CHAPTER 5

INCORPORATING A FOREIGN PE/BRANCH

5.1 Introduction

Companies will often set up their overseas operations by setting up a PE. This allows them more flexibility with regard to the use of losses. In addition, it keeps the number of associated companies low when calculating the rate of tax. Setting up an overseas PE may result in less paperwork than setting up an overseas subsidiary.

The rules relating to Societas Europaea are considered in a later chapter.

5.2 Reporting Requirements

From 1 July 2009 there is a reporting requirement regarding international movements of capital, this replaces the old treasury consent rules which are briefly outlined below.

The UK parent or sub-parent of an international group has to report certain transaction to HMRC within 6 months of them taking place. If a group is structured as, for example, two or more parallel sub-groups controlled by a foreign parent then the UK resident parents of each sub-group will be reporting bodies in respect of their subsidiaries unless between them they nominate a single reporting body. FA 2009, Sch 17 Para 8

FA 2009, Sch 17 Para 5-7

SI 2000/2192 reg (6)

Basically a reportable transaction is one where the value exceeds £100 million. Transactions/events that form part of a series are aggregated.

FA 2009, Sch 17 Para 8

The following categories of events are reportable

SI 2000/2192 para 4

- an issue of shares or debentures by a foreign subsidiary;
- a transfer by the reporting body, or a transfer caused or permitted by the reporting body, of shares or debentures of a foreign subsidiary in which the reporting body has an interest; or
- any situation which results in a foreign subsidiary becoming, or ceasing to be, a controlling partner in a partnership.

In addition to the £100 million limit there are exclusions for transactions carried out in the ordinary course of a trade, between residents in the same territory or the giving of any security by a foreign subsidiary to a financial institution.

FA 2009, Sch 17 Para 9

Regulations have been issued excluding several further transactions/events from the reporting requirements. The exclusions cover:

i. cash pooling arrangements pre-notified to HMRC where HMRC has given written notice to the parties that transactions entered into under the cash pooling arrangements may prospectively be excluded;

ii. certain issues of shares by the foreign subsidiary;

iii. certain issues of debentures by the foreign subsidiary;

iv. transfer by the reporting body of shares or debentures of the foreign subsidiary, transfer to the reporting body (or group company) of shares or debentures of a foreign subsidiary in which the reporting body has an interest; and

v. the giving of security by the reporting body (or group company) over shares of a foreign subsidiary in connection with the borrowing of money from an unconnected lender.

You should look at SI 2009/2192 for further detail on the exclusions.

In looking at the reporting requirements 'control' in relation to a body corporate means the power of a person to secure that the affairs of the body corporate are conducted in accordance with that person's wishes, whether this is achieved by: FA 2009 Sch 17 Para 12

- the holding of shares or the possession of voting power in or in relation to that or any other body corporate; or

- any powers conferred by the articles of association or other document regulating that or any other body corporate.

Where two or more persons taken together have this power then they shall be taken to control the body corporate.

'Control' in relation to a partnership means the right to a share of more than 50 per cent of the assets, or of more than 50 per cent of the income, of the partnership.

Transitional provisions provide that any reports in respect of events or transactions occurring before 1 October 2009 should be reported by 1 April 2010. This is intended to allow companies a period of time in which to establish internal procedures to monitor reportable transactions and events. FA 2009 Sch 17 Para 14

Regulation 3 of SI 2009/2192 gives details of the required information as it relates to a foreign subsidiary connected with the event or transaction for the report as follows:

A. its name, and

B. the territory from the laws of which it derives its status as a body corporate.

The required information as it relates to an event or transaction is a full description of the event or transaction (and, in the case of a transaction, a full description of all the steps taken in the course of the transaction) and includes in particular—

(a) the date on which the event took place or the transaction was carried out,

(b) for a transaction, the name of each party to it,

(c) the reason for the event or transaction, and

(d) an estimate of the effect of the event or transaction on the liability to tax in the United Kingdom of the reporting body and of any group company.

Failure to comply with the reporting requirement will result in a penalty which will not exceed £300 for the initial failure with a further additional penalty not exceeding £60 for each day on which the failure continues after the initial penalty was imposed. FA 2009, Sch 17 Para 10

For transactions taking place prior to 1 July 2009 s.765 ICTA 1988 was in point. This section stated that it was **unlawful for a company in the UK to permit a company over which it has control, not resident in the UK, to create or issue any shares or debentures without Treasury Consent.** S.765 also covered situations where shares or debentures in a non-UK resident company, controlled by a UK resident company, are transferred to any person (except to a person enabling him to be a director). ICTA 1988, s.765

The **penalties** for not complying with s. 765 were quite **severe** - imprisonment for up to 2 years and/or a fine.

If the offender was a company, then the fine was up to 3 times the amount of tax due on profits in the 36 months following the offence or £10,000 whichever was greater.

Treasury consents could be specific to the transaction or could be a general consent.

5.3 Tax impact of incorporation

When the PE is incorporated, there may be **a cessation of trade** by the UK company, if the branch carried on a separate trade. The items of plant on which capital allowances were claimed will be disposed of, as will all stock. As the disposals will be to a connected party they will take place at market value.

The capital assets of the branch will be treated as disposed of and re-acquired at market value. Special rules apply to allow the postponement of these gains.

5.4 S.140 TCGA 1992 Postponement of Gains

On incorporating a foreign branch, a claim can be made under s.140 to **postpone** the gains arising. Certain conditions have to be met: TCGA 1992, s.140

1) A UK resident company has to have been carrying on a trade outside the UK through a PE;
2) The trade and assets (excluding cash) used in the trade (or a part thereof) are transferred to a company that is non UK resident;
3) The transfer is wholly or partly in exchange for securities (shares or shares and loan stock) issued by the transferee to the transferor;
4) Following the issue of the shares, the transferor holds at least 25% of the ordinary share capital of the transferee; and
5) There is a net chargeable gain arises on the assets transferred.

If these conditions are met, the transferor can claim for the net gain on transfer to be postponed. If the entire consideration is securities, then the whole of the gain can be postponed. If the consideration is partly securities and partly cash, only a proportion of the gain can be postponed using the following formula:

$$\text{Net gain} \times \frac{\text{Market value of securities at transfer}}{\text{Market value of total consideration received at transfer}}$$

Illustration 1

Sherlock Ltd decides to incorporate a foreign PE. This gives rise to net gains of £145,000. The overseas company pays cash of £300,000 plus issues 200,000 £1 shares that have a market value of £1.20 each.

The gain that can be postponed is

$$£145{,}000 \times \frac{240{,}000}{540{,}000} = £64{,}444$$

The gain will come within the charge to tax in the following circumstances:

a) The transferor company sells some or all of the shares or loan stock received at transfer. The amount to be brought in here will be:

$$\text{Gains postponed} \times \frac{\text{Market value of securities disposed of}}{\text{Market value of total holding before disposal}}$$

b) Within 6 years, the overseas company sells any of the chargeable assets transferred, which gave rise to a gain at transfer. The gain brought in here will be:

$$\text{Gain postponed} \times \frac{\text{gain on asset sold at date of transfer}}{\text{total gross gains at date of transfer}}$$

Illustration 2

Continuing the above illustration, the assets transferred that gave rise to the net gain were as follows:

Asset	*Gain /Loss*
	£
Asset 1	100,000
Asset 2	(30,000)
Asset 3	75,000
	145,000

Two years later Asset 1 is sold, the amount chargeable will be

$$£64{,}444 \times \frac{100{,}000}{175{,}000} = £36{,}825$$

Illustration 3

A further 10 years later, Sherlock Limited sells 100,000 of the shares. At the time of the sale the shares were worth £3.50 each.

The remaining postponed gain is £(64,444 - £36,825) = £27,619

Thus we have

$$\text{£}27{,}619 \times \frac{\text{£}350{,}000}{\text{£}700{,}000} = \text{£}13{,}809$$

FA 2002 introduced similar postponement rules for **intangible fixed assets** transferred as part of the transfer of the trade. CTA 2009, s.827

5.5 Special rules for EU PEs

The reporting requirement set out above applies equally to EU movements of capital. However, for transactions taking place prior to 1 July 2009 s.765 does not apply to movements of capital between EEA member states which are covered by an EU directive, dated 24 June 1988. However, where the transactions would, but for the article, fall within s.765 (1), s.765A requires the company to give **written notice** of the transactions within **6 months** of carrying them out.

An EU directive dated 23 July 1990 provides for a form of relief where a non UK trade carried on in a member state is transferred to a company resident in a member state.

The form of this relief is quite different. The UK company's aggregate net chargeable gains on the assets are calculated in the normal way. A credit is then given against the UK tax on the net aggregate gain for any foreign tax **not actually payable** but which, without the directive, would have been payable in the EU state in which the PE is situated. TCGA 1992, s. 140C TIOPA 2010, s.122

There is **no requirement** for the transferor company and the transferee to be members of the **same worldwide group**. The trade must be carried on in a member state but does not need to be transferred to a company that is resident in the same member state as the trade.

By way of an illustration, if a UK company transfers its Italian PE to a company resident in France, the relief will be available in principle.

The relief is not confined to a trade carried on exclusively outside the UK. Relief can be available where a UK company transfers that part of its worldwide trade chargeable to corporation tax as trading profits carried out through a foreign PE.

The transfer must satisfy the following conditions set out in s.140C:

- Company A is resident in the UK and Company B is resident in another member state;
- The transfer includes all the assets of Company A used for the purposes of the trade (or part of the trade) transferred, or all the assets other than cash;
- The transfer is wholly or partly in exchange for securities (i.e. could be shares and/or loan stock) issued by Company B to Company A;
- The transfer gives rise to an excess of chargeable gains over allowable losses;
- The transfer takes place for **bona fide commercial reasons** and does not form part of a scheme or arrangement which has tax avoidance as a main purpose.

If the conditions are met, then the transfer is treated as giving rise to a single chargeable gain for Company A on which the UK tax can be reduced by the notional foreign tax credit.

Under self assessment it is the company's responsibility to support the calculation of the foreign tax. Previously a certificate was obtained from the foreign tax authority or the Board could be asked to determine the amount.

It may be the case that the transfer qualifies for relief under both the general s.140 rules and these special rules for the EC. Relief cannot be claimed under both.

This relief **cannot be claimed** by **dual resident** companies

It is possible to seek **advance clearance** under the rules in s.138 TCGA 1992. TCGA 1992, s.140D

FA 2002 provides for a similar treatment in relation to **intangible fixed assets** transferred with the trade. TIOPA 2010, s.117

Illustration 4

A UK resident company transfers the trade and assets of its Spanish PE to a company resident in Italy, in return for shares issued by the Italian company. The transfer is undertaken for bona fide commercial reasons.

The UK gains arising on the transfer are:

	£
Asset 1	300,000
Asset 2	(50,000)
Asset 3	250,000
	500,000
Tax thereon @ 28%	£140,000

The Spanish tax that would be payable, but will not in fact be paid as a result of the EU directive, is £175,000.

The gains are treated as a single gain of £500,000. The notional Spanish tax can be set against the tax on the UK gain, resulting in no tax being due in the UK.

If the notional Spanish tax had been say £120,000 the company may decide that it would be better to make a claim under s.140 TCGA 1992 as this would allow all of the gain to be deferred, whereas a claim under s.140C TCGA 1992 will result in £20,000 being charged now.

5.6 Transfers of a UK trade within the EU

TCGA 1992, s.140A

Special rules apply where a trade carried on in the UK is transferred by a qualifying company in one member state, to a company resident in another member state. Note the transferor or transferee may be resident in the UK.

The transfer must be wholly in exchange for securities issued by the transferee company.

The assets must be within the charge to UK tax after the transfer.

The transfer is treated as being **a no gain/no loss** transfer.

The transfer must take place for **bona fide commercial reasons** and not be part of a scheme or arrangement of which the main purpose or one of the main purposes is the avoidance of tax. It is possible to apply for clearance. TCGA 1992, s.140B

FA 2002 has introduced similar rules for **intangible fixed assets** transferred with the trade. CTA 2009, s.819

Example 1

1) Watson Ltd, a UK resident company, established a branch in Ruritania ten years ago. The branch assets consist of:

	Cost	Market Value
	£	£
Stock	100,000	120,000
Debtors	250,000	225,000
Buildings	850,000	800,000
Fixed plant	350,000	420,000
Goodwill	nil	500,000

The branch is to be transferred to a Ruritanian resident company, in return for £545,000 of cash to be left outstanding on loan account, £600,000 preference shares and 75,000 £10 ordinary shares which had a market value of £12 each.

All plant has a cost of more than £6,000.

Calculate the gain that can be deferred on incorporation of the branch.

Ignore indexation allowance.

2) Two years later, the company sells 25% of the preference shares. At the time of the sale, the preference shares were worth £650,000 and the ordinary shares were worth £14 per share.

Calculate the gain chargeable as a result of this sale.

3) 8 years after the incorporation, the Ruritanian company sold the plant for £650,000.

Calculate the gain that will be brought into charge following this sale.

Answer 1

1) The gains arising on the transfer of the branch are:

	£
Buildings	(50,000)
Plant	70,000
Goodwill	<u>500,000</u>
Total	<u>520,000</u>

As the branch was set up ten years ago, the goodwill was created before 1 April 2002 so is therefore within the chargeable gains regime.

The consideration received is:

	£
Cash	545,000
Preference shares	600,000
Ordinary shares	<u>900,000</u>
	<u>2,045,000</u>

The gain that can be deferred is:

$$520{,}000 \text{ X } \frac{600{,}000+900{,}000}{2{,}045{,}000} = \mathbf{£381{,}418}$$

2) The gain chargeable will be:

$$381{,}418 \times \frac{25\% \times 650{,}000}{650{,}000 + 1{,}050{,}000} = \mathbf{£36{,}459}$$

3) The sale of the plant took place more than 6 years from the incorporation. Therefore it will not result in the crystallisation of the deferred gain.