

COMPLIANCE COST REVIEW

TAXATION OF UK BRANCHES OF FOREIGN COMPANIES

1. Introduction

1.1 Background

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published in April 2003 for the above-mentioned measure by Inland Revenue. The measure was implemented with effect in relation to accounting periods beginning on or after 1 January 2003. A copy of the published final RIA is attached.

This review re-assesses the compliance cost analysis published in the original RIA and addresses two main questions:

- whether the estimates of compliance costs used in the RIA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the RIA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

2. The published RIA

2.1 Description of the policy change

Under UK law prior to 1/1/2003 the UK branch of an overseas company could operate with little or no equity capital. This meant that, for instance, the branch of a non-resident bank could borrow every pound it lent to its customers and the

interest cost of this borrowing significantly reduced the UK profit. In contrast, a UK bank would need to have equity capital, and would not borrow every pound it lent, with the consequence that it would have a smaller deduction for interest expense. As a result the bank branch would pay less UK tax than a similar UK company. Unlike many other major industrialised countries, the UK had no effective domestic legislation to address this situation and the new domestic legislation was introduced to answer this problem.

The new legislation modernised the taxation of foreign companies operating in the UK through branches by ensuring that a branch will be treated as having such equity and loan capital as it would have if it were a separate enterprise operating in the UK, and engaged in the same or similar activities, under the same or similar conditions as the branch. This will, therefore, restrict the deduction for interest that can be claimed for tax purposes.

2.2 Anticipated compliance costs or savings

The RIA identified that the new legislation would be likely to impact the banking sector most significantly, but did not estimate the number of businesses affected.

It highlighted a one-off cost in setting up necessary systems and in training staff and/or seeking advice on the calculation of the capital that would be attributable to a branch if it was a separate entity trading in the UK. Furthermore, as branches of non-UK banks will require some knowledge of the UK regime with regard to regulatory capital, the RIA identified some training and system costs in this regard. The RIA also noted that there would be some ongoing costs of compliance.

There were also potential offsetting benefits highlighted in compliance costs as the calculation of the amount of capital to be attributed to the branch under the new legislation replaces one ("free working capital") that branches of banks carry out for tax purposes.

Details of these costs and benefits can be found in the "Compliance cost to business" section of the RIA.

3. Conduct of the review

Each compliance cost review is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, the review was led by an HMRC project team supported by consultants. The staff in the review team were completely independent of those involved with the original policy change.

An essential element of the review was consultation with those actually affected, and consultants were commissioned to carry out a small number of targeted in-depth interviews with some of those affected. The research was not intended to deliver any degree of statistical robustness (to do so would have been costly and impractical) but instead to provide indicative findings. Coupled with the consultants own knowledge and expertise, this has allowed the research to identify the major issues and any associated learning points.

The external research was complemented by an internal review of HMRC paperwork and electronic files.

4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	Comments
<p>Were the specific types of cost and benefit identified in the RIA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?</p>	<p>The RIA identified a one-off cost in setting up necessary systems and in training staff and/or seeking professional advice as well as some training and systems costs in regard to the UK regulatory rules capital rules. The external research confirmed this was the case except for systems (for example computer systems) and knowledge of the UK regulatory capital framework which were already in place, so costs in these areas were thought to be minimal. The system costs were more likely to be in respect of how the figures used were interpreted, or which reports were required to be produced..</p> <p>The external research also confirmed that there would be some ongoing costs of compliance One respondent said these were likely to be in respect of internal time alone and would not be significant, whilst another respondent identified ongoing professional advisor costs and these might be significant in years where there are regulatory changes. The disparity was because the first respondent has agreed a standard basis with HMRC for the calculations.</p>

	The RIA said that there would be no need to perform the calculation of “free working capital” in the future. The respondents felt that this did not produce a material saving as the new legislation imposes a more onerous method of calculation for branches.
Were costs/savings incurred at the expected time?	The one-off costs of interpretation and application and the on-going costs were incurred at the expected time. No savings were identified by the respondents.
Were costs/savings incurred by the expected people?	The costs were incurred both in respect of professional advisors and internally and as such are generally in line with the RIA
Were any other costs/savings, not identified in the RIA, incurred ?	None were identified by the external research.
If the type of costs/savings varied from the original estimates, why was that?	No material differences were reported by the respondents, but it was not possible to comment specifically as the RIA appears to state global figures of £3.5m for one-off costs and £0.5m for on-going costs. However, based on the evidence the consultants have collected whilst dealing with this change directly themselves they have roughly estimated that the average one off cost per insurance company was between £20k to £50k and the numbers affected to be about 75 - 100 giving a total of £2m. The evidence suggests costs to banks to be higher and in the region of £50k per bank with 200 affected giving a total of £10m. Therefore overall it was estimated that the number of groups affected to be in the order of 250 - 300 and the total one-off costs to be roughly £12m. They also believe the on-going costs to be higher.
Could such variances have been foreseen at the time?	It is possible that these differences could have been foreseen if the number of groups affected and the individual cost for those affected had been identified at the time of the RIA.
What is the assessment now of the total value of costs and savings?	The respondents experienced total professional fees on transition from £50k to upwards of £100k. The value of internal time was difficult to quantify, but was thought to be significant. Ongoing costs will be minimal in terms of internal time, but complex years may require professional costs of up to £25k to be incurred.
If different from the original RIA, what has caused the	It was not possible for the external consultants to comment on this point due to the lack of

discrepancies?	information contained in the RIA as to the basis of the cost analysis.
With hindsight, were the compliance cost estimates accurate?	Yes. The compliance cost estimates appeared reasonable at the time and identified the main types of costs. However the recent external research has indicated they have been underestimated.

5. Was the process used to estimate compliance costs reasonable?

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

Question	Comments
Who worked on the original RIA?	All the appropriate staff were involved.
Was an adequate audit trail maintained?	The audit trail was reasonable. There was no real consideration at the time that the RIA might be reviewed after implementation. This affected both the documentation and the RIA itself, which is very vague on how the policy change might be monitored. However, systems have improved since this RIA was done and the learning points have been addressed to a large extent.
Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?	There is no evidence of any problems here.
How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?	A public consultation was held along with meetings between the Inland Revenue, banks and insurance representative bodies. These efforts appear reasonable in trying to estimate the compliance cost in the context of the policy measure.
Were the right people (both internal and external) consulted, and were their views reflected appropriately?	A public consultation was held plus meetings with trade representative bodies. There were some concerns and points arising which were published in the RIA.
Did those who were consulted when the RIA was written express views on the reasonableness of the process?	There are no negative indicators.
Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the	The respondents generally felt that the RIA process was generally reasonable although it was suggested that HMRC's knowledge of the workings of a branch and what legal regulators

process?	require could be better. This also applied to HMRC's understanding of the regulatory rules governing the banking system which it was felt added to the incurrence of further internal and professional advisor costs. Furthermore it was felt that HMRC should consider individual (for example the position of loss making branches) as well as standard cases of application.
Were compliance costs estimated for all options mentioned in the RIA?	Compliance costs were only considered for the measure involved. The do nothing option was ruled out and not considered.
Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?	The measure applied broadly to both banking and other financial institutions, which were correctly identified in the RIA. It was also correctly stated that other groups such as non-banking, non-financial and small businesses would not be affected. The respondents generally did not express a view except to emphasise the point that individual circumstances should be considered in addition to a standard case.
Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?	Yes. The RIA did make a genuine attempt to identify all possible costs and savings, even if they could not be quantified precisely.
Was there sufficient time to produce a robust assessment of compliance costs?	Concern was expressed during the consultation about the process including lack of pre-Budget consultation, introduction of the measures six months before they became law, delay in publishing draft clauses and the short consultation period.
Were any assumptions reasonable, given the circumstances at the time?	The external research confirmed that the compliance costs were significant but that the magnitude was understated. It was thought this was due to the difficulty in quantifying internal time and HMRC's lack of understanding of the banking sector.
Were any estimates of compliance costs caveated appropriately?	The RIA did not include caveats and did not refer to costs on an individual basis, instead detailing total costs to UK business. The respondents considered caveats might have been appropriate in the circumstances, such as "it has been estimated that one-off costs to a business might be up to"
Were any risks correctly identified,	The RIA identified that without a change in

addressed and explained?	legislation there would continue to be significant differences between the tax payable by companies operating in the UK through a branch and others which operate through a subsidiary. This was not queried by the external research.
Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?	Not applicable
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	The external research identified that respondents thought that the RIA process could have been improved with greater consultation time in identifying in greater depth how the business sector identified would be affected by the change. The broad conclusion was that the RIA was reasonable, but there are a few learning points as outlined below.

6. Learning points arising from the review

6.1 Learning points for future work in this policy area

- Where the legislation is industry specific as in this case timely consultation should be used to gain a deeper understanding of the businesses and how they would be affected by the new legislation, in particular with regards to compliance costs.

6.2 Learning points for the RIA and compliance cost process in general

- Wherever possible, RIAs should quote estimates of cost or saving per business, as well as at industry level. This lack of information within the RIA has meant it has made the validation of the accuracy of such estimates extremely difficult.
- At the time this RIA was compiled there was no real consideration of what internal HMRC records would need to be kept and there is little evidence of how the compliance costs were worked out. Systems have greatly improved since, although there is still scope for improvement on the analytical side.

7. The way forward

Comments are invited on any aspect of this report or the wider compliance cost review programme.

The learning points are being fed into the policy development process directly if particular to one RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

8. Contact points for further information

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ANNEX : THE PUBLISHED REGULATORY IMPACT ASSESSMENT

http://www.hmrc.gov.uk/ria/foreign_companies.pdf