

Exemption for profits of foreign permanent establishments etc ("foreign branch exemption") – Technical Note

1. Introduction

1.1 This note is intended to highlight a number of points that may arise from the draft legislation published for foreign branch exemption alongside other draft clauses for the next Finance Bill. It mentions some matters that are not dealt with in the draft legislation and that may need to be addressed in continuing consultation on this measure. It is also intended to clarify some aspects of the legislation. Some questions on the issues discussed below are included at the end of this note.

2. Outline of the legislation

2.1 On 9 December 2010 the Government published draft legislation for reforming the taxation of foreign branches. The draft legislation relates to the detailed proposals published on 29 November 2010 in the document *Corporate Tax Reform: delivering a more competitive system* available at:

www.hm-treasury.gov.uk/corporate_tax_reform

2.2 Part IIIB of that document sets out the detailed proposals for the reform of foreign branch taxation and seeks views on the draft legislation and the implementation of the new regime. In particular, it covers the following key issues:

- The basis and territorial scope of foreign branch exemption
- The extension of the exemption to chargeable gains
- The transitional rule
- The anti-diversion rule
- Capital attribution

2.3 The legislation invokes treaty principles to establish the measure of exempt profits. Profits will be exempt to the extent that they are attributed to a permanent establishment ("PE") in that territory in accordance with the treaty between the UK and that territory. If there is no such treaty, or the treaty lacks a non-discrimination article applicable to the PE, then the OECD Model Convention is referred to instead.

2.4 Chargeable gains are also exempt to the extent that gains are attributable to the PE. Article 13(2) of the Model Convention permits the source State to tax gains on moveable property that forms part of the business property of a PE.

2.5 Investment income will be included in the exempt profit of the branch to the extent that it is 'effectively connected' to that branch. The term 'effectively connected' is used in several articles of the OECD Model

Convention and where it applies, the income will be taxable in the branch territory in accordance with the Business Profits Article. The income is consequently brought within the scope of draft section 18A(5) Corporation Tax Act 2009 (CTA).

2.6 The following exclusions from the legislation apply:

- Foreign branch exemption is not currently extended to long term insurance business, comprising life assurance and permanent health insurance. The life insurance tax regime is undergoing extensive changes to bring it in line with new regulatory capital requirements expected for 2013. 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.
- Foreign branch exemption is not extended to the profits and losses of a company whose business is mainly investment business and which derives the principal part of its profits or losses from that business.
- Profits of a close company that are derived from chargeable gains will also be excluded from the exemption regime. This is to prevent section 13 Taxation of Chargeable Gains Act 1992 (TCGA) from being bypassed through the use of a foreign branch.
- Foreign branch exemption will usually not extend to international air transport and shipping as taxation of these activities in the foreign jurisdiction is generally restricted by the relevant treaty article (based on Article 8 of the OECD Model Convention). This prevents the income from being included within the scope of exemption.

3. Capital Attribution

3.1 The consultation draft proposes to amend Taxation (International and other Provisions) Act 2010 (TIOPA) to substitute section 43 TIOPA with a new section to determine the profits attributable to the foreign PEs of UK companies for the purposes of section 42(2) (the limit on credit relief).

3.2 The current section 43 applies, "with the necessary modifications", the provisions of Chapter 4 of Part 2 CTA 2009. These are the provisions for determining the profits attributable to the UK PEs of non-resident companies.

3.3 The new section, as drafted, sets out the separate enterprise principle in a similar way to section 21 CTA 2009. It provides for the attribution of equity and loan capital, and the "free assets" of insurance companies, to PEs.

3.4 The OECD recognises different acceptable approaches for the attribution of capital and issues arising from this were covered in the July 2010 discussion document (*Foreign branch taxation: a discussion document*). The new section 43 provides for a capital allocation approach. This allocates the company's capital among the PEs through which it carries on business outside the UK, as well as to the rest of the business. The factual and functional analysis on which the attribution of capital to the PEs is based must therefore take into account the whole of the company's business.

3.5 However the OECD also recognises that problems of double taxation can potentially arise where different acceptable approaches are adopted in the State where the PE is situated and the State where the company is resident. The draft legislation makes clear that where a full double taxation treaty is in force between the UK and the State in which the PE is situated, the provisions of the treaty would take precedence.

3.6 The draft legislation also makes clear that the attribution of capital in accordance with the separate entity principle prevails over any allotment of equity or loan capital to a PE in the books and records of the company. This means that for the purposes of determining how much of the company's profits should be attributed to a PE, higher or lower amounts of equity or loan capital may be attributed to the PE than are allocated to it in the company's books and records

3.7 The draft also provides for the attribution of the "free assets" of an insurance company to its PEs, again by a capital allocation approach. "Free assets" follows the definition at Statutory Instrument 2003 no.2714 (which provides for the basis on which capital is to be attributed to a UK PE of a non-resident insurance company). In a similar way as for UK PEs, the Commissioners for HMRC will have the power to make provision as to the definition of "free assets" for this purpose by regulations. There is no current intention to use this power.

4. New Article 7

4.1 The legislation provides that the measure of exempt profit or loss in the foreign branch should be based on the Business Profits Article (Article 7) of the relevant treaty, or, if there is no treaty, on the Business Profits Article of the OECD Model Convention published in July 2010. That Model Convention contains a new version of the Business Profits Article which extends the separate enterprise hypothesis further than the article in the old Model Convention, on which all of the UK's existing treaties that contain that article are largely based. Thus the measure of exempt profit or loss may differ depending on whether the foreign branch is located in a State with which the UK has a double taxation treaty or not.

4.2 The chief difference between the articles is that under the new Model Article 7, internal royalties and (in certain situations concerning non-

financial enterprises) internal interest will be recognised in arriving at the profit or loss of the branch, whereas under existing treaties they are not. Until existing treaties incorporate the new Article 7, such internal transactions would be taken into account only where there is no treaty and the new Model Article 7 determines the measure of profit of the branch.

5. Matters not covered in the legislation

Minimisation of branch profits rule

5.1 There is currently no explicit rule in the legislation requiring companies 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;
- By making claims and elections that are available to reduce the corporation tax measure of profits arising in the branch (such as capital allowances).

5.2 Such rules would simply be a continuation of the minimum foreign tax rule that currently applies in giving credit for foreign tax under S42 TIOPA 2010. To some extent, this requirement is implicit in S18A(5) of Sch 1 (the foreign branch profits legislation), but further rules may be required here.

Capital allowances

5.3 The Government is considering whether any legislation will be required for capital allowances, to ensure that the appropriate relief is given against UK chargeable profits and an appropriate treatment of any assets whose use changes at some stage from the UK to a foreign branch (or vice versa). A possible approach could be to treat any activity carried on both in the UK and through a foreign branch as two separate activities, for the purposes of applying capital allowance rules.

Corporate intangible regime

5.4 Intellectual property (IP) deductible debits and taxable credits should be allocated to the branch calculation consistently with IP use. The Government invites views as to whether treaty based attribution of profits to a PE is sufficient to achieve this result while preserving UK taxing rights for IP used otherwise than in a branch.

6. Manufactured Overseas Dividends (MODs)

6.1 The draft clauses contain basic provisions for MODs, treating MODs paid and received by foreign PEs in the same way as those paid by foreign subsidiaries. It may be that these rules are all that is necessary, but the

Government welcomes views on whether anything further may be required.

7. Other anti-avoidance rules

7.1 HMRC will be reviewing the legislation for avoidance risk and so there is a possibility that further anti-avoidance protection may be identified. Two areas where the Government will need to consider whether specific anti-avoidance rules are necessary:

- Leasing (depending on how far the general approach to capital allowances controls Exchequer risks)
- For cases where branch business is transferred between group companies, perhaps following losses incurred in the branch or in anticipation of loss relief. The aim here will be to preserve the effect of the transitional rule.

8. Further publication

8.1 The Government intends to publish draft legislation as appropriate during the consultation period to supplement the draft Finance Bill Schedule.

9. Questions

- The Government invites general comments on the draft legislation.
- Is a branch profits minimisation rule necessary, or are existing rules sufficient?
- What rules might be needed to ensure appropriate capital allowance treatment of assets used for branch activity, and any change of use between the UK head office and branch, or vice versa?
- Is the draft legislation on MODs sufficient?
- Views on other potential anti-avoidance rules are invited.