

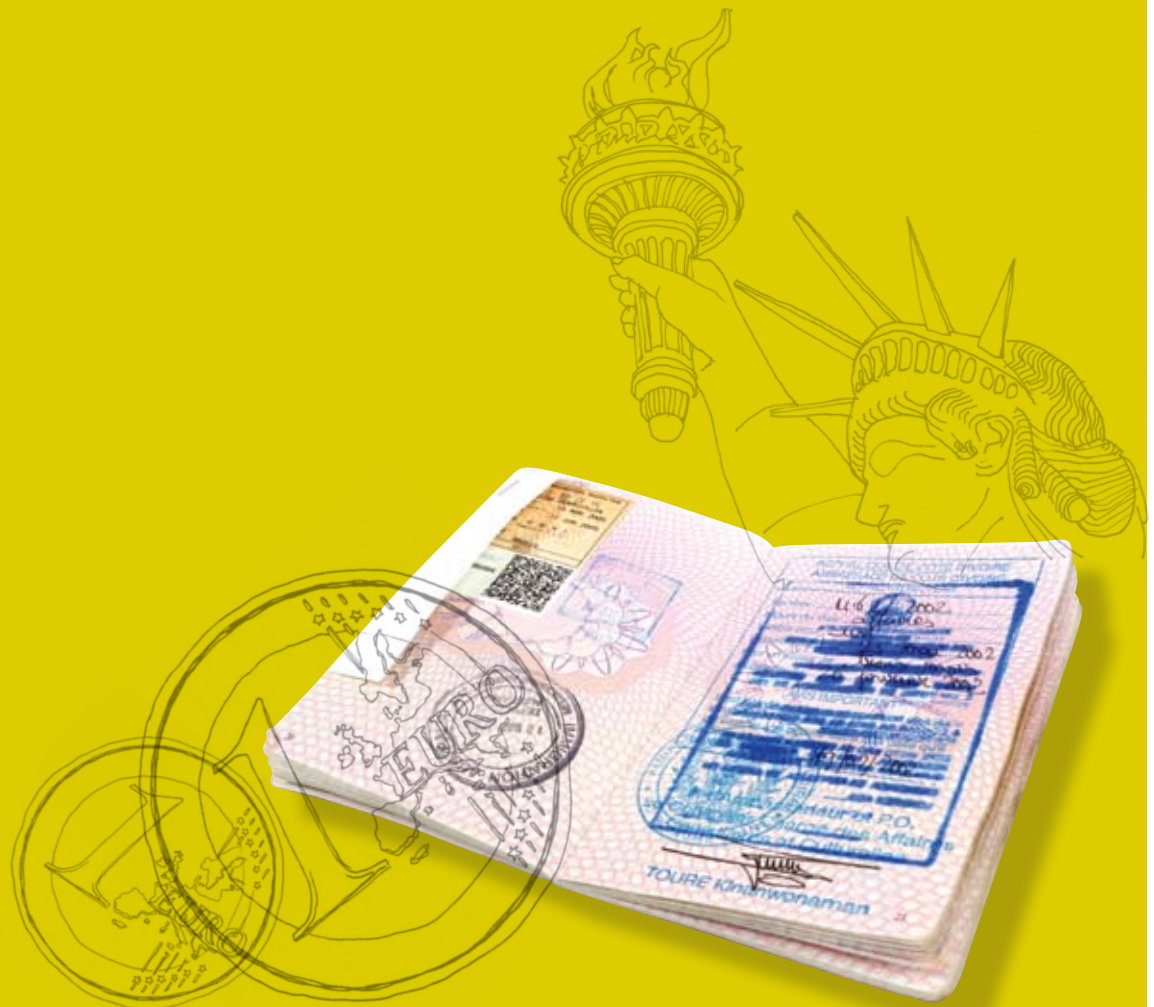


MacIntyre Hudson

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International advisory guide

# Taxation of business profits of overseas enterprises in the UK



# Contents

Introduction 03

---

Practical Considerations 04

---

## Appendix

1. Permanent Establishment 06

---

2. Legal and commercial considerations 08

---

3. Double Tax Relief 09

---

4. Transfer pricing 10

---

# Introduction

Where an overseas enterprise carries on business activities in the UK a key concern is whether the UK tax authorities will have the right to tax the element of the profits of the overseas enterprise that are attributable to the activities carried on in the UK.

The basis for determining whether this right exists is the concept of a permanent establishment (PE). Only where it is deemed that the overseas enterprise has a PE in the UK can the UK tax authorities levy taxes on its business profits.

Once this right has been established, it must be determined what proportion of the business profits of the overseas enterprise can be attributed to the PE, since the UK only has taxing rights on those profits attributable to the PE.

It is therefore the aim of this guide to consider the options for trading in/with the UK and to outline the principal factors for:

- Determining whether a PE will be deemed to exist
- Attributing business profits to the PE

## Basis of Taxation Rights

In the case of a non-UK resident and non-UK incorporated company or business, the UK has the right under its domestic legislation to tax profits attributable to UK activities if they derive from a PE in the UK. The domestic legislation then goes on to set out the circumstances under which a PE exists. Appendix 1 discusses and defines Permanent Establishment in some detail.

If there is no UK PE then there will be no UK taxation of business profits even though profit may be attributable to UK activities.

However, provisions within the legislation<sup>1</sup> allow for domestic law to be overridden by tax treaties made with overseas jurisdictions.

The result of this is that where business activities transcend international boundaries, taxing rights may be determined by the provisions of officially concluded Double Tax Agreements (DTAs) rather than domestic legislation.

The detail set out in this paper reflects the current UK tax legislation. While, most DTAs follow very similar principles to the UK legislation, it should be kept in mind that there may be minor differences. The relevant DTA should always be

<sup>1</sup> s788 ICTA 1988

# Practical Considerations

considered as part of the review of the tax implications of international operations.

There are clearly significant legal and commercial implications that must be factored into the choice of which of the trading styles described below is most appropriate (some of these implications are highlighted in Appendix 2).

It should be noted that in many cases the tax consequence of the creation of a PE may be an administrative rather than a financial burden as double tax relief in the home territory will prevent, or at least reduce the effect of, income being taxed twice. The concept of double tax relief (DTR) is explained in Appendix 3.

## Establishing operations in the UK

The manner in which an overseas company decides to access the UK market place will determine whether a PE, and therefore a taxable presence, will be created in the UK.

Typically companies seeking to access UK customers will do so via one of the following options:

- Set up a UK subsidiary company
- Set up a UK branch
- Establish a UK place of business
- Trade directly from overseas

### UK Subsidiary

The most common manner in which to establish operations in the UK is to incorporate a UK company, the shares of which are owned by the overseas enterprise. Such a company is referred

to as a UK subsidiary of the overseas enterprise and is a separate legal entity, usually with limited liability.

As a separate legal entity, such a UK company is taxable in its own right and thus is generally not a PE of its overseas parent. This remains the case even where the trade or business that is carried on by the subsidiary is managed by the parent company. However it is important that the two companies' affairs are kept separate to avoid one company becoming a PE of the others.

Under the provisions regarding PEs that are set out in Appendix 1, the activity of the parent could cause it to be considered to have a UK PE in addition to the subsidiary's activities and thus have an element of its profits subject to UK tax. This could be, for example, where the parent has space or premises belonging to the subsidiary at its disposal, thus giving it a fixed place of business in the UK. Or where the subsidiary acts as an agent for its parent (and has the authority to conclude contracts in the name of the parent) but is not considered to be an independent agent as it is not acting in the ordinary course of its own business. In this structure, the key concern from a tax perspective tends to be transfer pricing (see Appendix 4).

### UK Branch

Where an overseas enterprise carries on significant business activities in the UK but not through a separate UK entity, then such operations would generally constitute a branch.

A branch is, prima facie, a PE by virtue of being a fixed place of business

through which the trade of the overseas enterprise is carried on. The overseas enterprise will therefore be subject to UK corporation tax or income tax on the profits of the branch activity.

### UK Place of Business

Where an overseas enterprise owns or rents fixed premises in the UK that it uses in connection with its trade, but the activities carried out there are not sufficient to constitute a branch, the enterprise will have a place of business in the UK.

This place of business may or may not constitute a PE and would be subject to the considerations of fixed place of business in Appendix 1. Essentially the enterprise would have to demonstrate that the premises are maintained solely for activities that are of a preparatory or auxiliary character for a PE **not** to exist.

### Directly from Overseas

Many overseas enterprises sell their products or provide services directly to UK customers from their home territory. Generally this will not create a UK PE as they are considered to be trading **with** the UK rather than **in** the UK. However, the method of operation and the activities of representatives must be carefully reviewed to ensure that the conditions under which a PE would be deemed to exist are avoided.

### Effect of a PE in the UK

Once it has been established that an overseas enterprise has a PE in the UK, the next question is what, if any, are the profits on which the PE should pay tax.

The profit attributed to the PE should be the profit which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE.

As far as possible the tax authorities will seek to use the trading accounts (internal management accounts of the enterprise in many cases<sup>2</sup>) of the PE to ascertain the profit properly attributable. However, even where such accounts are available, it may still be necessary for the tax authorities to rectify any such accounts on a similar basis to the transfer pricing regulations (see appendix 4 for further discussion regarding transfer pricing).

It should be noted that the method of attributing profits used by the enterprise (either in the management accounts or otherwise) should not be changed from year to year unless there is a good and sufficient reason to do so. Also, certain income streams (such as interest, dividends and royalties) may be subject to more prescriptive methods of attribution. This possibility would need to be considered in each individual case.

#### Conclusion

International operations offer significant scope for tax planning. It is crucial that advice is sought to ensure that commercial objectives are achieved in the most tax efficient manner.

<sup>2</sup> It is generally assumed that these will be available as the expectation is that a well run organisation would be concerned to know the profitability of its various operations. Where no branch/PE trading accounts are made up, the trading accounts of the business as a whole will need to be apportioned to the various branches and head office to determine the proper attribution of profits to the UK PE.

## Appendix 1

# Permanent Establishment

An enterprise can be deemed to have a PE in the UK in two situations:

- Where an enterprise has a fixed place of business in the UK through which the business of an enterprise is wholly or partly carried on.
- Where a person, other than an agent of independent status, is acting on behalf of the enterprise in the UK and has (and habitually exercises) the authority to conclude certain contracts that are binding on the enterprise.

It should be noted that the application of these conditions may not be straight forward and each situation must be carefully considered on an individual basis. However, some general points are considered below.

### Fixed Place of Business

This definition of a PE essentially contains the following conditions, each of which must be satisfied:

- The existence of a “place of business”  
This is a facility such as premises, but can in certain circumstances be machinery or equipment. The premises do not need to be used exclusively for the purpose of carrying on the business of the enterprise, nor does it matter whether the premises are owned, rented or otherwise at the disposal of the enterprise, for there to be a PE.
- The place of business must be “fixed”  
It must be established at a distinct place with a certain degree of permanence. It is not necessary that the “fixed” place of business actually be attached to the ground upon which it stands, and cases where the presence of

an enterprise is subject to minor changes in location but where there is a single commercial aim may still be considered to give rise to a PE<sup>3</sup>.

With respect to what constitutes a degree of permanence, there is no strict definition. This must be considered on a case by case basis and could vary considerably depending on the nature of the business. Also, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

- The business of the enterprise must be wholly or partly carried on through this fixed place of business.

The activity does not necessarily have to be of a productive character as the authorities take the view that within the framework of a well-run business it can be assumed that each part contributes to the productivity of the whole. However, a number of exceptions are discussed below.

The legislation<sup>4</sup> provides that, without prejudice to the generality of the expression, a “fixed place of business” includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop,
- An installation or structure for the exploration of natural resources

- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources, and
- A building site or construction or installation project.

Notwithstanding the conditions set out above, fixed places of business that are maintained solely for the purpose of carrying on, for the enterprise, activity of a preparatory or auxiliary character are not be considered to be PEs. This would include, for example, facilities used solely for the purpose of storage, maintenance of stock, collecting information or purchasing.

It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those that do not, and each case has to be examined on its own merits. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole.

### Dependent Agent

Even where an overseas enterprise does not conduct business through a fixed place of business in the UK, the fact that they are conducting business in the UK can still give rise to a PE.

An enterprise can be treated as having a PE in the UK where there is, under certain conditions, a person acting for it. The two key conditions which would both need to be met are that:

- The person must be deemed to be a dependent agent. This is essentially all agents that are not considered to be independent agents. Agents are considered to be independent if they are independent from the overseas enterprise both legally and economically and, when acting on behalf of the enterprise, are acting in the ordinary course of their own business.

Dependent agents may either be individuals or companies and need not be residents of, nor have a place of business in, the UK. However, it is generally accepted that the dependent agent's presence in the UK must be sufficient for them to be deemed to be trading in the UK, rather than with the UK. As such, if agents are present in the UK for short periods of time and on an infrequent basis then a PE being deemed

to exist is unlikely. Again, situations must be considered individually.

- The person must have the authority to conclude contracts in the UK that are binding on the enterprise, and must exercise this authority habitually.

This authority must be exercisable on contracts that relate to operations that constitute the actual business of the enterprise, i.e. it would be irrelevant if the person only had the ability to conclude contracts relating to internal operations.

A person who is authorised to negotiate all elements and details of a contract in a way that is binding on the overseas enterprise shall be deemed to be exercising this authority in the UK even if the contract is ultimately signed by another person in the territory in which the overseas enterprise is situated.

Exactly what constitutes the "habitual" exercising of contracting authority is not defined and each case has to be

reviewed individually. The frequency required will essentially depend on the nature of the contracts and the business of the principle (the overseas enterprise).

The activities of an agent will not give rise to a PE if those activities are restricted to those that are of a preparatory or auxiliary character.

<sup>3</sup> For example a market trader whose stall is not fixed to the ground and who may set up in different areas of the market on different occasions would still be considered to have a PE.

<sup>4</sup> Paragraph 2, s148 Finance Act 2003

## Legal and Commercial Considerations

There are important considerations aside from taxation that must be taken into account when deciding the optimum manner in which to access the UK market.

As noted earlier the first consideration is whether a fixed place of business or the continued presence of dependent agents in the UK is necessary to support commercial objectives. If not, then the enterprise can potentially access the UK market without creating a taxable presence.

Where a physical presence is required then the decision regarding whether to set up a UK subsidiary company or a branch should consider the following areas.

### Separate Legal Entity

A UK subsidiary is a separate legal entity, usually with limited liability. As such the overseas enterprise's liability is limited to the capital injected. A branch is legally the same entity as its "parent" and the overseas enterprise is liable for all losses.

As the same entity, the profits of the branch flow automatically to the overseas enterprise. A company has greater control over the profits generated from the operations, with the ability to retain them in the UK or remit them to the overseas enterprise as a dividend.

A subsidiary company is run by a board of directors. While the overseas enterprise, as the owner of that company, has the right to appoint this board, the directors are legally responsible for the company and are obliged to act in its best interest. As such, a branch structure may facilitate closer and more efficient control of the UK operation.

In some cases customers, suppliers and finance providers may be more comfortable dealing with a UK company rather than an overseas enterprise. The decision may therefore impact such things as sales and credit terms.

Using a company may provide a more convenient exit route if this is part of the medium to long term strategy.

### Filing and administrative requirements

A UK incorporated company must be registered with Companies House, provide certain documentation, operate within a more complex legal framework than that applied to branches and file annual accounts.

A branch of an overseas company or business must also register with Companies House within one month of being established. While a branch does not have to submit accounts for the UK operation it must submit each year (in English) the accounts of the overseas enterprise of which it is a branch. As submitted documents are a matter of public record, this requirement could be seen as a competitive disadvantage.

These accounts must be audited where turnover of the UK Company or the entire international group combined exceeds £6.5m or if aggregate total amounts exceed £3.26m, for periods beginning on or after 6 April 2008. For accounting periods the thresholds are £5.6m and £2.8m repeatedly.

## Double Tax Relief (DTR)

The majority of the UK's major international trading partners operate a system of double tax relief which reduces the impact of overseas income being taxed twice. Many countries have complex and differing methods of achieving this, however, commonly credit is given either on a tax-for-tax basis or less advantageously as treating foreign tax as an expense.

Where an overseas enterprise has a UK PE it will pay corporation tax on profits arising in the UK. However, as the UK business is not a separate legal entity from the overseas "parent" this profit will also be included within the profits chargeable to corporation tax in the jurisdiction of the "parent". In order to prevent the overseas

enterprise from being subject to tax on the same profits twice, the enterprise will usually be entitled to deduct the tax paid in the UK from the domestic tax that is calculated on the same profits.

Where the domestic tax rate is higher than that of the UK, the enterprise will pay additional tax in its home territory that approximately reflects the rate differential applied to the UK profits. Where the domestic tax rate is lower than that of the UK then usually no further tax will be levied. Essentially, therefore, the enterprise will end up having suffered corporation tax on the profits attributable to the UK activity at the higher of the UK or domestic tax rates.

Where an overseas enterprise has a UK subsidiary, the dividend that it receives from that UK company will already have suffered UK corporation tax. In some overseas territories, this income would not be subject to any further tax locally, however, the majority operate systems that aim to tax the profit as if it had arisen locally and then deduct the underlying UK tax to get to a similar result as the PE situation above.

## Appendix 4

# Transfer Pricing

### Introduction

The transfer pricing legislation is concerned with the prices used by related parties (for example companies within the same group) when accounting for transactions between them. Where such transactions are between persons located in different jurisdictions, transfer prices could potentially be used to artificially relocate the profits of the overall group to the jurisdictions with more beneficial tax systems.

The transfer pricing rules have arisen to stop multinational organisations manipulating the location of profits and to protect each individual jurisdiction's tax revenue.

The transfer pricing legislation has been extended to the transactions between related parties within the UK. While such transactions do not jeopardise the UK tax base overall, this has been effected to counter discrimination claims in the European Courts.

The transfer pricing rules are significantly relaxed in the case of small and medium sized companies. This is detailed further below.

### Transfer Pricing Legislation

The UK transfer pricing legislation incorporates the OECD concept of the arm's length standard, which states that related enterprises should set prices on intra-group transactions to be similar to those which would have been charged had they been independent parties, dealing with one another on an arm's length basis.

In this context, enterprises are related where one participates directly or indirectly in the control of the other or where enterprises are directly or indirectly under common control.

Technically, therefore, the UK transfer pricing law does not apply to branch structures as transactions between the branch and its "parent" are within a single legal enterprise and not between related parties. However, if a DTA applies it is likely that similar principles will apply to these internal transactions as would apply to transactions between related parties by virtue of the DTA.

Appropriate adjustments must be made in a UK company's tax return to increase profits (or reduce losses)<sup>5</sup> to reflect arm's length prices on the relevant inter-company transactions where they have not already been used in the preparation of the financial statements. However, if the UK company has reported a higher than an arm's length profit in its accounts, the "one-way-street" provision within the rules serves to prevent the taxpayer from making pricing adjustments to reduce UK profits (or increase losses) .

To minimise exposure to potential transfer pricing adjustments, interest and negligence penalties (of up to a maximum of 100% of the additional tax due as a result of the adjustment), companies should prepare and retain appropriate documentation in support of the pricing for related party transactions undertaken.

Set out below is a brief description of the accepted methods for applying the arm's length principle. These are split into transaction methods, which are preferred by the UK tax authorities (and therefore more robust in the face of a challenge), and transactional profit methods.

### Transaction Methods

- Comparable Uncontrolled Price (CUP)

The CUP method compares the price

charged for the controlled transaction (i.e. the one between the related parties) to the price charged in a comparable uncontrolled transaction in comparable circumstances

- Resale Price Method (RPM)

This method begins with the end selling price (the price at which the final product/service that the controlled transaction was required to produce is sold), which is then reduced by the gross margin that the reseller can reasonably expect, in the light of the functions performed, to cover its selling and other operating expenses, and make an appropriate profit. What is left, after adjusting for any costs involved in the controlled transaction itself (e.g. customs duties), can be regarded as the arm's length price.

- Cost Plus Method (CPM)

The CPM starts with the costs incurred by the supplier of the product/service in the controlled transaction with the related purchaser. An appropriate cost plus mark up is then added to this cost to provide an appropriate profit to the supplier in light of the functions performed and the market conditions.

### Transactional Profit Methods

- Profit Split Method

This method is useful where transactions are so interrelated that they cannot be evaluated on a separate basis. Here, the overall profit from the combined activities is split between the related enterprises involved by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions.

- Transactional Net Margin Method

This method compares the net profit margin, relative to an appropriate base (e.g. costs, turnover or assets), that the taxpayer realises from a controlled transaction to the net margin that the same taxpayer earns from comparable uncontrolled transactions.

#### Advanced Pricing Agreements

Provisions exist to enable companies that engage in transactions with related parties to agree with the tax authorities in advance that their transfer prices<sup>6</sup> are acceptable from a tax perspective. Known as Advanced Pricing Agreements (APA), they provide certainty for the tax payer that the tax authorities will not seek retrospective adjustments in the tax returns. However, it is uncommon to apply for an APA for transactions of less than £50m per annum.

#### Thin Capitalisation

An important area of the transfer pricing legislation relates to connected party financing. The fact that interest costs are in principle deductible for tax purposes can mean that debt finance is preferred to equity when capitalising international operations.

However, the transfer pricing legislation will restrict interest deductions where the absolute amount of the loan exceeds the amount that an independent party would have been prepared to lend. In such situations, the interest attributable to the excessive part of the loan will be disallowed, and will (at least in the UK) be treated as a "dividend".

#### Exemption for Small and Medium Sized Companies

The transfer pricing provisions set out above do not apply to small and medium sized enterprises. Broadly, these are defined as:

Small enterprise - A business with less than 50 employees and either turnover or assets of less than €10m

Medium Enterprise - A business with less than 250 employees and either turnover of less than €50m or assets of less than €43m

It should be noted that associated companies are taken into account when applying these limits, i.e. it is the combined totals for all associated companies that determines whether the limits are exceeded.

There are several exceptions to this exemption. The exemption will not apply and companies will be subject to the transfer pricing provisions where:

- a. The company elects for the exemption not to apply. Once made, this election is irrevocable
- b. The other party to the transaction is resident and liable to tax in a country with which the UK does not have a double tax treaty containing a non discrimination article<sup>7</sup> or in a country which has been specifically excluded by the Treasury<sup>8</sup>
- c. The company is medium sized and HMRC gives specific notice while enquiring into particular accounting period that the provisions are to apply to that period. Essentially this means that in a situation where transactions have not been carried out at arm's length and as a result a

medium sized UK company has gained a tax advantage, then HMRC can issue a notice requiring the company to increase its taxable profits or reduce losses to reflect the position that would have arisen had arm's length prices been used.

<sup>5</sup> The exception to this is on UK-UK transactions when there is scope for the entities on both sides of the transactions to make adjustments through the domestic transaction compensating adjustment provisions.

<sup>6</sup> Usually it would be the methodology underlying the transfer prices rather than absolute values that would be agreed.

<sup>7</sup> Many double tax agreements (DTAs) that the UK is a party to include a non discrimination article. This is a general provision in the DTA that essentially prevents states from subjecting nationals from the other party to the treaty to any taxation or requirements that are different or more burdensome than those to which their own nationals would be subjected to in the same circumstances.

<sup>8</sup> This exception allows the Treasury the power to apply the transfer pricing provisions in respect a territory deemed to be engaging in harmful tax practices. At the time of writing, the Treasury had not utilised this power.



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