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a closer look

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Global Tax Weekly – A Closer Look

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Major Upcoming UK Corporate Tax Reforms: The Good, The Bad, And The Incomplete

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Gide Loyrette Nouel

On December 5, 2016, the UK Government published the draft provisions for this year's Finance Bill ("**Finance Bill 2017**") setting out the legislative changes to UK tax law that will take effect in April 2017. For multinational businesses within the charge to UK corporation tax, these draft provisions promise some significant changes which will present both challenges and opportunities.

This article will look at three of the biggest areas of planned tax reform – some of which will be more welcome than others – from the perspective of multinational businesses with interests in the UK.

Loss Relief

Two key reforms to the availability of loss relief, which were originally announced at the time of the Government's Budget delivered in March 2016 (with further details being provided in a consultation paper in May 2016), have been confirmed and will take effect from April 2017, as set out below.

1. Loss restriction

From the perspective of UK companies and UK branches of overseas companies that have carried-forward losses and profits over GBP5m (USD6.07m) per year, there is not-so-good news in the form of a loss restriction.

From April 2017, each standalone company or group of companies will have a GBP5m annual profit allowance (which in the case of group companies applies to the *whole* group) above which carried-forward losses, whenever arising, may only be used against 50 percent of taxable profits.

Previously there was no such restriction at all.

Banking companies and building societies within the charge to UK corporation tax are singled out in a measure designed to restrict the rate at which the significant losses accumulated by banking groups during the financial crisis are offset, with a lower profit threshold of 25 percent of taxable profits applying to losses accrued prior to April 1, 2015.

2. Loss relaxation

The more positive reform takes the form of a loss "relaxation" which provides that carried-forward losses arising from April 1, 2017 will not be subject to the existing requirement which states they can be set off only against total taxable profits of the same income stream – a move that will allow companies and groups increased flexibility in choosing how to allocate reliefs against their various trading and non-trading profits.

Some further positive changes which will be introduced include the following:

3. An extension of terminal loss relief, which will allow companies that have ceased to trade to carry forward losses (without restriction) to use against profits accrued during the final 36 months of its trading (but not before April 1, 2017), without having to apply the abovementioned 50 percent restriction.

4. The automatic expiration that currently applies to a company's losses when it goes into liquidation, will be abolished.

5. Simpler loss relief calculations will be introduced for companies that have no pre-2017 carried-forward losses and those that elect to forgo them.

6. UK real estate investment trusts ("REITs"), which benefit from their own favorable UK tax regime, will be excluded from the loss relief reforms (on the basis that they would not benefit from the relaxation with regards profit streams).

While the planned loss relief rules are significantly relaxed compared to the original proposals announced during the first half of 2016, the new rules are expected to be complicated to apply, in particular for banking companies. What is more is that the rules will be accompanied by a host of targeted anti-avoidance provisions, the drafting of which we have not yet seen.

Concerns also emanate from the insurance industry as to the effect the rules will have on their regulatory capital position, with no clear proposals to address these concerns having so far been made (although the UK Government has said it will continue to monitor the regulatory consequences of the new rules closely).

Corporate Interest Restriction

Although the draft provisions governing the deductibility of interest are not yet complete, they do provide some wanted clarity as to how the UK Government will implement Action 4 (*limiting base erosion involving interest deductions and other financial payments*) of the OECD/G20's base erosion and profit shifting ("**BEPS**") initiative.

UK companies that have interest (or interest like) expenses on which they claim relief for UK tax purposes will see those expenses subject to the new legislation from April 1, 2017. The new rules were first announced in an HM Treasury and HM Revenue & Customs joint consultation document in May 2016, with the key resulting reforms being the following:

1. The introduction of a fixed ratio rule that limits the amount of net interest expense a group is able to deduct against its taxable profits to 30 percent of its tax EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization).
2. The introduction of a group ratio rule (calculated with reference to accounting EBITDA and then applied to UK tax EBITDA). Groups will be able to apply the group ratio rule if it results in a better position than the fixed ratio rule.

The rules will apply to expenses that relate to loan relationships, contracts for derivatives relating to financial assets, and financing costs payable under arrangements such as debt factoring.

In line with OECD recommendations, a key exemption from the rules will be the public benefit infrastructure exemption ("**PBIE**") for qualifying interest expenses incurred by "qualifying companies" which invest in infrastructure projects for the public benefit.

Although the draft provisions have not yet been provided (they are expected at the end of January 2017), the Government's response to the initial consultation states that the PBIE will be somewhat wider than envisaged in May 2016, and will broadly speaking apply in the following way:

- The exemption will be elective and irrevocable once an election has been made.
- Qualifying interest paid by a company which has made the election, to an unrelated third party, will fall outside the scope of the corporate interest restriction rules mentioned above.
- "Qualifying companies" will be those that provide "public benefit services," being:
  - Services procured by a public body (or its wholly owned subsidiary);
  - Services provided in consequence of specific Parliamentary arrangements, such as the regulatory frameworks for the transmission of water and electricity, for port and airport operators, and for the rail network;
  - Services performed in the interest of national security; and
  - Somewhat surprisingly, services for the provision of rental property to unrelated parties.

On the whole however, the UK Government seems to be taking a tough line in its interpretation of the OECD Action 4 guidance, which as per the case with the loss relief reforms discussed above, will hit banking and insurance groups hardest. Whereas the OECD's guidance on Action 4 seems to suggest a modification of the fixed ratio rule would be appropriate for the banking and insurance sectors, the UK Government's current position – while acknowledging "the significant constraints that regulation provides to the use of interest for base erosion purposes in banking and insurance groups" [1] – is that it does not intend to implement such a modified rule.

To what extent (if any) continuing concerns from the two industries with respect to interest deductibility will be addressed when the remaining draft legislation is published later this month, remains to be seen.

Reform Of The Substantial Shareholding Exemption

Of particular interest for UK corporation taxpayers will be the proposed changes to the substantial shareholder exemption (the "**SSE**"). The SSE exempts the disposal of certain shares in subsidiaries from UK corporation tax on capital gains. Very broadly speaking, the SSE currently applies where the following conditions are met:

1. The investing company has held a substantial shareholding (broadly, at least 10 percent) in the investee company and such shareholding was held for a continuous 12-month period beginning not more than two years before the disposal.
2. The investing company was a sole trading company (or member of a trading group) during the 12-month holding period.

3. The investee company was a sole trading company (or member of a trading group) during the 12-month holding period.
4. The investee company remained a trading company immediately after the disposal.

The above conditions will be significantly relaxed (and simplified) in Finance Bill 2017, with the following changes applying to disposals made on or after April 1, 2017:

(a) The SSE will be extended to disposals of shareholdings of less than 10 percent, provided that at least 10 percent was held for a 12-month period within the six years (as opposed to two years under the current rules) leading up to the disposal – *i.e.*, condition 1 has been relaxed.
(b) It will no longer be a requirement that the investing company is a trading company – *i.e.*, condition 2 above is removed.
(c) Provided the disposal is being made to an unconnected person, there will no longer be a requirement for the investee company to meet the post-disposal trading condition – *i.e.*, condition 4 above is removed.

These changes should provide companies and groups with greater certainly as to the availability of the SSE, for example in situations where shareholdings are to be sold in tranches or where it is unclear that the investee company will remain a trading company after the disposal. It should also, for larger groups in particular, prove to be more user friendly and remove some of the administrative burden in claiming the SSE.

There is welcome news too for companies owned by qualifying institutional investors ("**QIIs**") insofar that in addition to the abolishment of conditions 2 and 4 above, where the investee is owned at least 80 percent by QIIs, any gains made on the disposal will be exempt from UK corporation tax in full. Where the ownership is anywhere between 25 percent and 80 percent by QIIs, a proportionate exemption will be available.

"Qualifying institutional investors" for the purposes of the SSE include trustees and managers of registered or overseas pension schemes, sovereign wealth funds, charities, life assurance businesses, investment trusts, and certain widely marketed authorized investment funds or exempt unauthorized investment funds (but notably not at present, REITs).

Concluding Thoughts

The draft provisions are now open for consultation until February 1, 2017; however, Finance Bill 2017 itself is not expected to depart materially from the draft provisions published on December 5, 2016. Rather, it will be a question of fine-tuning.

As described above, for multinational businesses there are major changes on the horizon with regards to loss relief and restrictions on interest deductibility, with each regime boasting over 40 pages of new legislation that businesses will need to make sense of and implement relatively quickly.

What may soften the blow to some degree is the welcomed simplification of the SSE rules, which in their current form are quite cumbersome and in certain circumstances can lead to results which are contrary to the original policy intention.

It is clear, however, that the UK Government – despite calls from some in the wake of the result of the referendum on EU membership to slow down its reform of the UK tax system – is pressing on with corporate tax reform.

Endnote

1 HM Treasury / HM Revenue & Customs response to the consultation on tax deductibility of corporate interest expense (December 2016).