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The International Business  
Information Source™

August 2010  
Volume 12, Number 8

## An Exemption for Overseas Branch Profits—The Discussion Continues

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On July 27, 2010, the Government published a discussion document on reforming the taxation of profits of overseas branches of UK tax-resident companies with a view to introducing an exemption in relation to those profits (and a corresponding restriction of loss relief). A joint HMRC/HM Treasury Open Day was then held on September 7, 2010 at which further details have emerged as to the way in which the various issues will be resolved.

The primary impetus for change is the desire to achieve greater territoriality in relation to corporation tax, a principle that is already reflected in the overseas distribution exemptions that were enacted with effect from July 1, 2009 and that derive their origin from a consultation process on foreign profits which began in 2007. Currently, UK companies are subject to corporation tax on the profits of their foreign branches, with double taxation relief (DTR) given for any foreign tax paid on the same profits to prevent double taxation. Where the foreign tax paid is less than the UK tax, the company must pay the additional UK tax.

A number of questions are posed by the discussion document in relation to the perceived difficulties that need to be overcome to achieve an effective exemption. The key questions relate to:

- the scope of the exemption (and how closely it should be linked to the profit attribution provisions in the UK's double taxation arrangements with overseas territories);
- the treatment of accrued and unrealized chargeable gains on assets held by or transferred to foreign branches;
- preventing artificial diversion of profits to branches

in low tax jurisdictions (with proposals to align the branch profits exemption with the controlled foreign companies (CFC) legislation at Chapter IV of Part XVII of Income and Corporation Taxes Act 1988); and

- the extent to which losses arising from the activities of an overseas branch will continue to remain available.

The options under consideration will also be assessed by their degree of fairness and simplicity. Detailed proposals and draft legislation will be published later in

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2010, with legislation scheduled to be included in Finance Bill 2011.

### Scope of the Exemption

The Government is currently considering two options with regard to defining the scope of the exemption.

The first option is to follow the allocation of profits required under the business profits article of the relevant double tax treaty. This route entails potential uncertainties when it comes to resolving issues that need to be dealt with under the mutual agreement procedure. However, it does have the virtue of following the income measure used for the purposes of DTR. A variation on this theme, which was considered at the Open Day on September 7, 2010, was replicating the attribution provisions within the new Article 7 of the OECD Model Double Taxation Convention. While this would provide a degree of consistency, it was noted that none of the UK's double taxation arrangements currently contain the new article and adopting this approach would not therefore prevent double taxation or double non-taxation.

The second option under consideration is drafting the scope of the exemption as a mirror image of the

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profit calculation used in relation to UK branches of overseas companies (in accordance with sections 21 to 32 of Corporation Tax Act 2009). However, this option also has some disadvantages. Tax practitioners and HMRC representatives involved in the working group (which met on August 3, 2010) appear to prefer the approach of calculating the UK chargeable profits of a UK company as an alternative to calculating the 'exempt profits' for each overseas branch. Having a domestic law calculation also raised the prospect of creating a mismatch with the profit attribution determined in accordance with a double tax treaty (which could give rise to double taxation or double non-taxation). This may lead, in turn, to a need to retain DTR in respect of profits that were taxed twice.

One major issue for insurance companies and banks, when it comes to determining the amount of branch profits, is how capital should be attributed to the branch. For banks this will affect the amount of interest expense

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that may be claimed against branch profits. The two authorized methods under the OECD guidelines are the 'capital allocation' approach (which is rooted in the Basel I and II regimes) and the 'thin capitalization' approach. The Government's view is that HMRC's current thin capitalization approach for UK branches of overseas banks effectively adopts a capital allocation methodology in any case (owing to the starting point for the approach being to take the bank's overall capital ratio after attributing risk-weighted assets to the UK branch). However, in the discussion document the Government notes that a discrepancy may occur where the capital ratio of the non-resident bank falls below a level that is comparable to other UK banks. For insurance companies, the problem centers around how much investment income to allocate to the branch in the first place. The Government currently believes that the most appropriate method of attributing capital is the allocation method used for the purposes of DTR. The discussion document points out that the alternative thin capitalization method could require more assets than are held by the insurance company to be allocated to the branch.

#### **Chargeable Gains**

The Government is also considering extending the scope of the foreign branch exemption to cover chargeable gains on assets held by the overseas branch. This raises questions as to how to treat accrued but unrealized gains

and how to apportion gains on assets used partly by overseas branches and partly by the UK concern. At the Open Day on September 7, 2010, a form of 'holdover' regime was suggested that would result in accrued gains on assets being 'transferred' to the overseas branch being frozen and taxed upon eventual disposal. The post-'transfer' gain would be exempt. However, the question of how to identify a 'transfer' arises, given that there will be no disposal where assets held for the purposes of UK operations simply become held for the purposes of those of the branch instead. A similar problem was identified in relation to assets that had a shared use between the UK concern and an overseas branch. The Government's initial reaction has been to suggest that a 'just and reasonable apportionment' approach be taken in these circumstances.

With regard to existing branch assets, it seems that gains that have accrued prior to the introduction of the exemption will remain within the scope of corporation tax. However, the Government does not appear to have taken a definite view on this point, but neither has it formed a definite intention to exempt overseas branch chargeable gains in the first place. This would be disappointing, as leaving branch gains within the charge to UK corporation tax could be argued to represent a departure from the principle of territoriality at the heart of the foreign profits consultation.

#### **Anti-Avoidance**

A major area of the proposed reform will be how to frame the anti-avoidance rules needed to prevent the exemption being used as a means of circumventing the UK's CFC legislation. A degree of conformity will be needed and the Government is considering three options which, by and large, attempt to limit the scope of the exemption to the profits that would not otherwise fall within the CFC apportionment rules were the overseas branch to be a subsidiary.

An obvious problem arises from the fact that reformed CFC rules are not due to be enacted until Finance Bill 2012 (whereas a foreign profits exemption is expected to be introduced by Finance Bill 2011). However, the CFC-style limitation to the branch profits exemption will be revised again in 2012 to bring the exemption into line with the new CFC legislation.

A number of options are under consideration. Two options appear to merely limit the scope of the exemption, with overseas branch profits falling outside the exemption being subject to corporation tax with credit for overseas tax (as is currently the case). The third option envisages the CFC legislation being applied to the overseas branch as if the branch were a subsidiary. This last option would appear to be more complex, and may result in the profits of the branch having to be recalculated on a different basis depending on how the scope of the exemption is defined in the first place. Conversely, the incorporation of exemptions similar to those in the CFC rules offers the opportunity of

having a level playing field when comparing the taxation of overseas branches and overseas subsidiaries. At the Open Day on September 7, 2010, the Government did seem to be favoring the third option (i.e., applying the CFC rules to the branch as if it were a subsidiary). This did, however, raise the question as to how the motive test and the effective management test (for the purposes of the CFC exempt activities exemption) would apply to an overseas branch.

The Government is also considering limiting the exemption to overseas branches in territories with which the UK has double tax arrangements containing a non-discrimination provision. This would seem to represent a 'doubling-up' of anti-avoidance measures, in the event that the Government were to introduce CFC-type restrictions as well as a treaty-based qualification. Adding this extra condition to the exemption would also undermine the conformity of the branch profits exemption to the distribution exemption (in respect of which only distributions received by 'small' companies are required to be received from treaty jurisdictions to benefit from the distribution exemption). Indeed, the Government does not believe that it is appropriate in any case to extend the branch profits exemption to small companies that have branches in non-treaty jurisdictions due to the potential for avoidance to which this might give rise. Plans for a specific anti-avoidance rule applying exclusively to small companies are also being considered. In these last two respects, at least, the proposed treatment of small companies with branches may be seen as being aligned to the treatment of small companies receiving dividends from overseas subsidiaries. Small companies should therefore be left in no worse a position than before as there appears to be no suggestion that DTR will be unavailable for future overseas branch profits of small companies.

#### Branch Losses

The understandable *quid pro quo* of a branch profits exemption is the disallowance of branch losses (at least insofar as the losses of subsidiaries cannot be used in analogous circumstances). The Government is therefore proposing to allow terminal loss relief but also accepts that there is a strong case for the exemption to be accompanied by rules allowing relief for losses beyond only terminal losses.

This will obviously be an area of concern for those enterprises that favor a branch model of business (principally in the banking, insurance, and oil and gas sectors). The loss of current year loss relief and group relief in respect of losses made by overseas branches will disproportionately affect these sectors. Accordingly the Government is considering allowing companies to elect out of the branch profits exemption or, alternatively, to allow loss claims to be made but for tax to be 'clawed back' once the branch moves back into profit. The form of a potential election is, as yet, undecided. There is support for an irrevocable election among taxpayers, due to the

long-term nature of some loss-making branch activities (particularly in the oil and gas sector) and the Government is considering this. The possible claw-back mechanisms under consideration include taxing subsequent branch profits either with or without double tax relief until the tax saved by the losses used is recovered.

The use of brought forward overseas branch losses is also being consulted upon. The proposed branch profits exemption would potentially delay the point at which brought forward losses are exhausted and the Government is therefore considering a number of options to redress the balance. At one extreme, brought forward branch losses could be cancelled. A 'claw-back' treatment is also being considered that would essentially require a company to

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match all its brought forward branch losses with branch profits before it would be entitled to an exemption in respect of branch profits. Despite the uncertainty in this area, the Government's response to concerns regarding the revaluation of deferred tax assets, which is that the Government is only concerned that deferred tax assets should not become *more* valuable as a result of the branch profits exemption, does at least provide some reassurance as to the intended effect of the proposed treatment of overseas branch losses.

#### Other Issues

The Government is currently proposing that overseas branch profits will remain within the scope of UK corporation tax in a number of discrete areas. Worldwide air transport and shipping profits will remain subject to corporation tax as they are generally taxed by the state of residence under the UK's double taxation treaties. Overseas branch profits from BLAGAB business will remain subject to corporation tax, as this is a proxy for the taxation of profits accruing to policy holders and the Government does not want to give insurers an incentive to transfer policy books to overseas branches.

It also seems that the Government wants profits of overseas branches in low-tax or no-tax jurisdictions to remain within the scope of corporation tax. It was made clear at the Open Day, on September 7, 2010, that by using the term 'low-tax' the Government did not mean to suggest a comparison to the 'lower level of taxation' test used by the CFC rules but, rather, meant 'no-tax or very near to no-tax.' It appears that this exclusion would only be relevant for UK companies with overseas

branches in treaty jurisdictions (as branches in non-treaty jurisdictions should be largely excluded by the proposed CFC-style restrictions), which suggests the Government is becoming more concerned about the effect of low tax treaty jurisdictions on the UK tax base. As with proposals

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to limit the branch profits exemption to treaty jurisdictions, this approach does not seem to be entirely consistent with the tax position for overseas subsidiaries given the CFC-style restrictions to the branch profits exemptions that have already been proposed.

Capital allowance pools may need to be split, and the Government is currently considering whether a deemed disposal and reacquisition of branch plant and machinery is needed (with a corresponding balancing

charge or allowance).

Despite the anti-avoidance protections discussed above, the Government also remains concerned that it will be possible to ‘artificially’ divert income from intangibles (and other passive forms of income) to overseas branches. It is therefore considering an ‘effective connection’ test that will identify passive income that will remain subject to UK corporation tax.

**Conclusion**

Viewed in the whole, the progress made by this consultation has been positive. The Government is clearly trying to introduce a regime that will simplify the tax calculations for the majority of companies with overseas branches. The objective of simplicity should probably be viewed in this practical context as it does not seem as likely that the wholesale removal of parts of the existing tax code (the DTR rules, for example) will be possible. The greater challenge will be achieving consistency of tax treatment between conducting overseas operations through subsidiaries and branches in order to prevent those sectors favoring a branch model from being unduly prejudiced. Whatever the outcome, the situation is likely to be an improvement on the current rules, not least because HMRC estimate that the new exemption will have a negative effect on exchequer revenues. In this regard, at least, the UK business community is likely to congratulate the Government. □