevent relief being given for losses incurred by the branch, because of the general principle that loss relief and profit taxation should share a common scope.

4.2 Some companies, particularly in the oil and gas sector, have expressed concern about the prospect of losing relief for foreign branch losses if foreign branches are made exempt from corporation tax. These companies point out that early exploration costs do not always lead to profitable business and that a denial of loss relief would increase the effective cost of such projects. They also say that competitors in other countries generally get relief for exploration losses. The Government will need to consider how the availability of loss relief will impact on the UK's competitiveness, and what value for money the different options for providing relief represent.

4.3 Some form of terminal loss relief could be part of a branch exemption regime.

4.4 The Government recognises the difficulties that some companies, including those in the oil and gas sector, might encounter if relief for branch expenditure were lost. It also recognises that terminal loss relief alone is unlikely to be capable of being taken into account in investment decisions.

4.5 The Government therefore considers that there is a strong case for any move to branch exemption to be accompanied by provision to allow relief in excess of terminal losses. This chapter examines different options for this.

Current position

4.6 Losses incurred in foreign branches may be relieved against profits arising in the same company and (subject to certain restrictions) may also be surrendered as group relief. Where UK loss relief is given but the losses are subsequently relieved in the branch territory, this will reduce the amount of foreign tax available for credit against UK corporation tax. In this way, the tax effect of the UK loss relief may be "clawed back" through restriction of the credit, although the extent to which corporation tax is increased as a result will depend upon exactly how losses are relieved in the branch jurisdiction. However, this "claw back" only operates where the foreign branch moves into profit.

Election for exemption not to apply

4.7 The Government is aware that for some companies, particularly in the oil and gas sector, the value of loss relief may outweigh the advantage given by exemption for branch profits. Those companies, or groups of companies, would therefore benefit by remaining under the current rules for branch taxation.

Option F

- Loss relief might be given by means of an election for exemption not to apply.

4.8 As with the other options on loss relief and on profits exemption, this option will need to be considered in terms of its affordability to the Exchequer. There are a number of sub-options in relation to an elective regime:

- An election could be made permanently binding upon a company, so that it is permanently denied branch exemption.
- The election could be binding solely on the company that makes it, or it might bind other group companies as well.
- Rules might be needed to extend the election to any company into which the branch business is transferred.
- If an election is capable of being revoked, it might be necessary at that point to reverse loss relief previously given under the election, to the extent the losses have not been matched by subsequent taxable branch profits.

Loss relief claw-back

4.9 If instead of an election, loss relief were to be given in combination with exemption for branch profits, it would be necessary to consider whether the value of the relief should be clawed back in some way once the foreign branch moves into profit. The purpose of such a rule would be at least to replicate the extent to which taxation of branch profits under current rules can reverse the value of loss relief over time. There are a number of ways this might be achieved:

Option G

- A claw-back mechanism might tax branch profits to the extent necessary to reverse loss relief. Under this option, DTR would apply to the profits being taxed under the claw-back mechanism. This would be equivalent to, but (at least theoretically) more generous than, the current position, because profits would only be taxed to the extent of the earlier losses.

Option H

- A new regime could reclaim loss relief provided, without the benefit of DTR. As under Option G, profits would be taxed only in so far as necessary to reverse loss relief, but with the difference that foreign tax paid would not be creditable against the UK tax on those profits. This would mean that UK loss relief would always begin to be reclaimed as soon as the foreign branch moved into profit, regardless of the amount of foreign tax due.

4.10 The Government will need to consider what impact options F, G and H would have in terms of affordability, fairness and competitiveness, both on their own and in combination with other options on loss relief.

Questions

- How might an elective regime work in practice?
- How beneficial would Option G (a claw back mechanism to reclaim loss relief provided) be to businesses?
- How beneficial would Option H (a claw back mechanism to reclaim loss relief provided, without the benefit of DTR) be to businesses?

Transitional rules

4.11 There might be some companies that are carrying forward losses at the date of introduction of branch exemption, some of which may be derived wholly or partly from branch business. Under current rules, any brought forward losses are set against the profits of the whole company, including any branch profits. A consequence of exemption for branch profits would be that a company would no longer need to set off brought forward branch losses against branch profits, and so there would be more losses available to set against UK profits. This would potentially delay the point at which losses are exhausted and the company starts paying tax on its UK profits.

4.12 The Government would want to consider preventing any such enhancement of the effective value of brought forward losses. This points to the use of a transitional rule as outlined in the following options. A transitional rule would apply to all companies moving into an elective exemption regime (under option F) or a compulsory exemption regime (under options G and H). It would not apply to any companies opting out of exemption, if option F were adopted.

4.13 Additionally, there may be a case for applying a claw-back mechanism in respect of branch losses incurred before the commencement of branch exemption irrespective of the existence of brought forward losses. Such a rule could apply to the extent that those losses would have been clawed back if branch exemption had not been in place by the time branch profits arose.

Option I

- Cancellation of losses. Brought forward branch losses would be lost for all companies moving their foreign branches into an exemption regime.

Option J

- Deferral of exemption. There could be a rule whereby a company would be subject to a claw back mechanism on its brought forward foreign branch losses. In this case, exemption would in effect be delayed until all of a company's brought forward branch losses were matched with taxable branch profits.

Option K

- Application of claw-back to pre-exemption losses. A claw-back mechanism would be applied to losses incurred prior to exemption, to the extent that the mechanism would apply if exemption rules had always been in place.

4.14 If a transitional rule were to be introduced, then to help manage compliance burdens, the Government would consider whether to introduce a time limit for the losses subject to the transitional rule. Foreign branch losses generated in a set period prior to the date of introduction of an exemption regime would then be subject to the transitional rule.

Questions

- Would Option I, J or K be the most appropriate transitional rule?
- Do you see any difficulties arising in practice with these options, and if so, what are they?

Questions for consideration

5.1 The Government welcomes views from businesses and their representatives, as well as the views of professional advisers, on the questions asked in this discussion document. These are listed again below for reference, along with some further questions on the likely impacts of the options on administrative and compliance burdens.

General questions

- Would any of the options listed in the document be likely to make a significant difference to the way businesses structure their activities?
- How would the options affect the competitiveness of the UK's tax system?

Impact Assessment

- Would any of the options be likely to have a significant impact on administrative burdens?

Scope of exemption

- In the case of Option A (an exemption based on treaties), to what extent do you see difficulties arising from disputes with other jurisdictions about the scope of exemption?
- Which of Option A and Option B do you prefer, and why?
- What method do you consider to be most appropriate for attributing capital to the foreign branches of banks, and why?
- What method do you consider to be most appropriate for attributing capital to the foreign branches of insurers, and why?
- If assets used by a foreign branch were made exempt from chargeable gains, what would be the administrative and compliance impacts?
- Is limiting the scope of exemption defined by reference to the CFC rules, or rules equivalent to them (Option C, Option D) a simpler approach than applying the CFC rules to a UK company with a foreign branch as if the branch were a foreign subsidiary (Option E)?
- What impact do you consider that limiting the scope of a foreign branch profits exemption to treaty territories would have on UK competitiveness?
- How would small companies be affected by the options in this discussion document?

- In the case of a profits exemption for small companies, would a generic anti-avoidance rule be a more appropriate way to protect Exchequer revenues than a reference to the CFC rules?

Loss relief

- How might an elective regime work in practice?
- How beneficial would Option G (a claw back mechanism to reclaim loss relief provided, subject to DTR) be to businesses?
- How beneficial would Option H (a claw back mechanism to reclaim loss relief provided, without the benefit of DTR) be to businesses?
- Would Option I, J or K be the most appropriate transitional rule for foreign branch losses?
- Do you see any difficulties arising in practice with these options, and if so, what are they?

Next steps

How to respond

6.1 Responses and enquiries should be sent to:

Alexander Harris

Room 2/E1

HM Treasury

1 Horse Guards Road

London SW1A 2HQ

Alternatively, please email: alexander.harris@hmtreasury.gsi.gov.uk

6.2 Further information may be found at:

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

Telephone enquiries: 0207 270 6014

6.3 Comments should be received by 15 October 2010.

Confidentiality disclosure

6.4 Information provided in response to this discussion 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.

6.5 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).

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.

Additional detail on quantification of branch profits

A.1 This Annex explains in more detail some of the issues that arise when defining the profits of a foreign branch for the purpose of exempting them from corporation tax. These issues involve double taxation and double non-taxation of foreign branch profits, as mentioned in paragraphs 3.3 – 3.7, and how capital will be attributed to the branch, as mentioned in paragraphs 3.8 – 3.10.

A.2 Issues of double taxation and double non-taxation arise when the method used to determine the profits of the branch to be exempted differs from that used in the foreign jurisdiction in which the branch is located. For example, this may be as a result of a difference in approach between domestic legislation and a tax treaty. These issues could arise under both options A and B, but the introduction of the new Article 7 in the OECD model treaty will mean that there could be particular difficulties present under option B. The section below on attribution of profits to branches sets out these issues.

A.3 Attribution of capital to branches is of particular importance to banks and insurers as they are required to hold a certain amount of capital for regulatory and commercial purposes. The section below on capital attribution sets out the potential methodologies and why a capital allocation approach appears to be the more appropriate methodology to adopt for any legislation that might be enacted under Option B.

Attribution of profits to branches

Article 7 – Business profits article

A.4 A new business profits article (Article 7) has been incorporated into the 2010 update of the OECD model treaty and the Government will need to consider whether any legislation on foreign branch taxation should incorporate it.

A.5 The new Article 7 recognises internal interest payments and receipts for non-financial concerns, and internal royalties for all concerns. However, the existing UK legislation in sections 31 and 32 Corporation Tax Act (CTA) 2009,[1] contains a specific disallowance of royalties, and, in the case of non-financial concerns, of interest and other financing costs paid by the branch to any other part of the enterprise of which it is a part.

A.6 If the new Article 7 is not adopted in legislation, then when the UK agrees a treaty incorporating the new article it will have the effect of overriding the domestic legislation as it applies to a foreign company. As a result, the profits attributable to a UK branch may be reduced by internal royalties and interest below what they would have been had the legislation applied.

A.7 In the case of a foreign branch of a UK company, the new Article 7 may reduce the taxing rights of the branch territory, but the UK measure of exemption would be based on the old

[1] These provisions replace paragraphs 4 and 5 of Schedule A1, Income and Corporation Taxes Act 1988

version of the article currently incorporated in UK legislation. As a result, a greater amount of profit would be exempted than the treaty would permit the overseas fiscal authority to tax, with the consequence that part of the income would be taxed in neither jurisdiction.

A.8 Alternatively, if the new Article 7 is adopted in legislation, but the relevant treaty contains the old article so that there is no reduction for interest and royalties, the amount of exempt profit is likely to be less than the amount that may be taxed by the other jurisdiction. This would lead to double taxation and so credit relief may need to be retained for the part of the income that is taxed in both territories due to the differing measures of branch profits.

A.9 It seems probable that the existence of two different business profits articles in the UK's treaties will make a mismatch with the profits calculated according to UK legislation more likely. This could increase the complexity of implementing option B in practice.

Capital attribution

Attribution of capital: banks

A.10 Capital is of particular significance in the banking industry. Banks are required to hold a certain amount of capital in the form of both equity and subordinated or long-term debt to meet regulatory and commercial requirements.

A.11 Section 21 CTA 2009 provides that a reasonable amount of capital, both equity and debt, must be attributed to UK based branches of non-UK resident banks. The OECD has authorised two methodologies or approaches for making that attribution. These are the "capital allocation" approach and the "thin capitalisation" approach. The UK has adopted a thin capitalisation approach, but it is also useful to look at the capital allocation approach.

A.12 Under the capital allocation approach, the relevant share of the total assets of the bank as a whole, weighted for risk according to regulatory requirements, is attributed to the branch. These are the assets that are created in the branch or the assets whose attached risk is managed by the branch, for example through hedging. A share of the total capital of the non-UK resident bank is then attributed to the branch by applying the bank's overall capital ratio to the risk weighted assets attributed to the branch.

A.13 The thin capitalisation approach is based on the principle that the capital to be attributed to a branch should be comparable to that which would be held by a host country resident bank of a similar size, and conducting a similar type of business, to the branch. The UK application of this approach is described in HMRC guidance in the International Manual. After attributing risk weighted assets to the branch (on the same basis as is used in a capital allocation approach) the UK usually takes as its starting point the capital ratio of the non-UK resident bank as a whole. If that ratio is in line with the ratio one would expect for a similar UK resident bank, capital is usually attributed to the branch based on that ratio. Hence in practice the UK thin capitalisation approach effectively adopts a capital allocation methodology in many cases. If, however, the capital ratio of the non-UK resident bank falls outside the range of capital ratios found amongst similar UK resident banks, a ratio reflecting an appropriate UK based ratio will be applied. It is this element of comparability with local banks, when applied, that highlights the difference between the two authorised OECD approaches.

A.14 Currently section 43 Taxation (International and Other Provisions) Act 2010 (TIOPA) applies the provisions of Chapter 4 of Part 2 of CTA 2009 to the overseas branches of UK resident banks for the purposes of computing DTR and the same underlying principle could be followed for a branch exemption regime.

A.15 Under an exemption regime, the UK would expect a reasonable amount of both equity and debt capital to be attributed to the overseas branch of a UK bank. As the bank will be regulated by the UK regulator and subjected to the commercial constraints of the UK money markets, it will hold a reasonable amount of capital. A key question, therefore, is how to allocate to the relevant branch an appropriate amount of the capital actually held by the UK bank. The authorised OECD capital allocation approach can easily be adopted for this purpose.

A.16 The banking industry worldwide is generally governed by regulations based on the "Basel I" or "Basel II" regimes adopted by the Bank for International Settlements. The OECD authorised capital allocation approach to attributing capital is rooted in and utilises the Basel regimes. The approach and the concepts it reflects are therefore already familiar to UK banks, and to foreign tax authorities, and use of it for branch exemption purposes should not involve any significant additional compliance costs or burdens.

Attribution of capital: insurance

A.17 Debt funding is not normally a major feature in an insurer's balance sheet. Capital, along with reserves, provides support for risks insured. The capital and reserves are backed by investment assets and consequently investment income makes up a significant part of the total income of an insurer's business. The attribution of capital and reserves is therefore an important component in calculating the profit attributable to a branch of an insurance company. The levels of capital often referred to as "surplus and reserves" or "technical provisions" are determined by a mixture of commercial and regulatory requirements.

A.18 The attribution of capital to an insurance company branch is provided for in section 24 CTA 2009 and Statutory Instrument 2003/2714. The statutory instrument uses the term "free assets" in place of "capital", which recognises the fact that the capital is backed by investment assets and the attribution is the first stage in determining the investment income allocated to the UK branch of an overseas insurer. Section 43 TIOPA 2010 applies the provisions to overseas branches of UK resident insurers for the purposes of calculating double taxation relief. Reserves must also be attributed to the branch in order for the full amount of investment income to be allocated. The established practice for attributing investment income in insurance businesses is to use one of two mechanical methods and is set out in more detail in HMRC's General Insurance Manual.

A.19 The authorised OECD methodologies for attributing investment income in insurers are an allocation approach and an adaptation of the thin capitalisation approach or the adjusted regulatory minimum approach. The mechanical methods described in the General Insurance Manual are simplified versions of the authorised OECD approaches and will give a reasonable result under certain circumstances.

A.20 The two guiding principles of the capital allocation approach are that the investment assets of an insurance business support all of its business, without regard to where the business is conducted and that the sum of the investment assets attributed will be neither more nor less than the total investment assets belonging to the business as a whole. The investment assets are attributed using an appropriate allocation key. The thin capitalisation approach attributes investment assets to the branch by reference to the amount of investment assets an independent insurance business would have in the same circumstances.

A.21 Unlike the allocation approach, the thin capitalisation approach has the potential to require the allocation of more assets than is held by the entity, particularly where the capital and reserves of the entity are reduced to take account of the diversification of risk. The capital allocation approach is therefore the most appropriate methodology for attributing investment assets should an exemption regime be adopted.

Code of Practice on consultation

About the consultation process

This consultation is being conducted in accordance with the Code of Practice on Consultation.

The consultation criteria

1. When to consult - Formal consultation should take place at a stage when there is scope to influence the policy outcome.

2. Duration of consultation exercises - Consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

3. Clarity of scope and impact - Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

4. Accessibility of consultation exercise - Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

5. The burden of consultation - Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

6. Responsiveness of consultation exercises - Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

7. Capacity to consult - Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

Richard Bowyer, Better Regulation Unit
Email: richard.bowyer@hmrc.gsi.gov.uk
Telephone: 020 7147 0062

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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