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Association for Financial Markets in Europe

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The voice of banking & financial services

Joint AFME/BBA submission on the 'Foreign Branch Taxation' draft legislation and Technical Note

The Association for Financial Markets in Europe (AFME) and the British Bankers' Association (BBA) note the publication of the draft legislation for Finance Bill 2011 and welcome the opportunity to comment on the drafts in advance of the Budget.

We would, of course, be happy to clarify any points raised in these comments and discuss any issues related to our understanding of HM Treasury (HMT) and HM Revenue and Customs' (HMRC) intentions. We look forward to continuing this dialogue and to further meetings with officials at the appropriate stage.

AFME and the BBA re-affirm their commitment to transparency and openness in dealings between their members and HM Government and the observations and comments that follow are provided in that light.

General

The overview of the draft legislation confirms the intention to include legislation in Finance Bill 2011, which was anticipated in earlier consultation. We believe that reform which seeks to address the discrimination in taxation between the foreign subsidiaries owned by UK based companies and the foreign branches of UK based companies is needed to ensure a level playing field and is rightly being expedited.

The decoupling of the reform of branches from the work on the Controlled Foreign Companies (CFC) legislation is helpful; the conclusion of the CFC work is needed, but the decoupling allows the reform of the taxation of branches to be completed more speedily. We welcome the commitment of HMT and HMRC to ensure that the views of the sector will be taken into account in preparing the formal consultation on CFCs.

A key aim of the reform of the taxation of foreign profits is to make the UK more attractive internationally, to move towards a more territorial corporate tax system and to create a level playing field across different business operating models. We collectively fully endorse these aims, and were very glad to have the opportunity to meet you to share our concerns that the measures as originally published were likely to fall some way short of achieving them.

General Comments on the draft legislation as originally published

When we met we were able to explain why we did not consider the proposed regime would live up to the hopes which our earlier discussions and consultations had fostered.

- The irrevocable election combined with the absence of loss relief would mean that few companies would find the regime attractive
- The transitional provisions would be severely detrimental in the case of very large losses.

- The regime did not provide either the cashflow advantage or the capital support of the current system.

In our discussions we recognised that moving to an exemption system means that ultimately the profits and losses of a branch will be outside of the charge to UK tax. However over time branches are run to make profit and we asked you to consider how it might be possible to continue the timing support provided by the current regime. In this regard, we noted that the manner in which any relief is clawed back will be critical in determining whether the capital support is achieved.

Alternative proposal

We are very pleased to have discussed with you an alternative approach on the new regime which would allow for features that address these concerns. In particular the features of this design would include:

- Transitional rules to apply only to the losses utilised against UK profits prior to the introduction to the new regime.

- Optional streaming by individual branch of losses on transition.

- The option to claim 'exceptional' foreign branch losses against UK profits subject to a clawback mechanism

- Limitation of clawback to utilised losses for which relief obtained.

We are pleased to confirm our initial thoughts when we met that this alternative would be workable and very welcome to business.

The proposal meets our concerns about the attractiveness of the regime for business and increases UK competitiveness, making London more attractive as a base.

These are of course initial impressions following our discussions, and we look forward to seeing more detail and draft clauses to enable us to consider in more depth. But we are firmly of the opinion that this adaptation is taking the measure along the right lines to achieve its stated objectives.

We would be very pleased to discuss the substance of this consultation response with you further and look forward to seeing the results of the consultation.

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AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

For more information please visit the AFME website, www.afme.eu.

The **British Bankers' Association ("BBA")** is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK and international banking issues. In addition, 40 professional firms are also associated with us. Our members, whilst predominately banks, engage in activities which range widely across the financial spectrum, encompassing services and products as diverse as primary and secondary securities trading, insurance, investment advice and wealth management, custody, as well as conventional and non conventional forms of banking.

Annex I: Initial Responses to the Specific Consultation Questions

Is a branch profits minimisation rule necessary, or are existing rules sufficient?

The technical note of 20th December (para. 5.1 second bullet point) refers to "making claims and elections that are available to reduce the corporation tax measure of profits arising in the branch (such as capital allowances)". It is not clear whether this is referring to the UK corporation tax measure of profits or the foreign (local) measure of profits for (local) corporation tax. Para. 5.2 of the technical note goes on to say that "such rules would simply be a continuation of the minimum foreign tax rule that currently applies" and that "to some extent this requirement is implicit in s.18A(5)" but minimising foreign tax is not the same as minimising the UK measure of those profits and in s.18A (5) ((a) presumably) "profits attributable to the PE … for the purpose of ascertaining the amount of any credit to be allowed under TIOPA 2010 … against corporation tax to which the company would be liable" could – under current rules- be computed with a disclaimer of capital allowances to maximise DTR capacity.

We consider that the correct approach is that the exempt branch income should be the same income as currently determines the limit of credit relief, whether the relief is currently given by reason of a treaty or unilaterally. This again has the merit of simplicity, in that it would enable present tested and agreed compliance processes to be maintained.

What rules might be needed to ensure appropriate capital allowance treatment of assets used for branch activity, and any change of use between the UK head office and branch, or vice versa?

The current system enables a disclaimer of CAs in order to ensure that DTR is not lost. This flexibility is valued and should be retained. It is possible that a pooling system would address questions of change of use, but a simple system of allocation would be needed to ensure that unnecessary complexity is not introduced.

Is the draft legislation on Manufactured Overseas Dividends sufficient?

The draft clauses would seem to meet the aim of the proposals. However, there will be consequential amendments required to other provisions and it is likely that the MOD regulations in SI 1993/2004 will also need to be updated.

Views on other potential anti-avoidance rules are invited

We accept that a level playing field with foreign subsidiaries also implies some similar protection in the case of branches but without knowing how the CFC reform will be resolved it is difficult to present a view on how to afford protection from the artificial diversion of profits in the context of branches. We have set out below the issues which we have identified in our discussion on potential approaches for branches:-

a) For trading branches, we question whether CFC type protection is needed, particularly if capital gains are excluded from the exemption. The attribution of profits will be linked to the activities and functions performed in the branch and a CFC type approach would appear to simply add complexity.

b) In the context of such trading branches, the attribution of capital would appear to be the most significant matter which arguably gives rise to such risk and this has been separately addressed.

c) We can see practical difficulties in seeking to impose CFC type rules on a branch. We have previously discussed our concerns over the use of quantitative measures in determining the application of a CFC regime e.g. relative number of employees, ownership of assets, location of customers. Our discussions and concerns have been in the context of subsidiaries, but applying similarly measures in the context of branches would be meaningless and require such a degree of deeming provisions as to make careful targeting of their impact practically impossible.

Other suggestions for how the draft legislation could be improved

<u>Chargeable gains and losses</u>

The wording of Paragraph 18A(9) is very difficult to comprehend. It is not clear what situations (a) and (b) actually mean and therefore in what situations an adjustment would be made. The same can be said of Paragraph 18D(3). Furthermore the use of the term "adjusted relevant profits" in 18D(2) makes it unclear how the anti-diversion rule links into 18A to be effective. Therefore would it be possible to redraft these provisions to make it more clear?

<u>Election deadline</u>

Given that the election can be revoked at any time up to the filing date of the first accounting period to which it relates, companies are incentivised to make pre-emptive elections that they can revoke later once the actual branch results are known. Such a process could potentially be repeated. This would create unnecessary paperwork and complication. It would appear much simpler and not unreasonable to permit the election (and revocation) at any time up to the filing date of the first period to which the election relates. The earliest period for which an election could be made could be specified e.g. as the period commencing after the passing of Finance Act 2011.

<u>Bank merger</u>

Occasionally banking entities are merged together. The branch election status of each of the merging entities should not influence or obstruct the commercial decision to merge. Therefore it would appear reasonable to include a provision deeming the merged entity to be treated as having not made an election under 18A but entitled to do so from then on. It is suggested that a provision also be added to clarify how the transitional rules should be applied to merging entities e.g. aggregate all branches to calculate the adjusted foreign permanent establishments amount.