MOORE Kingston Smith

BRANCH PROFITS EXEMPTION

The exemption

The basic rule of UK corporation tax is that a UK resident company is taxed on its worldwide profits wherever arising, including those of any foreign branches. Credit relief is then given against the UK corporation tax for the foreign tax paid on the profits of foreign branches.

UK resident companies can however elect for profits of their foreign branches to be exempt from UK taxation. The exemption will apply to the branch's trading profits, investment income connected with the branch and chargeable gains. The following profits, gains and losses are outside of the scope of the exemption:

- Profits or losses of a trade of dealing in or developing UK land (or which would be if the company were non-UK resident);
- Gains or losses which, if the company were non-UK resident, would be gains or losses on disposals of direct and/or indirect interests in UK land;
- Profits or losses of a UK property business, or profits consisting of other UK property income (with effect from 6 April 2020, subject to transitional provisions);
- Profits or losses arising from loan relationships or derivative contracts to which the company is a party for the purposes of its UK property business or to generate other UK property income (with effect from 6 April 2020, subject to transitional provisions).

A branch in this context is anything that constitutes a "permanent establishment" for UK corporation tax purposes. This will usually mean any fixed premises of the company that are located in a foreign territory, although certain agency arrangements can also be included even where there is no physical presence.

The new branch profits exemption will usually improve a company's overall tax position where the rate of foreign tax is lower than the UK rate because the taxation of branch profits will usually be capped at the foreign tax rate, with no additional UK tax being levied.

In addition, where the foreign tax rate is higher than the UK rate, there may be an administrative advantage in treating the branch profits as tax-exempt, instead of treating the profits as taxable in the UK and then calculating the relevant double tax reliefs.

Making an election

The exemption is claimed by making an election. Once made, the election will enable the total taxable profits of a UK tax resident company to be apportioned so that any profits genuinely allocated to foreign branches of a UK company may be excluded from UK corporation tax.

However, this also means that any branch losses cease to be tax-deductible in the UK. The election will apply to all accounting periods starting after the election is made.

The election is on a company by company basis, so different companies in the same group may elect or not as they choose. The election must be on an "all or nothing" basis for the company making the election. This means that an election will apply to all foreign branches of a company including branches set up after the election is made.

It may be beneficial to hold any loss-making foreign permanent establishments through a separate UK company which does not elect into the branch exemption, if further losses are expected. In this way, UK tax relief should be available in respect of foreign permanent establishment losses.

A company may decide to enter the regime at any time. However, the election must be received by HM Revenue & Customs before the start of the first period to which it relates.

Once an election has been made, it is irrevocable after the day on which the company's next corporation tax accounting period was expected to begin.

How the exempt branch profits are calculated

It is important that profits are allocated fairly between the UK and the non-UK activities of any company that has elected for the branch profits exemption.

Generally, the profits are allocated to a branch on the basis outlined in the relevant double tax treaty between the UK and the foreign country concerned or, if there is no treaty, on the assumption that the Organization for Economic Cooperation and Development (OECD) model treaty is in place.

The relevant profits will be the profits that the permanent establishment would expect to make if it were a separate entity carrying on its business at arm's length from the UK company.

Anti-avoidance

Provisions exist to prevent companies attempting to inflate the profits of their exempt branch to increase profits falling outside UK tax. Certain expenses of the company must be taken into account at branch level when calculating the profits of the branch. For example, any capital allowances available on equipment used at an exempt branch are assumed to have been claimed by the exempt branch. Transitional rules also exist to manage profits of a branch moving from taxable to exempt.

Losses

Where a branch incurred losses in any of the six years prior to the exemption coming into force, profits will become exempt only after the tax losses of those branches in the immediately preceding six years have been matched by branch profits.

Currently all the branches looking back six years and looking forwards are considered in aggregate when working out whether past losses have been matched with subsequent profits.

However, it is possible to elect for the branches in specified territories to be streamed so that, for example, once all the losses previously incurred in that territory have been matched with profits from the same territory, any future profits from that territory will be exempt.

Excluded territories

If a branch is located in a country where there is no double tax treaty with the UK, the branch profits exemption is not available for a foreign branch of a “small” company. A small company is defined in accordance with the EU commission guidelines as a company that: i) has fewer than 50 employees; and, ii) an annual turnover of less than, or equal to, €10 million or an annual balance sheet with assets of less than, or equal to, €10million.

Diversion of profits

There is no automatic exclusion of branches set up in tax havens but there are restrictions on the application of the regime to branches in low-tax jurisdictions. A low-tax jurisdiction is one in which the tax liability is less than 75% of the corresponding UK tax liability.

Where a branch is based in a low-tax jurisdiction and the profits of the branch exceed £50,000 (or £500,000 if there is no more than £50,000 of non-trading income), it is necessary for the company to demonstrate that the branch does not exist for the purpose of avoiding UK tax and it does not carry out transactions that have the purpose of avoiding tax.

The details of the anti-avoidance rules are complex. However, the existence of genuine economic activity in the territory of the overseas branch should help mitigate against their impact.

This exemption could be very valuable for UK companies with overseas branches.

Even if there is no tax benefit, it may reduce the administrative burden of reporting overseas profits and claiming UK tax relief. Due to the complexity of the anti-avoidance rules, advice should be taken before making an election. Please get in touch with our team if you would like to discuss whether your business would benefit from the exemption.

How can Moore Kingston Smith help?

Trading overseas has a complex array of UK and overseas tax implications. We can help analyse how these issues apply to your business and advise whether making an election for the branch profits exemption is appropriate.