ALL CHANGE ON THE TAX FRONT

WITH SO LITTLE GUIDANCE AVAILABLE ON CORPORATION TAX FOR FOREIGN FIRMS WITH UK BRANCHES, REFORM HAD TO COME SOONER OR LATER. **MOHAMMED AMIN** AND **HARSHA BORALESSA** OF PRICEWATERHOUSECOOPERS FIND OUT MORE.

Most foreign groups that have a significant UK presence tend to set up a UK subsidiary company. While 'branches' appear less often than subsidiaries, in some sectors such as banking they are common and can be found in most industries and services, such as retailing. We expect them to arise more frequently in future, however, especially branches of companies that chose to incorporate directly under European Union law to demonstrate their non-national credentials.

With branches having been around since the inception of taxation, it is surprising how little statutory guidance there is regarding their taxation. The corporation tax charge on branches comprises just one section of the Taxes Act, taking up less than 20 lines of text.

This absence of detailed legislation has meant that the taxation of branches has been governed by 'custom and practice', as modified by case law. For example, there is little guidance on the deductibility of interest expense in connection with a branch. It is relatively clear that interest on borrowings demonstrably taken out solely for the purposes of generating branch income is deductible in computing branch profits. But there has been no clear mechanism for taking the overall interest expense incurred by a company and allocating part of that against the branch's income.

Reform was announced in this year's April Budget speech and on 25 July 2002 the Inland Revenue published draft legislation. Most discussion of the proposed legislation has focused on banks, although the new rules will apply equally to all industries and the government expects to raise an extra £650m of tax each year from the changes.

To illustrate the changes, we have XYZ Inc, a non-UK resident company. The simple question is: "What should be the profit of the UK branch subject to corporation tax?" As explained above, the present statute gives little guidance. The new legislation, expected to apply from 1 January 2003, takes some radical steps.

DON'T CALL IT A BRANCH. Double taxation treaties do not refer to "branches", they refer to "permanent establishments" (PEs). Under the UK's tax treaties, for example that with the US, an American company's business profits are only chargeable to corporation tax if it has a PE in the UK. There was never a detailed statutory definition of a branch, but now we will have a statutory definition of a PE, modelled on the language of tax treaties. A precise definition will make it much easier to decide if a foreign company has come within the scope of corporation tax.

FIGURE 1

XYZ Inc balance sheet

	$	$
Operating assets		
– overseas	25,000	
– in UK branch	11,000	36,000
Business liabilities, interest bearing		
– overseas	(20,000)	
– borrowings specifically by UK branch for branch business	(11,000)	(31,000)
Net assets		5,000
Share capital and reserves		5,000

XYZ Inc profit and loss account

Turnover		
- overseas	2,800	
- in UK branch	1,200	4,000
Operating costs and interest paid		
- overseas relating to overseas business	(1,500)	
- in UK branch	(800)	(2,300)
Administration costs incurred overseas relating to UK branch		(300)
Profit before tax		1,400

ASSUME IT STANDS ALONE. The profits attributed to the PE are those it would have made if it were a separate and distinct enterprise, dealing independently with the non-resident company.

This also mirrors the language of tax treaties. However, the practical application of the provision raises many difficult conceptual questions. The OECD, which considers international tax policy, started consultations in 2001 regarding practical aspects of this provision. This consultation process is still under way, but as discussed in below, the Inland Revenue appears to have pre-empted some of the conclusions.

ALLOW RELIEF FOR COSTS INCURRED OVERSEAS. To quote the draft legislation, "There shall be allowed as deductions any expenses incurred for the purposes of the PE, including executive and general administrative expenses so incurred, whether in the UK or elsewhere. This applies only to expenses of a kind that would give rise to a deduction if incurred by the PE in the UK."

While it has always been possible to seek a deduction for "branch costs incurred in the head office", statutory support for the deduction is welcome. For XYZ Inc, it assures a deduction for the administration costs incurred overseas of $300. This new provision does not give general authority for allocating part of the overall interest expense incurred at "head office" (that is, interest paid overseas on general corporate borrowings) to the branch. In the case of industries such as banking, even if there are no interest bearing liabilities in the UK, it has always been accepted that the branch profit cannot be determined without some deduction for overall financing costs. The difficulty has been in determining the deductible quantum.

'IT IS SURPRISING HOW LITTLE GUIDANCE THERE IS – THE CORPORATION TAX CHARGE ON BRANCHES COMPRISES ONE SECTION OF THE TAXES ACT, TAKING UP LESS THAN 20 LINES OF TEXT'

However for, a retailer, say, it is not self-evident that part of the head office interest expense is incurred for the purposes of the UK PE – for instance, all of the debt may have been in place before the UK PE was even established.

ASSUME THE BRANCH HAS EQUITY. No deduction may be made in respect of costs in excess of those that would have been incurred if three assumptions are made in computing the PE's profits:

- the PE has the same credit rating as the company of which it forms part;
- the PE has an equity capital not less than it would have if it was a distinct enterprise; and
- loan capital of no more than it would have, if it had that equity capital.

This provision is the one expected to raise the extra £650m a year in tax revenue. While it will apply to all companies, it appears targeted specifically at banks. In the case of XYZ Inc, the UK branch has no equity, since there are UK branch assets of $11,000 and UK branch liabilities of $11,000. The Inland Revenue's position is that no independent company would operate with zero equity.

If XYZ Inc should have had equity of, say, $2,000 then part of its interest costs will be disallowed, in our case 2/11 of the branch interest, as we are assuming that all the liabilities are interest bearing.

ASSESSING THE EQUITY. This offers much scope for dispute between taxpayers and the Inland Revenue, as do many other transfer pricing issues. Real world companies operate with all kinds of gearing ratios, sometimes negative ones, where operating losses or goodwill write-offs have wiped out the balance sheet equity.

Even in banking, where the Basel Capital Adequacy Guidelines lay down minimum requirements for equity compared with risk weighted assets, there is significant scope for dispute, as most banks operate with more than the minimum equity, but there is no obvious standard regarding how much more.

IS THE LEGISLATION NEEDED? We are sceptical about the need for legislation to raise the £650m a year indicated. The Inland Revenue acknowledges that the legislation will have no direct impact on companies based in countries that have a tax treaty which contains a business profits article. The reason is that tax treaties override domestic law, and none of the UK's present tax treaties contain the language about deemed equity of the PE. Accordingly, UK branches of overseas companies from all the major territories such as the US, Canada, EU countries and Japan) should, strictly speaking, be unaffected.

However, it is open to the Inland Revenue to argue that the "independence" hypothesis in present treaties allow them to deem the existence of branch equity. It has argued in this way under old law, and for companies whose UK branches are long-standing, these issues have generally been settled.

However, such agreements can always be re-opened for future periods, since the treaty must be applied for each taxable period. Foreign companies are likely to have difficulty resisting such a new Inland Revenue interpretation of the treaty, since, in many cases, their home jurisdiction will already be applying similar concepts.

The legislation will bite immediately on companies from territories that don't have a tax treaty with the UK containing a business profits article. However, we doubt if companies from such countries make enough profits in their UK branches, and with sufficient equity, to raise the extra tax revenue expected.

Accordingly, the extra tax revenue, if it arises, will come from the new interpretation of the existing treaties, rather than from the legislation itself. However, enacting the language statutorily will have the benefit of making it clear to everyone how the UK considers the profits of a PE should be computed.

In due course, the Inland Revenue is likely to include a similar clause when negotiating new tax treaties to put any arguments regarding treaty interpretation beyond doubt. We expect it will be able to persuade foreign tax authorities to sign up to the new language, since both tax authorities will then unambiguously be able to apply it to PE's in their territory.

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www.inlandrevenue.gov.uk/consult_new *gives the draft legislation and Inland Revenue explanatory notes. The OECD work on taxation of branches can be found most easily by typing OECD permanent establishments into a good search engine.*