

## Foreign Branch Profits: Consultation on Scope of Exemption

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### BACKGROUND

When a UK company has a branch overseas, the results of that branch are incorporated into the company's own results for corporation tax purposes, and taxed as part of the company's taxable profits, with credit being given for any tax paid in the relevant overseas jurisdiction.

This means, amongst other things, that the company gets immediate tax relief in respect of any losses incurred in a branch, which is particularly relevant whilst the branch is in a "start-up" stage. Once the branch starts generating taxable profits, the UK company can normally arrange to transfer the activities of the branch into a new overseas subsidiary and, since the introduction of the so-called dividend exemption, any dividends received from that subsidiary will generally not be subject to UK tax. In short, the UK company gets UK tax relief for losses incurred overseas without subsequently having to pay UK tax on profits.

### BANKS AND INSURANCE COMPANIES

In two particular sectors, however, the "incorporation" of a profitable foreign branch is not so easily achieved. For regulatory and commercial reasons (especially the efficient allocation of capital) banks are driven to operate through larger single entities, and so to operate overseas through branches, rather than subsidiaries. Similarly, developments in solvency rules push insurance companies, too, to operate through branches, rather than through subsidiaries.

These two sectors would, therefore, prefer profits generated by overseas branches to be exempt from tax in the United Kingdom. That is what appears to have led to a decision by the Treasury that the system of taxation of foreign branches needs changing (legislation is proposed in the Finance Bill 2011), and to the publication of the discussion document released on 27 July 2010. This presents the proposals as an exemption from corporation tax for foreign branch profits, and as being something that will enhance a more territorial approach to company taxation; but, of course, it is not going to be as simple as that.

### THE OIL AND GAS EXPLORATION SECTOR

For one thing, one would have expected a simple exemption for foreign branch profits to mean that neither the profits nor the losses of foreign branches would be taken into account for UK corporation tax purposes. However,

the oil and gas exploration sector also operates abroad through branches, so that relief can be claimed against UK tax for losses incurred in those branches. The oil and gas exploration sector does not want to lose that relief; and it appears that the Treasury is convinced that UK competitiveness requires that relief for overseas losses must continue to be made available.

## DOUBLE NON-TAXATION

Another complication is that a straightforward exemption would raise the possibility that profits might be earned by UK companies abroad, without suffering tax abroad, and then not taxed anywhere. This is what the discussion document refers to as double non-taxation; and what could be more horrifying? So what is actually proposed is some new rules that will exempt from UK tax profits earned through overseas branches in respect of which the relevant overseas territory has taxing rights, defined either by reference to the provisions of the treaty between the United Kingdom and the relevant overseas territory (and, in particular, the "business profits" article), or by using the rules that define the UK taxable profits of non-resident trading companies.

## FURTHER RESTRICTIONS

But an exemption for overseas branch profits could still lead to "artificial diversion of profit" to "very low tax jurisdictions"; and so the discussion document puts forward the possibility that any branch profits exemption might be limited to profits generated by branches in territories with which the United Kingdom has a double tax treaty.

Even then, our treaty partners cannot be relied upon to impose enough tax on foreign branch profits, and so two further measures are proposed. One is to devise a "pseudo CFC" regime for foreign branch profits, so that UK corporation tax can be imposed upon profits generated by a foreign branch in circumstances where, had the profits been earned in a subsidiary, a CFC apportionment could have been made. And, just in case that, too, does not provide the Treasury with sufficient protection, the Government will be considering whether any further anti-avoidance rules are required.

## NOT A SIMPLIFICATION

So any exemption that is introduced for the taxation of foreign branch profits is not going to be a simplification measure. In particular, although they would not often need to apply, the current rules giving relief for overseas tax paid on overseas branch profits would need to be retained for those profits to which the foreign branch profits exemption did not extend.

Given that a branch profits exemption is unlikely to be much used outside the banking and insurance sectors, one wonders why we cannot just have an exemption for the profits of overseas branches of banking and insurance companies, so that everyone else can be left alone.

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