Linklaters

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UK Tax Alert.

Budget 2016 - Key Measures for Large Business.

The Chancellor described this year's Budget as including a "fundamental reform of the business tax system". This means more closing of loopholes and reductions in reliefs. However, the quid pro quo is that the rate of corporation tax is to fall further, to 17 per cent. from 2020. The UK tax system continues to move towards a low rate, broad base system.

One of the most significant changes for large business is likely to be the introduction from 1 April 2017 of a "fixed ratio rule" limiting corporation tax deductions for net interest expense to 30 per cent. of a group's UK EBITDA (subject to a "group ratio rule" which may assist more highly leveraged groups in some cases). The UK's loss relief rules are also to be dramatically changed. From 1 April 2017 the amount of taxable profit that can be offset by losses carried forward will be restricted to 50 per cent. (with banks subject to even lower caps in some cases). However, it is not all bad news regarding losses as the rules will also be made more flexible so as to allow companies to use carried forward trading losses against non-trading income (and vice versa) or profits of other group companies.

For the full "Overview of Tax Legislation and Rates" for Budget 2016, setting out details of all proposed new measures, click here. Where draft legislation or further details are available we have linked to these below. However, in many cases draft legislation will only be available once Finance Bill 2016 is published on 24 March 2016. Some measures are also on a longer timetable still.

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Corporate Tax

Further decreases in the rate of corporation tax

One of the biggest headlines from the Budget is a further reduction in the rate of corporation tax. The rate was previously scheduled to fall to 18 per cent. from 1 April 2020. However, there is now to be a further percentage point decrease to 17 per cent. in 2020. The rate change will be implemented by Finance Act 2016.

"One of the biggest headlines... is a further reduction in the main rate of corporation tax."

*Measures to combat Base Erosion and Profit Shifting ("**BEPS**")*

As anticipated, the Government published a "Business Tax Roadmap", setting out plans for major business tax reforms to 2020 and beyond. The overriding ethos is that "*taxes should be low, but must be paid*". With this in mind, the Roadmap announces or confirms a number of actions in response to the OECD's Action Plan on BEPS. Indeed, the Chancellor made clear in his speech that "*Britain will be among the very first to implement*" the OECD's conclusions.

BEPS: Restrictions on interest deductibility

Perhaps the most significant BEPS-related announcement is that the UK is to introduce restrictions on the tax deductibility of corporate interest expense in line with the recommendations set out by the OECD in relation to BEPS Action 4. In particular, there is to be a "fixed ratio rule" limiting corporation tax deductions for net interest expense to 30 per cent. of a group's UK EBITDA. This is to be supplemented by a "group ratio rule" based on the net interest-to-EBITDA ratio for the worldwide group, recognising the fact that some groups may have high external gearing for genuine commercial purposes. There will be a *de minimis* group threshold of £2 million net of UK interest expense and rules to address volatility in earnings and interest.

"... the UK is to introduce restrictions on the tax deductibility of corporate interest expense..."

The details are otherwise limited at this stage, with the Government planning to consult further on the design of all aspects of the measure. The Government will also continue engaging with the OECD on rules to apply to the banking and insurance sectors and there remain questions as to how the rules will be implemented in an EU law-compliant manner. However, the extremely short timetable that the Government has announced for this measure (it is expected to be included in Finance Bill 2017 but is planned to take effect from 1 April 2017) means that businesses need to start planning now.

Once the new provisions are introduced, there will no longer be a need for the "worldwide debt cap" rules, which will be repealed, although rules with similar effect will be integrated into the new provisions to help counter BEPS in groups with low gearing.

BEPS: Other measures

A number of previously announced measures targeting BEPS were also confirmed or expanded upon:

> **Hybrid mismatches:** The proposed anti-hybrids rules published in draft in December 2015 are to be introduced from 1 January 2017 as planned, and are to be extended to address mismatches involving permanent establishments.

> **Patent Box:** Finance Act 2016 will amend the patent box regime so that it is consistent with the "nexus approach" agreed via the OECD BEPS project, which links benefits to the level of R&D investment undertaken. The Government will also keep under review the case for

reducing the current 10 per cent. tax rate available under the regime, in light of the scheduled reductions in the main rate of corporation tax.

> **Country-by-country reporting:** The UK has already legislated to require country-by-country reporting of tax and other information to HMRC for 2016 accounting periods onwards. However, the Government believes there is an opportunity to go further by requiring multinationals to make the details of tax paid publicly available. The UK will therefore press the case for public country-by-country reporting on a multilateral basis.

"The UK will therefore press the case for public country-by-country reporting..."

> **Double taxation treaties:** A multilateral instrument to modify tax treaties to:

- address hybrid mismatches;
- prevent the granting of tax treaty benefits in inappropriate circumstances;
- prevent the artificial avoidance of permanent establishment status; and
- make tax treaty dispute resolution mechanisms more effective,

is expected to be ready for signature by the end of 2016. Over 90 jurisdictions are involved in this project, which is chaired by the UK.

Other points to note include:

"No amendments are to be made to the UK's controlled foreign companies rules in light of BEPS..."

> **CFC rules and DOTAS:** No amendments are to be made to the UK's controlled foreign companies ("**CFC**") rules in light of BEPS, and there appears to be no immediate plan to extend the UK's disclosure of tax avoidance schemes ("**DOTAS**") rules to cross-border avoidance.

> **Transfer pricing:** Legislation will, however, be included in Finance Bill 2016 to ensure that the UK's transfer pricing rules refer to the latest version of the OECD's guidelines. The Government will also consult on whether to introduce secondary adjustment rules into the UK's transfer pricing legislation. According to the Government, such rules would address the underlying cash benefit from incorrect transfer pricing and encourage broader compliance with the transfer pricing legislation.

> **Anti-Tax Avoidance Directive:** The Government made no mention of the EU Commission's proposals for an Anti-Tax Avoidance Directive so it is assumed that, at least to the extent this would cover the same ground as the OECD's Action Plan on BEPS, the Government has chosen to follow the OECD's recommendations rather than those of the Commission.

VAT and e-commerce

Another focus of the BEPS project was the tax challenges posed by the digital economy. Whilst not explicitly linking the measures to BEPS, in Budget

2016 the Government announced two measures to tackle VAT evasion which, it considers, has grown alongside the growth of e-commerce.

> First, VAT legislation pursuant to which HMRC can require overseas businesses to appoint a UK-established VAT representative, or give security, will be strengthened.

> Second, HMRC will be given new powers to make online marketplaces jointly and severally liable for the unpaid VAT of overseas businesses who are non-compliant with the UK VAT rules.

Neither of these mechanisms will apply automatically to any businesses, and the relevant policy paper seeks to provide reassurance that HMRC will use them to target the highest risk cases. However, whilst the Government sees the measures as necessary to protect the UK market from unfair online competition, no doubt online marketplaces will be concerned at the tax exposure they will have as a result of the actions of their users. The new measures will apply from Royal Asset of Finance Act 2016.

The Government has also launched a consultation in relation to the introduction of a fulfilment house due diligence scheme, applicable to UK-based businesses that fulfil orders of imported goods.

More generally, the Government seems to have a focus on VAT avoidance and evasion, and has announced that it will consult during summer 2016 on updating the VAT disclosure regime.

Changes to corporation tax loss relief

There are to be two significant changes to the rules on corporation tax loss relief:

> First, the rules will be made more flexible for losses incurred on or after 1 April 2017, by allowing companies to use carried forward losses against profits of other group companies and to allow carried forward losses of a particular type to be used against income of a different type. (Currently, for example, carried forward trading losses can only be used against income from the same trade.)

> Second, the amount of taxable profit that can be offset by losses carried forward will be restricted to 50 per cent. from 1 April 2017. This restriction will only apply to profits in excess of £5 million.

The Government will consult on the design of the reforms in 2016 and will legislate in 2017. Clearly the 50 per cent. restriction may be costly for many companies, delaying the period over which their losses can be used (indeed the policy costings published alongside the Budget indicate that overall the changes to corporation tax loss relief will be revenue-raising). However, for some groups, the restriction may be outweighed by the benefit of being allowed to use carried forward losses on a group basis or against other profits.

"There are to be two significant changes to the rules on corporation tax loss relief..."

The Government has already restricted to 50 per cent. the amount of profit that banks can offset with pre-April 2015 carried-forward losses. This will be further restricted to 25 per cent. from 1 April 2016. Losses that banks have incurred post-April 2015 will continue to be treated in the same way as those of other companies, as will pre-April 2015 losses that are covered by the existing "new-entrant" bank and building society reliefs.

Withholding tax on royalty payments

The Government is to introduce anti-avoidance rules to prevent the abuse of double taxation arrangements ("**DTA**") to avoid the duty to deduct income tax from royalty payments made to connected persons. This is designed to ensure that royalty payments cannot be used to directly or indirectly shift profits from the UK to low tax jurisdictions.

To achieve this, draft legislation for inclusion in Finance Bill 2016 has been published which will require royalty payments made to a connected person on or after 17 March 2016 to be made under deduction of income tax regardless of any DTA if the payment is part of an arrangement one of the main purposes of which is to obtain a tax advantage by virtue of a provision of a DTA in circumstances which are not in accordance with the object and purpose of that DTA. Presumably the Government takes the view that, because this measure only applies in "avoidance" cases, it does not conflict with the UK's obligations under its DTAs.

Legislation will also be introduced at a later stage of the Finance Bill 2016 process to amend the definition of intellectual property rights in respect of which withholding applies and to add a new provision providing that royalties connected with a UK permanent establishment will be considered to come from a source in the UK.

*Consultation on the Substantial Shareholdings Exemption ("**SSE**")*

The Government is to consult on the extent to which the SSE is still delivering on its original policy objective and whether there could be changes to its detailed design in order to increase its simplicity, coherence and international competitiveness. No further details are provided at this stage.

"The Government is to consult on the... Substantial Shareholdings Exemption..."

Delay to changes in corporation tax payment dates

At the Summer Budget 2015, the Government announced it would bring forward the corporation tax payment dates for companies with profits in excess of £20 million. Such companies will be required to make corporation tax payments in the third, sixth, ninth and twelfth months of their accounting periods. The new payment schedule had been due to apply from 2017, but, to give companies more time to prepare for the transition, the Government has deferred the measure such that it will now apply to accounting periods starting on or after 1 April 2019.

How will the Budget announcements affect the competitiveness of the UK tax regime?

The UK Government has consistently expressed its desire to ensure that the UK is a competitive place to do business. However, will the significant changes to the corporate tax system announced in Budget 2016 further this cause?

Clearly the headline-grabbing reduction in the corporation tax rate to 17 per cent. increases the UK's attractiveness for business. (Although the policy costings that accompany this measure indicate that the Government expects it will result in a cost to the exchequer that will only be alleviated to a small extent by the behavioural change it effects (i.e. increased investment in the UK).)

On the other side of the coin, the new (and unexpected) restrictions on loss relief and the UK Government's response to BEPS in the form of restrictions on interest deductibility and anti-hybrids rules will be less welcome, and change some fundamental aspects of the UK tax system that have been valued by business to date.

Competitiveness is, of course, a question of relative attractiveness of the UK tax system when compared with others.

If all jurisdictions comply with the OECD BEPS recommendations, the UK's decision to early-adopt BEPS-compliant measures in relation to interest deductibility and anti-hybrids, and the fact that the UK tax system already has in place many of the other measures recommended by the OECD (e.g. CFC rules, disclosure rules) and has committed to implement the others (e.g. treaty change) should not, in due course at least, be damaging. Indeed, the fact that the UK system will in a short space of time be BEPS-compliant, and therefore less uncertain, may be advantageous.

The UK's concern, however, should be whether it is playing on a level field. The big unknowns are whether, how thoroughly and how soon other jurisdictions will align their tax systems with the OECD BEPS recommendations. Unless and until they do, there is a risk that they will enjoy a competitive edge.

"...the UK system will in a short space of time be BEPS-compliant, and therefore less uncertain..."

Financial Services Tax

A number of changes potentially helpful to the financial services industry were announced, including:

> Changes to the exempt entity test to ensure that the tax regimes specific to banks (including the bank loss restriction, banking surcharge, Code of Practice on taxation for banks, bank compensation restriction and bank levy (although there is some lack of clarity about whether the changes will apply to the bank levy)) are appropriately targeted;

> A power to make statutory instruments to deal with the tax treatment of insurance-linked securities issued in the UK (complementing the current consultation on insurance-linked securities, which is focussed on attracting insurance-linked security business to the UK).

> An extension to HM Treasury's existing power to make Regulations concerning the taxation of securitisation companies, which currently only applies to the provisions of the Corporation Tax Acts, to encompass the Income Tax Acts. This will enable the Government to clarify, in particular, that 'residual payments' made by securitisation companies will not be treated as annual payments and can accordingly be paid without withholding tax. The Government notes that this is currently an area of some uncertainty, which has resulted in taxpayers seeking HMRC clearance on a case-by-case basis. The Regulations will form part of a wider ongoing consultation with industry to update and modernise the tax regime for UK securitisation companies.

> An HMRC review of the Double Taxation Treaty Passport scheme to ensure it still meets the needs of UK borrowers and foreign investors. A consultation document released later this year will also seek to determine whether the scheme should be extended to other types of foreign investor, including sovereign wealth funds, pension funds and partnerships.

"HMRC plans a review of the Double Taxation Treaty Passport scheme..."

However, the news was less positive in relation to loss relief: as noted above, measures will be introduced with effect from 1 April 2016 to further restrict the proportion of a banking company's annual taxable profit that can be offset by pre-2015 brought forward losses from 50 per cent. to 25 per cent. This is discussed further here.

Real Estate Tax

SDLT

Budget 2016 saw the announcement of further reform of the SDLT regime, this time in relation to non-residential property. Transactions in non-residential (including mixed residential and non-residential) property which complete on or after 17 March 2016 (subject to transitional rules) will be subject to a new method of calculating SDLT. The current "slab" system will be abolished and replaced with a "slice" system; SDLT will be payable on the portion of the consideration given for a freehold purchase or as a lease premium which falls within each band as follows:

"Budget 2016 saw the announcement of further reform of the SDLT regime..."

Consideration	Rate
£0 to £150,000	0%
Over £150,000 and up to £250,000	2%
Over £250,000	5%

Additionally, the SDLT charge on the rental element of leasehold transactions for non-residential property will be calculated by reference to a new 2 per cent. rate band where the net present value of the rent is above £5 million.

The Government has also reconfirmed the introduction of higher rates of SDLT on purchases of additional residential properties, such as second homes and buy-to-let properties. The higher rates will be 3 percentage points above the current rates of SDLT, payable on the total price paid for the property (although will not apply to purchases under £40,000). The Government has decided not to include an exemption for significant investors.

Profits from trading in or developing UK land

Significant changes will also be made to the taxation of profits from trading in or developing UK land. The Government is concerned about property developers using offshore structures to avoid UK tax on their profits. To address this, essentially the current territorial restriction which has been relied on by such developers will be removed so that the profits of a trade carried on by a company will be subject to UK corporation tax on income where the trade comprises dealing in UK land, or developing UK land with a view to disposing of it, regardless of the residence of the company carrying on the trade, wherever the trade is carried on and whether or not the trade is carried on through a permanent establishment in the UK or elsewhere. There will be equivalent changes for income tax.

"The Government is concerned about property developers using offshore structures to avoid UK tax on their profits."

Changes will also be made to the DTAs between the UK and each of Guernsey, the Isle of Man and Jersey to align them with the new approach. It is possible that this measure was a late addition to the Budget - a technical note has been published but the legislation will only be introduced at Report Stage of Finance Bill 2016 and will take effect from the date of introduction (although anti-forestalling measures apply in the meantime). The measure itself is to be accompanied by a number of anti-avoidance rules.

Other changes

The Government will publish a discussion document in spring 2016 with options for change to the tax treatment of leases of plant and machinery in response to the International Accounting Standards Board's new lease accounting standard (IFRS 16).

The Business Tax Roadmap and Budget Report also contain details of significant changes to business rates.

Finally, it should be noted that the announced reduction in the capital gains tax rate from 1 April 2016 to 10 per cent. (from 18 per cent.) and 20 per cent. (from 28 per cent.) will not apply to chargeable gains accruing on the disposal of residential property (although this will only be relevant where principal private residence relief does not apply).

Employees, Funds and Private Equity Tax

As has become commonplace, there were a number of changes relevant to the private equity sector, funds and employee taxation more generally.

In the “good news” list:

> There are to be various changes to entrepreneurs’ relief, including:

- Very significantly, an extension of entrepreneurs’ relief to external investors in unlisted trading companies. This new so-called “investors’ relief” will apply the 10 per cent. rate of capital gains tax to gains accruing to an individual on the disposal of ordinary shares in an unlisted trading company, where those shares were newly issued to the taxpayer and acquired for new consideration on or after 17 March 2016, and have been held for a period of at least three years starting from 6 April 2016. There will be no requirement for the investor to be an officer or employee of the company or to hold 5 per cent. of shares.

  There will be a lifetime cap of £10 million on the gains that can benefit from “investor’s relief”, and as might be expected, this new relief will be supplemented by anti-avoidance provisions.

- Changes to mitigate some of the effects of the Finance Act 2015 restrictions on relief for ‘associated disposals’, assets held through joint ventures and partnerships and goodwill on incorporation.

> As expected, legislation will be introduced in Finance Bill 2016 to set out the circumstances in which performance-related rewards paid to asset managers may be charged to capital gains tax rather than being charged to tax as income. Under this legislation, eligibility for capital gains tax treatment will be determined by the length of time for which the underlying scheme holds its investments on average.

The Government has now stated that full capital gains tax treatment will apply where the average hold period is 40 months or more (rather than 48 months as specified in the draft legislation published on 9 December 2015). Bespoke calculation rules will also be introduced for additional asset classes, including venture capital and real estate, alongside a number of other minor technical changes.

> The Government has given some comfort in relation to salary sacrifice. Whilst stating that it is concerned about the growth of salary sacrifice schemes, the Budget 2016 policy paper states that “*the government’s intention is that pension saving, childcare and health-related benefits such as Cycle to Work should continue to benefit from income tax and NICs relief when provided through salary sacrifice arrangements*.”

> Finance Act 2017 will contain legislation to remove the obligation on OEICs, authorised unit trusts and investment trust companies to

“There are to be various changes to entrepreneurs’ relief...”

withhold amounts on account of income tax from payments of interest from April 2017.

Changes which are likely to be less well received include:

> A lifetime limit of £100,000 on the capital gains tax exempt gains that a person can make on the disposal of shares acquired under Employee Shareholder Agreements, where the agreement was entered into after midnight on 16 March 2016.

> Increases to the rate of tax chargeable under the close company loans to participator rules, to mirror the dividend upper rate following the changes to dividend taxation applicable from April 2016. The rate of tax charged will increase from 25 per cent. to 32.5 per cent. with effect from 6 April 2016 (with appropriate apportionment for any straddle period).

> An additional tightening up of the disguised remuneration rules, including this year by the introduction of a targeted anti-avoidance rule (with effect from 16 March 2016), and the withdrawal of relief on investment returns (with effect from 30 November 2016). More changes will be made in future Finance Bills, following consultation. The Government states that it is committed to tackling all avoidance in this area.

It should be noted that the announced reduction in the capital gains tax rate from 1 April 2016 to 10 per cent. (from 18 per cent.) and 20 per cent. (from 28 per cent.) will not apply where carried interest is subject to capital gains tax (with the current rates continuing to apply).

The Government will consult on measures to streamline the tax rules for investors in Authorised Contractual Schemes and on how partnerships calculate their tax liabilities.

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