UK Taxation of Non-UK Branches

UK Government Announces Detail of Elective Exemption from UK Tax for Non-UK Branches of UK Companies

SUMMARY
On 9 December 2010, the UK government published draft legislation which, once enacted, will introduce an ability for UK-resident companies to make an irrevocable election to have their non-UK branches treated as exempt from UK corporation tax, rather than taxable with credit for foreign tax, as currently.

The new regime is elective because some companies (e.g. in the oil industry) are likely to want to continue to be able to take advantage of the deferral benefit provided by being able to set branch losses against their UK profits under the current system. This benefit will be lost for companies making the election. However, such companies will benefit by no longer having to pay UK tax on branch profits to the extent that such tax exceeds the tax paid locally.

The exemption will apply to all branch profits and losses, including chargeable gains, but subject to some exceptions. In particular companies carrying on predominantly investment business will not qualify for exemption. In addition branches in many jurisdictions will have to consider broad anti-diversion rules.

A transitional rule will apply such that companies that have made losses in their branches prior to the date of the election will not be able to benefit from exemption until their branches have made enough corresponding profits subject to UK tax.

This announcement follows a period of consultation on this policy. Consultation is ongoing on the detail of the draft legislation, with comments sought by 9 February 2011. The legislation is expected to be enacted later this year as part of the Finance Act, with the ability to elect taking effect from a date to be specified in 2011.
THE REFORM OF THE TAXATION OF NON-UK BRANCHES

Historically, like the U.S., the UK has taxed the profits of non-UK branches of UK-resident companies, while giving a foreign tax credit for non-UK taxes on those profits. Likewise, losses from such branches can be set against other profits of the UK-resident company and (subject to certain restrictions which have been called into question under European Community law) against profits of certain UK-taxpaying affiliates of that UK-resident company. There is no specific provision for the clawback of branch losses used in this way when the branch becomes profitable although it is expected that when this occurs, the branch will be able, under the relevant non-UK tax rules, to use its losses to reduce the local tax charge. That in turn limits the UK foreign tax credit in respect of those profits and hence increases the overall UK tax charge once the non-UK branch becomes profitable.

As described in our client memorandum of 2 August 2010, the UK government has been consulting on the possible replacement of this credit system for non-UK branches with an exemption system. The UK government has now concluded on the policy design – an elective exemption regime as described below. Details of the policy design were included in the document entitled Corporate Tax Reform: delivering a more competitive system, published by HM Treasury on 29 November 2010. Draft legislation was published on 9 December 2010 (along with other draft clauses for the Finance Bill 2011) and a further supplementary technical memorandum was published on 20 December 2010. The draft legislation is open for consultation until 9 February 2011.

UK-resident companies will shortly be able to elect for the profits (and losses) of their non-UK branches to be exempt from UK corporation tax. The effect of such an election would be broadly to align the UK tax treatment of non-UK branches with the treatment of non-UK-resident subsidiaries following the recent introduction of exemption from UK corporation tax for most dividends and other distributions received by UK-resident companies.

We do not expect that the election will be attractive to all UK companies because of the loss of the ability to set losses of the non-UK branch against the UK-resident company’s other profits. In the oil and gas sector in particular, this treatment has been beneficial in relation to the costs of abortive exploration activity by non-UK branches. Some companies may conclude that this benefit outweighs the benefit of not having to top up local tax to UK rates, particularly as it may be possible to incorporate a non-UK branch in a reasonably tax-efficient manner once it becomes profitable. On the other hand, companies in sectors such as banking or insurance, which have a regulatory or other impetus to establish branches rather than subsidiaries, are likely to benefit from the election. The exemption for non-UK branches may be of interest in cases where establishing a subsidiary in the relevant jurisdiction would trigger non-UK tax such as capital duty. It may also be of interest where the relevant jurisdiction imposes withholding tax on dividends from local subsidiaries but no branch profits tax on a local branch. HM Treasury estimates that the elections will cost the Exchequer approximately £100 million per year.
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For UK companies not making the election, the current credit system, described above, will continue to apply. Once in force, the election is irrevocable and will apply to all of a company’s branches. However, the election is company-specific and so it is not necessary for companies within a group to have consistently elected or otherwise. It may be desirable for groups whose main UK trading entity makes the election to retain a UK-resident company that does not make the election. This company could undertake non-UK business thought likely to be loss-making initially, though it should be noted that the ability to use any losses in the UK will be more limited in this scenario.

THE EFFECT OF THE ELECTION

Subject to certain exceptions (summarised below), the effect of the election will be to reduce or increase the UK-resident company’s taxable profits or losses, wherever earned, by, respectively, the amount of the profits or losses attributable to that company’s non-UK branches. The same rules apply to chargeable gains and losses, with the proviso that an excluded non-UK loss cannot increase a chargeable gain, and an exempt non-UK gain cannot increase an allowable loss. Profits and losses will be attributed to branches in treaty jurisdictions broadly according to the profit attribution method in the “Business Profits” article of the relevant tax treaty. This is normally, though not invariably, based on the notion of treating the branch as an “independent enterprise” dealing at arm’s length with other parts of the entity to which it belongs. However, there are variations within the UK’s wide treaty network. This approach has the merit of ensuring that the UK will only exempt the amount of tax which the treaty partner is permitted to tax. Where there is no relevant tax treaty (a “relevant tax treaty” is one with a non-discrimination provision), the 2010 OECD model tax treaty is deemed to apply for these purposes. However, this only binds the UK and does not affect how the relevant non-UK jurisdiction computes local branch profits. There is therefore scope in such cases for a mismatch between the branch profits which the UK exempts and those which the local jurisdiction taxes, especially as the 2010 OECD model tax treaty’s “Business Profits” Article makes significant changes to the “independent enterprise” attribution principle. These changes include the recognition for tax purposes of intra-entity “royalties” and (for non-financial institutions) intra-entity “interest”. Such internal “payments” will reduce the profits exempted by the UK but not necessarily the locally-taxed profits. Hence double taxation or double non-taxation is a risk, at least where the non-UK branch is in a jurisdiction which has no relevant tax treaty with the UK.

However, partially because the UK’s treaties are generally not specific as to how profits are attributed and because the OECD recognises different approaches to this, the draft legislation sets out a method for attributing equity and loan capital to a branch for the purpose of calculating its profit or loss. The method chosen is to attribute part of the actual capital of the UK company to the branch on a just and reasonable basis. A non-UK branch of an insurance company, on the other hand, is simply deemed to have the “free assets” it would have if it were a separate enterprise. These provisions take effect as a limit on the amount of profits that will qualify for exemption as calculated by reference to the appropriate treaty, although these provisions do not apply if there is a relevant tax treaty providing for a different method of
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attribution. Where an election is not made the same provisions will apply to limit the amount of credit that is available. Arguably this clarifies rather than amends the existing position. We would not expect that this would be a significant limitation in most cases.

Generally, companies are expected to minimise the profits subject to tax in the exempt branch jurisdiction, and to make claims and elections (e.g. for capital allowances) which reduce the corporation tax measure of profits in that branch.

Given that enterprises engaged in international shipping and air transport operations are typically taxed (under double tax treaties and equivalent arrangements) only in their jurisdiction of residence, the profits of UK companies conducting such operations from branches in treaty jurisdictions should not be UK-exempt, because such profits would not be attributable to the branch under the applicable tax treaty.

EXCLUSIONS

Even where an election has been made, profits of a non-UK branch will not be exempt in the following circumstances:

- where the company is a “small” company and the branch is in a jurisdiction which does not have a relevant tax treaty (this is to limit the scope for individual tax avoidance: there is an equivalent restriction on the tax exemption for dividends received by “small” companies);
- profits arising from life assurance or permanent health insurance (the position of companies carrying on such business is being considered as part of a wider review of their tax regime);
- where the company is predominantly carrying on investment business; and
- where the company is a close company and the profits are chargeable gains (this exclusion probably goes further than needed to target capital gains tax avoidance by individuals).

The UK is also keen to avoid the branch exemption regime being used to set up low-taxed branches in other jurisdictions which are UK tax-exempt. Under the credit system an equivalent of the UK’s controlled foreign company (“CFC”) rules is not required but under the exemption system, where tax on the branch’s profits will no longer be topped up to the UK rate, it is logical that an equivalent will be introduced. As the CFC rules are complex and likely to be replaced next year, the government has proposed to replicate only the essence of the rules, to be replaced when the new CFC rules are introduced. This is a pragmatic solution but is likely to give rise to considerable problems for any companies to which an election has effect in the interim period. This is because much of the complexity that has not been introduced consists of safe-harbour provisions.

Under the draft legislation, income profits (chargeable gains are not affected, nor are income losses) will not be exempt where the amount of tax paid in the jurisdiction of the branch is less than 75% of the UK tax that would have been paid on the same profits (the main rate of UK corporation tax is currently 28%, coming down to 27% in April), unless they are less than £50,000 for the year for a company which is not a “large” company, or £200,000 for a “large” company, or the motive test is satisfied. The motive test is
modelled on the equivalent test in the CFC rules. It has been notoriously difficult to get clearance for the purposes of those rules but it is hoped and expected that HMRC will take a more liberal view in this context. In summary, the motive test requires both that none of the transactions which produce the relevant profits has the effect and the purpose of achieving a reduction in UK tax and that it is not one of the main reasons for the company carrying on business through the permanent establishment to achieve a reduction in UK tax by a diversion of profits from the UK. This will not be an easy test to satisfy in any but the most straightforward situations.

Where profits are subject to UK tax because exemption is excluded, credits for any foreign tax should be available.

### TRANSITIONAL RULES

The intention of the transitional rule is to maintain the clawback of relief for branch losses where loss relief has already been given in the UK. Where a company has made aggregate branch losses for any period in the previous six years (and for future periods this can be extended back further, subject to a cut-off date of 2005, if a branch has made more than £50 million losses in an earlier period), the exemption will not take effect immediately unless it is exceeded by aggregate branch profits made subsequent to the first such period in which a loss is made but prior to the date of the election. Instead it will be deferred until aggregate branch profits have been made in following periods which exceed the amount of the remaining loss. Any aggregate branch loss made in a subsequent period will be ignored. This rule only works by reference to income profits (i.e. not chargeable gains), but if it applies, it will also defer exemption of chargeable gains.

In applying these rules there may be practical difficulties (because of how businesses evolve over time) in identifying the branch in which losses arise and the branch in which profits arise subsequently.

Owing to the fact that this rule works on an aggregate basis, it is likely it could produce winners and losers, for example losses in a branch in a low-tax jurisdiction could be exceeded by profits made in a high-tax jurisdiction and, subject to the motive test, the subsequent profits in the low-tax jurisdiction would be exempt. Companies considering making the election should take account of the likely impact of these rules in deciding when to elect. The UK government is considering bolstering the intended effect of the transitional rules with an anti-avoidance provision. While the election is generally irrevocable, it should be noted that if the transitional rules apply it can be revoked prior to taking effect.

No specific transitional rules for chargeable gains have been announced. If this position remains, accrued but unrealised gains (and losses) on branch assets will be fully exempt once the election applies.

### UNRESOLVED ISSUES

The draft legislation is to some extent a work in progress and a number of the details and consequential changes in what is a major change to the UK tax system are still under consideration. Some of these
issues are set out in a technical note by HM Treasury on 20 December 2010. In particular, the UK government is still considering whether to introduce further anti-avoidance rules, notably regarding leasing transactions and intra-group transfers of chargeable assets to/from an exempt non-UK branch. It is also considering further rules to deal with capital allowances and similar reliefs where depreciable assets (e.g. intangibles) are used by both an exempt non-UK branch and by other parts of the same UK-resident company. It seems likely that still further issues will be identified as HMRC work through the details.

OTHER ISSUES

It will be interesting to see whether the UK’s treaty partners will wish to modify double tax treaties so as to limit benefits where income or gain accrues to the non-UK branch of a UK company which is more favourably taxed than the other operations of that UK company. As things stand the application of the UK’s treaties is a notable exception to the convergence of the UK tax treatment of a non-UK branch and a non-UK subsidiary.

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CONTACTS
London
Michael McGowan +44-20-7959-8444 mcgowanm@sullcrom.com
Andrew Howard +44-20-7959-8501 howarda@sullcrom.com
Emma Hardwick-Panks +44-20-7959-8401 hardwicke@sullcrom.com