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Reform of the foreign permanent establishment exemption
Comments by the Chartered Institute of Taxation

1. Introduction

1.1. The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 20,000 members, and extensive volunteer network, in providing our response.

1.2. In May 2026, the government announced a fundamental shift from an elective to a mandatory exemption regime for foreign permanent establishments (PEs), with potentially far-reaching consequences for UK headed multinational groups. The draft legislation for this measure was published on L-day (13 July) alongside the rest of the draft Finance Bill legislation. Overall, the changes will remove the long-standing previously elective treatment allowed in the UK corporate tax system to create a consistently territorial approach for foreign branch profits. The new regime will take effect from 1 January 2027.

1.3. The lack of prior consultation on this measure has removed the opportunity to consider different ways to address the perceived issue and to allow time for the far-reaching consequences to be identified, considered and evaluated. Some of these likely unforeseen consequences are discussed below and seem to fall outside of the stated policy intention of the measure.

1.4. In addition, the proposed commencement date for the measure provides businesses with little time to assess the impacts of the reform on them and prepare for the change.

2. Policy intent, consultation and timing

2.1. This reform is one of the most significant changes to the UK's international tax framework in recent years. It is rare to have a tax policy announcement of this magnitude made without consultation and outside of the normal Budget cycle.

2.2. The Chancellor was clear that oil and gas companies were the main target, stating, "some oil and gas groups that operate overseas through foreign branches have structured their tax affairs in a way which ensures they pay little or no corporation tax on their UK energy trading profits". However, it is worth emphasising that the proposed changes will affect all companies in all sectors (apart from PEs with UK property businesses).

2.3. While we recognise the issue of situations where multinational groups can obtain UK tax relief for overseas losses without paying UK tax on future profits, this was a stable part of the UK tax system. Moreover, it was part of the package of UK tax rules aimed at making the UK an attractive place to headquarter multinational enterprises (MNEs). By removing the ability to obtain UK relief for foreign branch losses, the government is resetting the balance between competitiveness and protecting the domestic tax base. Although this may be an issue that is addressed by many jurisdictions (the May Policy Paper says that it is 'standard international practice'), it need not necessarily be done in the way of this reform to the UK's rules. Different jurisdictions have different regimes for foreign PEs. Also, the aim is to address the issue of a perceived imbalance, but the proposed changes will have general effect and are not limited to situations where corporation tax is not being paid on the profits of the overseas branch.

2.4. As noted above, the exemption for profits or losses of foreign PEs was introduced in 2011 as part of a suite of measures designed to place the UK taxation of companies on a more territorial basis, improve the international competitiveness of the UK tax system, and ensure greater alignment between the taxation of foreign PEs and foreign subsidiaries. The decision was made at the time to make the treatment of foreign PEs elective to provide some flexibility for different businesses, and as such is a feature of the UK system that has been in place for many years and is routinely applied by businesses within its scope. The one-off nature of the election and the fact that it applies to all PEs of the taxpayer are important protections against abuse.

2.5. The rules interact with many other areas of the corporation tax rules and due to the lack of consultation, and relatively short period provided to consider the new rules, the impacts in the relevant areas, including intangible property, hybrid rules, withholding taxes and double tax treaty obligations, Pillar 2 and the R&D Expenditure Credit (RDEC) and Patent Box regimes are still being explored and analysed. We comment on some of these below. But due to the relatively short consultation period, we have limited our comments to high level points around underlying principles. Some sectors such as Lloyds insurance will face particular challenges including both an impact on current tax positions and ongoing treatment of complicated tax affairs governed by bespoke international arrangements interacting with specific UK legislation. We understand that industry specific bodies are engaging with HMRC about these, and we do not address them in any detail in our response. But we note that the lack of consultation means that there is now a scrabble to sort out the issues within the constraints of the policy announcements and that these issues are exactly the type of things that consultation could have avoided.

2.6. Our aim is to ensure, so far as possible, that changes to the UK's tax code will be practicable, achieve HMRC's policy aims and meet the CIOT's objectives for the tax system. Our stated objectives are for a tax system that includes a legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences and greater certainty, so businesses (and individuals) can plan with confidence. The lack of consultation on this measure and the short timeframe proposed for its implementation mean that these proposals do not meet these objectives.

2.7. It is also notable that the change will apply from 1 January 2027. This is a short period for businesses to undertake the necessary analysis to understand what the change means for them and revisit business structures and economic modelling. It is also a very short period for large businesses to consider their reporting and audit requirements for the accounting period in which the changes will apply. The implications for businesses go beyond 'familiarisation with the measure and updating reporting processes' as envisaged in the July Policy Paper.

2.8. This change comes at a time when the compliance burden for businesses is already significant, because of recent international tax reforms (country by country reporting and Pillar 2 etc. in the case of very large businesses), changes to transfer pricing documentation and other measures coming in in the next few years such as E-invoicing for VAT and the standardisation of corporation tax computations. These measures all put an enormous administrative burden on those dealing with compliance, and the pace of change will have a detrimental impact on the UK's competitiveness and perception that it is a stable place to do business.

2.9. In our view, this change being introduced in this way is contrary to the overall message of stability that was promised in the Corporate Tax Roadmap in 2024. Although the Roadmap notes that the government can take action 'in response to unforeseen developments, such as an identified risk of abuse or an identified issue with the application of legislation to new business models or practices', we do not think that this reform or the issues it is intended to address fall within these categories, and they do not warrant such expeditious action by the government. This significant change to a settled area of the UK tax code would have benefited from a proper consultation process.

2.10. However, we also recognise that for some the change may be welcome. If the exemption for foreign PE profits and losses provides a simple system which avoids the need to claim double tax relief for tax incurred on profits and income of a foreign PE, the system can help UK-based businesses invest overseas. Making the exemption mandatory further simplifies the position by drawing a clear dividing line between UK-generated profits and losses and those generated offshore. But the change removes some of the flexibility, potentially jeopardising some investment. As intended by the government, it will no longer be possible to utilise early-stage losses of an overseas branch to shelter UK profits before choosing to make an election for the exemption to apply or incorporating the business into a foreign subsidiary.

2.11. But there are a variety of ways that the perceived issue could have been tackled. The lack of consultation and immediacy of the change are unhelpful. Piecemeal, reactionary, sector-specific taxes risk undermining business confidence and investment.

3. Definition of PE and treaties

3.1. The draft legislation includes a bespoke definition of PE for the purposes of the exemption. Rather than relying on the UK's domestic PE definition, the legislation provides that the existence of a foreign PE will be determined by reference to the relevant double tax treaty or, where no treaty exists, the OECD Model Convention.

3.2. While this is described in the July Policy Paper as ensuring that the term 'permanent establishment' is given its 'international meaning' in all cases, we recognise that this is an anti-avoidance feature. Without it, a business could have had sufficient presence overseas to constitute a PE under the UK domestic definition, but not under the provisions of the relevant double tax treaty. In those circumstances, profits might otherwise have fallen outside the scope of tax in both jurisdictions. The new rule appears designed to ensure that such non-treaty qualifying branches remain within the charge to UK corporation tax and do not escape taxation entirely through mismatched definitions.

3.3. It does mean, however, that businesses must navigate different definitions of a PE for different purposes, with the definition being different for the purposes of UK domestic rules, Pillar 2 and now, the foreign PE exemption.

3.4. We recognise that differing definitions of a PE arise partly because of the complexities of international law and the different rules that are negotiated for double tax treaties, but this outcome creates a challenge that needs to be managed. One solution would be to have the treaty definition of PE apply for all UK tax purposes where a treaty applies and, for example, the OECD Model definition where there is no treaty.

3.5. As noted above, under the new regime, foreign PE profits will sit entirely outside the UK tax net, removing the need for double tax relief. This simplifies UK tax computations, but it also removes a mechanism that has historically smoothed differences in tax rates across jurisdictions.

3.6. The UK's double tax treaties generally require the UK to give credit for foreign tax imposed on a foreign PE and it is not clear whether the UK's approach to negotiating treaties will change to mirror the change to domestic law going forward. We would welcome clarification from the government about its future approach to treaty negotiation and whether it intends to renegotiate existing treaties.

4. Innovation reliefs – R&D and Patent Box

4.1. A mandatory foreign branch exemption will impact the relief available to UK companies for research and development (R&D) and application of the patent box rules.

4.2. Broadly, the mandatory exemption will mean that costs of the foreign PE will no longer be qualifying expenditure for the purposes of the R&D regime. This will be particularly relevant to staff costs. Currently, the costs of staff of the claimant company that were undertaking R&D in a foreign PE are claimable, if the company has not made an election into the foreign branch exemption. Once the exemption is mandatory, these costs will no longer be claimable. We recognise that this aligns these costs with the broader rules on overseas expenditure. However, because the legal structure is still that of a branch, it is also not possible for these staff costs to avail themselves of the R&D overseas exemption (in CTA 2009 section 1138A), which permits some overseas costs to be claimed in exceptional circumstances, because the staff costs in the foreign branch cannot be either 'contracted out' or in respect of externally provided workers.

4.3. It seems inequitable that, if the overall purpose of the change to the law is to align the treatment of foreign PEs with foreign subsidiaries, the relief available for R&D purposes is not also aligned. We suggest that a change should be made to the legislation to ensure that if the UK head office has supervision, direction and control over the R&D activities of the branch (that is to say the arrangements are akin to externally provided workers (EPWs)), then the costs of the workers are given equivalent treatment as EPWs under the R&D relief rules, and also the Patent Box rules.

4.4. There is a similar issue regarding the Patent Box rules because the mandatory exemption will mean that profits of the foreign PE will be excluded from Patent Box calculations and the treatment of R&D costs as 'contracted out to a related party' will adversely impact the R&D fraction. In the situation outlined in paragraph 4.3, where the arrangements are akin to EPWs, this again results in a misalignment between the taxation of foreign PEs and foreign subsidiaries as R&D undertaken by EPWs in a foreign subsidiary, would positively impact the R&D fraction.

4.5. The short period before commencement of mandating of the foreign branch exemption gives business little time to consider the impacts for them and to restructure to accommodate the new rules. In any event, for some businesses with foreign branches, it will not be possible for them to change their business structure to foreign subsidiaries for regulatory reasons.

4.6. The complexities for the profit attribution rules to foreign PEs also mean that there is a lack of clarity as to how the costs of services in a UK head office tax computation will be treated for the purposes of Patent Box calculations, and whether these will be considered 'deductions' in calculating the corporation tax profits of the company.

5. Pillar 2

5.1. The Pillar 2 rules (implemented in the UK as the Multinational Top-up Tax, the Domestic Top-up Tax and the Undertaxed Profits Rule) are very complicated. An MNE's effective tax rate (ETR) is an important part of the calculations, not least for the transitional ETR safe harbour. The introduction of a mandatory exemption for foreign PEs may well impact on the ETR for an MNE, not least because of the changes to the treatment of losses (see below).

5.2. Working through the Pillar 2 implications will be a significant piece of work for UK companies with foreign PEs and is another reason why the imminent commencement date is unwelcome. Pillar Two outcomes could change materially, with potential for increased top up tax where UK tax no longer contributes to jurisdictional ETRs.

6. Losses

6.1. The most immediate impact will be the loss of UK tax relief for foreign PE losses. For groups that have historically set overseas branch losses against UK profits, this will likely result in higher UK taxable profits, increased current tax cost and greater ETR volatility.

6.2. Under the current rules, if a foreign PE has not elected for the exemption, any tax losses attributable to the PE can be relieved against UK profits. To the extent that these have arisen, but have not been used by the group, there may be a deferred tax asset in the accounts of the UK company. Under the new rules, transitional rules will apply in respect of losses. But, in almost all cases, 'restricted losses', which arose before the exemption takes effect and are carried forward when the company enters the new mandatory regime, will not be available to relieve future UK profits.

6.3. For those UK companies that had reflected the losses in their accounts, the deferred tax assets may have to be released, which could have a significant impact on an MNEs balance sheet. Volatility of this nature is unwelcome for businesses' boards and investors.

7. Acknowledgement of submission

7.1. We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

8. About us

8.1. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

8.2. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

8.3. The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

8.4. Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation
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