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TAX | UNITED KINGDOM | 18 MARCH 2016

UK BUDGET 2016

Some big changes in a very mixed Budget delivered earlier this week.

There were some clearly positive announcements - among them an additional future reduction in the rate of corporation tax (falling to 17% by 2020).

However, the UK government appears emboldened in its continued drive against perceived avoidance by the presence of a new ally: the OECD.

The OECD's "Base Erosion and Profit Shifting" (BEPS) project is proving fertile ground for the government on which to base multiple anti-avoidance measures directed at multi-national groups (the still-fresh "diverted profits tax" being one of the most obvious examples of this phenomenon).

Thus in this Budget we say goodbye to the UK's previously generous regime for the deductibility of interest payments, and we welcome in its place the OECD-backed strict limitation on deductibility.

Another pillar of the UK tax system to disappear in the Budget is the unrestricted ability to use carry forward losses to reduce current profits. A limit will now be imposed on this too.

And finally no modern Budget would be complete without measures specifically targeting the banking sector; this one is no exception.

Restriction on interest deductibility

The UK will introduce a fixed ratio rule limiting corporation tax deductions for net interest expense to 30% of a group's UK earnings before interest, tax, depreciation and amortisation (EBITDA).

There will also be a group ratio rule based on the net interest to EBITDA ratio for the worldwide group as recommended by the OECD.

On the positive side:

- There will be a *de minimis* group threshold of £2m net of UK interest expense.
- The government will introduce carry-back and carry-forward rules to address volatility in earnings and interest.
- The existing worldwide debt cap rules will be repealed.

Loss relief: good news and bad news

The good news: in relation to losses incurred on or after 1 April 2017, companies will be able to use carried forward losses against profits from different types of income within the same company, and in set-off against the profits of other group companies.

This represents a major step forward: a feature of the UK loss regime which has affected certain sectors in particular (such as private equity) has been the limitation that only current year losses can be surrendered between group companies by way of group relief. Thus it will be possible to surrender to other group members carried forward losses, and in addition to use losses generally against all types of income.

The bad news: the government will restrict the amount of taxable profit that can be offset through carried forward losses. From 1 April 2017 the government will restrict to 50% the amount of profit that can be offset in this way.

The restriction will apply to profits in excess of £5m only.

Banking sector: special measures

The government has already restricted to 50% the amount of profit that banks can offset with pre-April 2015 carried-forward losses (to reduce the impact on corporation tax receipts of losses incurred during the financial crisis). However the government is to restrict the amount of profit that banks can offset using pre-April 2015 carried-forward losses to 25% from 1 April 2016.

This comes on top of the introduction of a new 8% tax on banking sector profit from 1 January 2016.

The above is somewhat offset by the previously announced phased reduction of the bank levy rate, from a rate of 0.21% in 2015 to 0.1% from 1 January 2021, and a change in the bank levy's scope from the latter date to exclude the balance sheet liabilities of non-UK companies from the charge.

Hybrid mismatch arrangements

This represents another OECD-led measure.

The perceived avoidance arises due to “mismatches” which can involve either double deductions, or deductions for an expense without any corresponding taxable receipt.

The measure addresses the mismatch by changing the tax treatment of either the payment or the receipt, by way of a "primary response" or "secondary response".

In the case of double deductions, the primary response is to deny a deduction to the parent company. If this does not occur (because the tax law in the country in which the parent company is resident does not provide for this), the secondary response is to deny the deduction to the hybrid entity / permanent establishment.

In the case of deduction/non-inclusion, the primary response is to deny a deduction to the payer. If this does not occur, the secondary response is to bring the receipt into charge for the recipient.

The targets of the measure are mismatches arising from hybrid financial instruments and hybrid entities, and from arrangements involving permanent establishments.

An example of a hybrid financial instrument is one which allows the payer to deduct an amount as interest, but allows the receipt to be treated as an exempt dividend in the hands of the payee. An example of a hybrid entity would be a partnership which is treated as transparent by one jurisdiction, but treated as opaque by another jurisdiction. The effect would be that one jurisdiction would apply its tax rules to the partnership, whilst the other would look through the partnership and apply its tax rules to the partners.

Other measures

Other specific Budget measures include:

- New rules to ensure that non-UK resident property developers will be subject to UK tax on their trading profits from building property in the UK regardless of the transaction structure employed.

- A targeting of cross-border intra-group arrangements using royalties to reduce taxable profits in the UK, by broadening the definition of royalty and permitting the use of double tax treaties to reduce or eliminate withholding tax on royalty payments only where such use is shown to be consistent with the purpose of the treaty.

- A reform of the method of imposing stamp duty land tax (SDLT) on non-residential property acquisitions: the new rates will be 0% for the portion of the transaction value between £0 and £150,000; 2% between £150,001 and £250,000; and 5% above £250,000. Previously the highest rate was 4%.

On a more positive note…

Corporation tax rate: additional reduction

The rate of UK corporation tax, currently 20%, will drop to 19% in 2017 and then to 17% in 2020 (one more percentage point than previously proposed).

Review of the participation exemption for corporate capital gains (the "substantial shareholdings exemption")

The government announced that it will conduct a review of the effectiveness of the UK's participation exemption for corporation tax on capital gains, with the aim of increasing its "simplicity, coherence and international competitiveness".

Although in principle the relief is generous, offering a 100% reduction, in practice the detailed conditions can be difficult to satisfy; if this review leads to a simplification then this could represent a very positive development for the UK corporate tax regime.

Taxation of capital gains for individuals

From 6 April, the top rate of capital gains tax will be cut from 28% to 20%, and the basic rate will be cut from 18% to 10%. Significantly, however, these reductions will *not* apply to gains on residential property, or to carried interest.

Extension to Entrepreneurs' Relief

A welcome announcement was the broadening of Entrepreneurs' Relief.

Currently the relief applies to the disposal of shares in private trading companies, but only in certain circumstances (broadly speaking, where the selling shareholder is an officer or employee of the company and holds more than 5 per cent of the shares). Where the relief is available a 10% tax rate applies (with a lifetime limit of £10m).

The extended relief will apply to disposals of shares in private trading companies by investors, without the requirement for the shareholder to be an employee or to meet the shareholding threshold. This relief will also be subject to a lifetime limit of £10m.

It should be noted that the new relief will apply only to shares which are subscribed for on or after 17 March 2016. In addition, the shares will have had to have been held for a minimum of three years.

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