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2011 branch profits exemption

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The UK has traditionally imposed worldwide taxation on any companies which were tax-resident in the UK. However, with effect from 19 July 2011, it has become possible for tax-resident companies to apply to be taxed in the UK on a more territorial basis through the exemption of any foreign branch profits from UK taxation.

This is a welcome development, although, as so often happens when the UK Government attempts to introduce business-friendly changes into the UK tax system, the relevant legislation is lengthy and complex. In practice, there may well be some uncertainties as to its application because a number of the detailed rules refer in rather vague terms to the making of various adjustments or apportionments on a "just and reasonable" basis.

The nature of the new exemption

It is important to emphasise that the new exemption does not make the UK corporate tax system strictly territorial in scope because the new exemption does not exempt either all foreign-source profits or all foreign activities. But it enables the total taxable profits of a UK tax-resident company to be adjusted so that any profits legitimately allocated to foreign branches of a UK company may be exempted from UK corporation tax (with any branch losses then ceasing to be tax-deductible, subject to certain transitional rules for accumulated prior losses).

A relevant "branch" is anything that constitutes a "permanent establishment" for general UK corporation tax purposes (meaning, broadly speaking, any fixed premises of the company itself that are located in a foreign territory or a general commercial agency relationship through which the company does business in a foreign territory).

This makes the UK's corporate tax regime more rational and consistent overall because it has been possible since July 2009 for a UK company to treat most foreign dividend income as tax-exempt in the UK. Therefore, a somewhat arbitrary distinction has existed in the recent past between a UK company which conducted foreign business through separate foreign subsidiary companies (generating dividend income which would usually be exempt from UK taxation in the hands of a parent company) and one which conducted foreign business through its own foreign branches (generating foreign business profits which were taxable in the UK).

Although a company's foreign profits are often eligible for reduced UK taxation under existing UK tax laws if such profits are subjected to overlapping foreign taxation, this new exemption regime will usually improve a company's overall tax position in any situations in which the relevant rate of foreign tax is lower than the UK rate (since the total taxation of branch profits will usually be capped at the foreign tax rate, with no UK tax now being charged in addition). Even in cases where the foreign tax rate is higher than the UK rate there might still sometimes be an administrative advantage in treating branch profits as tax-exempt instead of treating such profits as potentially taxable and then calculating relevant double tax reliefs in order to claim an effective tax exemption.

Claiming the tax exemption

The new exemption is claimed by means of an election. The new exemption regime is optional and so companies are at liberty to continue using the traditional credit system, under which worldwide income is fully taxable in the UK but also eligible for double tax relief when allocated to a foreign permanent establishment in a country that imposes local taxation on an overlapping basis.

A company may enter the new regime at any time from 19 July 2011 onwards but entry must be on an "all or nothing" basis, in that the new rules either apply to all foreign branches or to none; a company cannot choose to claim exemption only in relation to particular foreign branches whilst also continuing to claim the traditional form of credit for certain other branches. However, as explained below, the operation of the system might be compulsorily deferred under certain circumstances.

There is no particular time limit within which a company must decide to enter the new regime but a decision to enter, once made, is irrevocable after the "relevant day." An election to enter the new system is freely revocable at any time before the relevant day. This is the day on which the company's next corporation tax accounting period was expected to begin, viewing the matter as at the date of the election to enter the system. If, after the election has been made but before the relevant day, changes are made to the length of the company's accounting periods, the exemption will still operate as from the relevant day, so that such a change to the accounting mechanics will neither accelerate nor postpone the date on which an election actually takes effect.

If a company has accumulated losses, it might wish to make a "streaming election" (as explained further below) and such an election must be made at the same time as the basic election to apply the exemption.

Calculation of exempt branch profits

Since the UK "head office" part of a company will remain fully taxable when the company elects to exempt its foreign branches from taxation, it is important to ensure that profits are allocated fairly between the UK and non-UK sections of any company which has elected for this new tax treatment. In principle, profits (or, where relevant, losses) are allocated to a branch on the basis provided for in any applicable double tax treaty which exists between the UK and the foreign country concerned. However, it seems that there will be a fairly uniform basis of calculation in practice because the position in countries without a relevant treaty will be governed by the OECD model treaty and certain actual treaty provisions will be over-ridden.

Since it would be in a company's interest to inflate the profits of an exempt branch (thereby suppressing the profits of the fully taxable UK part of the company) there are various provisions which required certain forms of expense to be taken into account at branch level when calculating branch profits. For example, a company is assumed to have claimed any capital allowances that might have been claimed in respect of capital equipment used at an exempt branch, and the special tax deduction allowed for the cost of certain employee incentives might need to be allocated to a tax-exempt branch if the work of the relevant employees is associated with the branch rather than with head office.

In principle, the exemption is available in relation to both the income profits and the capital gains of a branch (and also the IP rights of a branch, which may sometimes have a hybrid revenue and capital character for corporation tax purposes), although capital gains cannot be taken into account in the case of close companies.

Special rules require certain prior losses to be taken into account in such a way as to defer the application of the exemption regime after an election to enter the regime has been made. In principle, collective branch losses are set against collective branch profits but it is possible for a company to make a "streaming" election under which losses of specified branches are matched against profits of specified branches.

There are also some special rules which are designed to modify the principles of tax-neutrality that usually apply as between closely related companies that are both chargeable to corporation tax. Since such rules (for example, those applying in relation to transfers of capital assets or intangible assets between group companies) are based upon an assumption of continuity as regards exposure to a particular form of taxation, it is clearly not always appropriate to permit such neutrality in the case of a taxpayer whose activities have become partially tax-exempt.

Exclusions

It should be emphasised that this new facility is only available to companies; there is no corresponding change to the UK's business tax regime for any individuals who trade through foreign branch structures.

In order to maintain consistency between foreign branches and foreign subsidiaries, tax exemption under the new regime is not available in respect of the profits of a foreign branch of a "small" company (ascertained by reference to EU Commission guidelines on staffing levels, balance sheet contents and business turnover) if the branch in question is located in a country where no comprehensive double tax treaty is in force with the UK.

Close companies are eligible for the regime, although (as mentioned earlier) capital gains of such companies are left out of account when applying the exemption, and certain types of insurance business cannot benefit from the exemption at all.
There is no automatic exclusion of branches based in tax havens and offshore centres but, in order to maintain consistency between taxation of foreign branches and foreign subsidiaries, there are certain restrictions on the application of the regime to branches based in low-tax jurisdictions. Unless relevant profits are below a prescribed threshold (initially set at £200,000) it is necessary for the company to satisfy a motive test in respect of a branch based in a jurisdiction which offers a "lower level of taxation" (meaning, in broad terms, less than 75% of the corresponding UK tax exposure).

The motive test relates both to particular transactions and to the existence of the branch structure as a whole; if particular transactions are tainted but the branch itself is not so tainted then partial tax exemption may be available. There is also a transitional rule which entitles a company to claim exemption on the basis of assumption that its motives were not improper if it had already operated a relevant branch structure for a specified time before the new exemption regime first took effect, provided that the nature and scope of the branch's activities did not change to more than a prescribed extent.

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