REGULATORY IMPACT ASSESSMENT (RIA)

TAXATION OF UK BRANCHES OF FOREIGN COMPANIES

Introduction

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. This approach was out of line with the approach adopted by other major industrialised countries and the new domestic legislation addresses this problem.

Purpose and intended effects

The new legislation modernises 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 entity operating in the UK, in the same or similar conditions and circumstances as the branch. This will, therefore, restrict the deduction for interest that can be claimed for tax purposes.

At the same time the new legislation modernises the terminology used in UK domestic tax legislation, changing the taxation of "branches" to the taxation of "permanent establishments" which is more commonly used in our double taxation agreements. Additionally the legislation incorporates into UK domestic law the relevant principles contained in the Commentary on the Business Profits Article of the OECD Model Tax Convention and in the OECD publication "Transfer Pricing and Multinational Enterprises: Three Taxation Issues”. As a result the OECD principles are explicitly applied by UK law to the taxation of all permanent establishments in the UK not just those where the non-resident entity is based in a country with which the UK has a treaty.

The new legislation is likely to impact most significantly in the banking sector, because it is primarily banks that operate through branches with substantial borrowings.

Risks

Without a change in the 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.

Options

New domestic legislation is required to remedy the existing weakness in UK tax law. Doing nothing is not an option as not only would the UK remain out of line with its major international treaty partners but branches of non resident banks could continue to obtain an advantage over UK incorporated businesses, i.e. branches would continue to pay less tax than a similar business operating in the UK through a separate legal entity.

Benefits

UK companies with foreign branches should benefit from the new legislation. This is because the treatment of UK branches of non-resident companies will be replicated for foreign branches of UK companies for the purposes of calculating the UK measure of profits for Double Taxation Relief (DTR) purposes. For example, in the past the following situation could arise: a UK company could have a branch in a country that did attribute an amount of equity capital to the branch. As a result the interest deduction available to the branch would be restricted and the profits taxable in that other country would be increased. The branch would therefore pay more foreign tax. However, because UK law did not attribute equity capital to branches in the same way, the restriction of interest relief would not be taken into account in computing the profits of the foreign branch when calculating the amount of allowable DTR. The profits for UK DTR purposes could therefore be lower than the profits assessed in the other territory with the result that not all double taxation would be relieved. Whilst this problem will not be entirely removed by the new legislation it should be improved as the way in which the UK measures the profits of branches will be more in line with that of its main treaty partners.

Another benefit will be the removal of any unfair competitive advantage that foreign branches may have been obtaining over UK companies. As foreign branches were effectively paying less tax than a UK company carrying on a similar type of business they would have a lower cost base and the potential to offer more competitive prices to customers.

Compliance cost to business

The new legislation will result in some compliance costs for business. For accounting periods beginning on or after 01/01/2003 branches of non-resident companies, which claim a tax deduction for interest, will need to calculate the amount of equity and other capital that they would have if they were a separate entity trading in the UK in the same or similar activities under the same or similar conditions. This mirrors the compliance costs borne by branches in other tax jurisdictions that already have domestic legislation of this kind.

As already mentioned, the impact of this legislation is most likely to fall upon the branches of banks. Banks are regulated entities and as such are required to hold a certain amount of regulatory capital (with specified limits on the amounts of what are effectively equity and loan capital) in order to trade. In order to arrive at a figure of regulatory capital, a calculation is undertaken that takes account of the different financial assets held by the bank and risk weights them (with riskier assets requiring more capital to support them). This produces an amount of capital required by the bank's regulator. But in practice most banks hold capital significantly in excess of the amount required by the regulator.

The absolute minimum level of capital that a branch would need, if it were a separate entity trading in the UK would be the amount of capital required by the UK regulator, the FSA. In addition it is likely that any such hypothesised separate entity would hold a level of capital above the regulatory minimum.

Banks are generally regulated by their home regulator (the regulator in their territory of residence) so, for instance, the branch of a bank resident in France will be regulated by the French regulator and not by the FSA. As a bank will calculate and make returns of its regulatory capital as one whole legal entity separate figures may not be available for the individual branches. Additionally, although most regulatory regimes have been governed by one international accord since 1988, there are some differences between the regulatory

regimes applying in different countries. Although a branch will have details of its financial assets it may not have the expertise or systems to enable it to risk weight its assets in accordance with the UK regulatory regime. There is therefore likely to be 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 the branch if it were a separate entity trading in the UK.

The banks are concerned that the non-resident company may have no knowledge of the UK regime. The Revenue has therefore agreed that where the home state regime, with which the bank is familiar, does not differ significantly from the UK regime the home state regime can be used as a basis for the calculation of the capital that the branch would require at arm’s length. The Revenue has also agreed that where there are significant differences, the home state regime may still be used if adjustments are made for those differences that actually have an impact on the ultimate tax calculation. The branch will still require some knowledge of the UK regime in order to identify the differences between the two and, therefore, there will still be some training and systems costs.

Relatively little information has been provided on the costs of complying with the new legislation but from the information that has been forthcoming it has been estimated that one off costs could total approximately £3.5m. It has also been estimated that the total on going costs of compliance could be in the region of £0.5m per annum.

The calculation of the amount of capital to be attributed to the branch under the new legislation will replace one that branches of banks already carry out for tax purposes, the calculation of “free working capital”, which ascribes a very limited amount of equity capital to the branch for tax purposes. There will in future be no need for branches to carry out a free working capital calculation for tax purposes.

Exchequer Effects

This is a revenue raising measure and the expected yield when the Chancellor announced this change in Budget 2002 was published then in the associated Budget Documentation. (Please see row 32, Table A.1 on page 155 of the 2002 FSBR). The revenue yield is likely to be somewhat lower than anticipated in Budget 2002.

Administrative cost to Government

There are unlikely to be major effects on Inland Revenue administration costs. There may be some one off costs relating to training staff for the new regime but training is only likely to be required by the small number of staff dealing with banks and other financial institutions. The estimated cost of this training is negligible. There will also be some resource cost as staff will be involved in discussions with affected branches about the amount of capital that they would require at arm's length. Again this resource cost is likely to be limited to those dealing with banks and other financial institutions.

Securing compliance

The Revenue has been talking to the banking representative bodies and the major accountancy firms to clarify the application of the new legislation. The Revenue has already published detailed written guidance on the operation of the new legislation taking into account particular points raised by the banks and their advisers. The Revenue will also provide support by talking to affected branches about the practical application of the legislation and the amount of capital that the branch would have at arm's length.

The new regime will be administered as part of the corporation tax self-assessment system and will be subject to the existing compliance procedures.

Impact on small businesses

The new regime will apply to all non-resident companies trading in the UK through a branch, whatever their size. However, as already mentioned, the largest impact is expected to be on banks and other financial institutions. The effect on non-banking and non-financial institution branches is expected to be very limited. And small businesses do not generally operate in the UK through branches.

Consultation

Following the publication of the main draft clauses on the Revenue website a public consultation was launched from 25 July to 4 October. This was accompanied by a series of meetings between the Revenue and banks, their representatives and advisers from Budget time until the close of the consultation. Meetings have also been held with the insurance representative bodies (that is, the ABI and IUA).

Respondents expressed concern about the timing of the change. Never the less, generally it was accepted that:

- capital should be attributed to permanent establishments, because commercially their operations required capital.
- most other major industrialised countries already have rules that have the effect of attributing capital to permanent establishments.

In addition the UK banks largely welcomed the clarification of the DTR position of their overseas operations.

The three broad themes to emerge from consultation were as follows:

- Concern was expressed about the process including lack of pre-Budget consultation with the City, introduction of the measures from 1 January 2003 (six months before they become law), delay in publishing draft clauses, short period of consultation, costs (unspecified) of complying with the legislation;
- The need to make it clear, to minimise the risk of double taxation, that the new legislation will be interpreted in a way consistent with the relevant OECD guidelines;
- The need for the publication by the Revenue of detailed guidance on the technical application of the measures well before 1 January 2003.

A number of technical points were made in the consultation, which have led to changes in some of the detail of the draft clauses.

Competition assessment

This measure will not produce a negative effect on competition and to the extent that it attempts to level the playing field between branches of non-residents and UK incorporated concerns the effect should be a positive one.

Monitoring & evaluation

The Revenue, in particular International and the Large Business Office, which deals with large branches of overseas banks, will monitor how the changes operate in practice.

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REGULATORY IMPACT ASSESSMENT

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Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

Dawn Primarolo
Paymaster General

8/4/2003