UK Pre-Budget Report Update

16 December 2005

This year’s Pre-Budget Report had a strong focus on anti-avoidance, mainly as a result of information HMRC have received under the Tax Disclosure rules. Some of the more important announcements were:

- **A UK REIT (Real Estate Investment Trust)**
  
  The UK Government announced a major move forward to the creation of a UK REIT; draft legislation will be published during December 2005 for consultation prior to its inclusion in the March 2006 Finance Bill. The Government are keen to ensure that the proposed model works and it is, therefore, logical that details of the conversion charge will not be available until March 2006.

  Preliminary details confirmed are that:

  - the regime will be available to UK tax resident companies
  - the companies must be publicly listed on a Recognised Stock Exchange (i.e. not just in London)
  - companies or groups meeting the eligibility criteria will be exempt from corporation tax on qualifying property rental income and qualifying chargeable gains
  - the requirement will be to distribute at least 95% of net taxable profits on rental income (i.e. no obligation to distribute capital gains)
  - investors will then pay tax at their marginal rate on distributions

  The attached table summarises the structure and investment criteria for REITs.

- **Tax Avoidance Disclosure Rules**

  The Disclosure Rules, which were introduced by FA 2004, require taxpayers or promoters to notify HMRC of tax avoidance transactions involving certain employment products and financial products. The rules contain three “filters” designed to exclude standard tax planning arrangements and ideas HMRC are already aware of.

  Proposed changes to the Disclosure Regime include:

  - improving the effectiveness of the ‘filters’ for direct tax to ensure they reflect recent developments in avoidance behaviour. This change is likely to lead to more disclosures being made;

  HMRC will be consulting on the proposed changes. The changes will be effective from April 2006.
• **Financial avoidance using stock lending arrangements**

A scheme reported under the disclosure rules that allows companies or persons to avoid tax on interest using a stock lending arrangement has been blocked. This measure is targeted at avoidance of tax on interest on cash deposits, using a stock lending arrangement with non-commercial terms. The arrangements affected are those where the stock borrower did not pay manufactured dividends and the stock lender did not account to the borrower for interest on any collateral.

• **Transfer of assets abroad**

Action is being taken to stop UK-resident individuals avoiding tax by exploiting offshore companies and trusts. Changes to the transfer of assets abroad legislation will tighten the rules for exemption from liability and close loopholes with effect from 5 December.

• **Avoidance through the creation and use of capital losses by companies**

Three new Targeted Anti-Avoidance Rules (TAARs) have been introduced which are aimed at preventing the ‘artificial’ creation and use of corporate capital losses where there are arrangements and one of the main purposes of those arrangements is to secure a tax advantage.

The legislation addresses three types of behaviour with three separate TAARs:

1. The contrived creation of corporate capital losses;
2. The buying of capital gains and losses; and
3. The conversion of income streams into capital gains, and the creation of a capital gain “matched” by an income deduction. In both scenarios the gain is wholly or partly franked by capital losses.

All three TAARs will only apply where there is a main purpose of obtaining a tax advantage. In addition TAAR 3 requires the issue of a notice by HMRC directing that the legislation applies.

• **Treasury consents**

The Treasury consent rules require companies to seek permission from HM Treasury to carry out certain transactions relating to their overseas subsidiaries. The Government is to begin discussions with business in 2006 on possible replacements for this legislation.

• **Leased Plant and Machinery**

As announced in the 2004 Pre Budget Report, legislation will be included in the Finance Bill 2006 to align the tax treatment of leased plant and machinery with that of other forms of finance. Broadly these rules will deny the lessor allowances on a “long funding lease” of plant and machinery and will give the allowances to the lessee; only the finance element of the rentals being taxable and deductible in their hands.
• **Sale of lessor companies - Lease Tails**

Changes have been announced to the way that lessor companies are taxed when they change ownership. Groups have benefited from capital allowances in the early years of a lease, before selling ‘tax positive’ lessor companies to loss-making groups to avoid paying tax on the subsequent profits.

This measure, effective from 5 December, imposes a charge on the leasing company on the day that it is sold in order to recover the tax benefits that have been taken, and grants an equal relief to the acquiring company on the day after the sale. HMRC say the measure is not intended to deter commercially driven sales; but the rules need to be considered on the sale of any company which owns leased plant and machinery.

The legislation also includes provisions to prevent tax being lost if partnership structures are used to achieve the same effect.

• **International Accounting Standards: Tax Implications**

Further Regulations are to be laid shortly which will come into effect before the end of 2005. These make a number of amendments to the existing rules:

The Regs:

− Amend the regulations enabling the existing UK GAAP tax treatment of hedging transactions to continue in certain circumstances, including hedging a share liability.

− Set out the meaning of exchange gain or loss in cases where fair value accounting is used.

− Ignore for tax purposes any gains or losses on embedded derivatives that are brought into accounts under IAS where the underlying subject matter is a commodity or is a contract of long term insurance.

− Spread transitional amount for debt impairment of bank and other financial institutions over ten years from accounting periods beginning on or after 1 January 2006, in common with the treatment of other transitional amounts announced on 22 July 2005.

− Defer bringing into account for tax transitional amounts for bank and other financial institutions unclaimed balances.

Also the Government will legislate in Finance Bill 2006 to enable most businesses affected by the March 2005 changes in the income recognition rules in UK Generally Accepted Accounting Practice (GAAP) to spread any extra tax charge over three years, while those businesses most severely affected will be able to spread the charge over a period not exceeding six years.

• **IAS and securitisation companies**

Following discussions with interested parties, the Government has decided to extend the temporary regime in section 83 FA 2005 for taxing securitisation companies for a further year to 31 December 2007. In the meantime, discussions will continue on the design of a permanent regime for securitisations of financial assets, with a view to the regime coming
into force by 1 January 2007. Representations will be sought on whether a similar regime may be needed for property and whole business securitisations.

Regulations will be laid early in 2006, to have effect for accounting periods beginning on or after 1 January 2005, to amend the definition of ‘securitisation company’ for the purposes of the temporary regime, to prevent it applying to non-securitisation companies (such as banks) who issue capital market investments in the course of their normal trade.

- **New Film Tax Incentives**
  Small budget British films will receive an enhanced tax deduction of 100 per cent with a payable cash element of 25 per cent, amounting to a benefit worth at least 20 per cent of qualifying production costs. Large budget films will receive an enhanced deduction of 80 per cent with a payable cash element of 20 per cent, amounting to a benefit typically worth 16 per cent of qualifying costs. The new tax incentives come into effect from 1 April 2006.

- **Planning Gain Supplement (“PGS”)**
  The Government are seeking to capture a “modest” portion of the land value increases or “uplift” created by the planning process to help finance additional infrastructure. The percentage at which this levy will be set has yet to be determined.

- **VAT exemption for insurance-related services, including outsourcing**
  The Government has considered responses to the HMRC consultation concerning VAT and insurance related services following the ECJ judgment in *Arthur Andersen & Co Accountants* (case C-472/03). The Government has noted that the VAT treatment of financial services and insurance will now be subject to review by the European Commission in the near future, and has decided to delay its decision regarding implementation of this ECJ judgment. The Government will monitor the progress of the review in deciding when to make the necessary changes to UK law and will provide industry with sufficient notice in advance of implementation.

- **Residence and domicile**
  The Government is continuing to review the residence and domicile rules as they affect the taxation of individuals, and in taking the review forward will proceed on the basis of evidence and in keeping with its principles.

- **EU Law Challenges**
  The Government has restated its position that it is determined to continue to defend robustly the corporation tax system against legal challenges under EU law.
• Corporation tax reform now dead

The Government has no current plans to take forward proposals to reform the UK’s Schedular system for the corporation tax charge on income reform or the taxation of capital assets although the Government are considering the scope for modernising capital allowances.