Financial Instruments
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UK Budget 2011: key tax aspects

Adam Blakemore and Oliver Iliffe summarise the key tax aspects of the UK Budget held on 23 March 2011 relating to financial sector taxation and the prevention of tax avoidance.

Financial sector taxation

Loan relationships and Derivative Contracts Disregard Regulations

The Government has announced that it will consult informally in May 2011 on secondary legislation to allow a company to be taxed on the basis of the economic outcome of certain loan relationship and derivative contract hedges which are entered into to reduce the exposure to foreign exchange movements that arise as a result of that company owning foreign currency assets. The secondary legislation will amend the Loan Relationship and Derivative Contracts (Disregard and Bringing into Account) Regulations 2004 (SI 2004/3256) (the 'Disregard Regulations'), which prescribe important exceptions to the general rule that a company's accounting treatment of loans and derivatives govern their tax treatment and which are relevant where a company enters a loan or derivative contract in order to hedge against certain exposures or risks arising to that company under an asset or liability and accounts for a loan or derivative contract in accordance with either IAS 39 or FRS 26.

The proposed changes to the Disregard Regulations are focused on allowing companies to replicate for tax purposes their economic position through forex matching (in respect of loan relationships and derivative contracts) in the following circumstances where companies:

- issue their own foreign currency preference share capital to raise foreign currency finance (with effect for accounting periods beginning on or after 1 July 2011);
- invest directly in foreign currency share investments or in foreign currency assets through a partnership, with deferral of recognition until either the partnership disposes of the assets or the company disposes of its interest in the partnership (with effect for accounting periods beginning on or after 1 January 2012); and
- agree to sell foreign currency shares and receive the proceeds at some future date, with deferral of recognition until the company receives the disposal proceeds (with effect for accounting periods beginning on or after 1 January 2012).

UK Investment Companies and Functional Currency

On 9 December 2010, the government published draft legislation aimed at (amongst other things) preventing investment companies from avoiding tax by changing their functional currency retrospectively.

Following consultation, the Government announced in the Budget that the draft legislation published on 9 December 2010 will be amended in Finance Bill 2011 to make it clear that the ability to elect for a functional currency for tax purposes is limited to companies whose main purpose is to make investments (and the principal part of whose income is derived from those investments) or which are newly incorporated but will meet the new conditions immediately before the start of the first accounting period. The measures will have effect for any period of account beginning on or after 1 April 2011, but a company can make (or revoke) a currency election at any time after 9 December 2010.

The Taxation of Banks: Bank Levy and Code of Practice on Taxation

The bank levy rates for 2012 onwards will now be 0.078% for short-term chargeable liabilities and 0.039% for long-term chargeable equity and liabilities.

Notwithstanding the adverse publicity in the early months of 2011 accompanying some statements by banks of their 2010 profitability and bonus rounds, it is noteworthy that 200 banks are stated by the Government to have adopted the Code of Practice on taxation for banks, including the 'top 15' banks operating in the UK.

Bank Capital Instruments under Basel III

The Basel III proposals on banks' capital requirements (published in December 2010), place a greater emphasis on higher quality capital which should be more able to absorb losses. A number of 'Additional' Tier 1 and Tier 2 instruments which may be developed in response to Basel III will be different in form and operation to previously issued regulatory capital instruments such as innovative, or hybrid, Tier 1, prompting a number of specific UK tax questions or uncertainties. Accordingly, the Government has announced an informal consultation commencing in April 2011 to consider the tax treatment of these instruments in the UK.

Retrospective Tax Treatment of Alternative Finance Investment Bonds

On 19 November 2010, the Government issued a statement acknowledging that Financial Services and

Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the '2010 Order') may inadvertently prevent some bond issuers benefiting from the tax regime applying to UK securitisation companies. The concern arose as a result of the 2010 Order designating alternative finance investment bonds ('AFIBs') a specified investment for the purposes of the Financial Services and Markets Act 2000. However, such a designation was achieved by amending the definition of 'instruments creating or acknowledging indebtedness' in article 77 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, and defining AFIBs in a new article 77A. Unfortunately, the conjunction of the legislative changes resulted in a risk that the AFIBs may no longer fall within article 77, thereby preventing the issuers of such bonds from benefiting from the UK securitisation regime.

A remedial statutory instrument was made on 25 January 2011 to reverse the effects of the 2010 Order and to apply the correct regulatory treatment on or after 16 February 2011. This will be made fully retrospective once clause 89 of the Finance Bill 2011 is enacted.

Index-linked gilt-edged securities

Currently, the rules applying to index-linked gilts (at ss399 to 400C of the Corporation Tax Act 2009) only apply to gilts which are linked to the RPI and not to any other index. The fair value adjustment for index-linked gilts, which excludes amounts attributable to RPI movements, will now apply any gilt which is linked to a price index published by the Office for National Statistics when clause 60 of Finance Bill 2011 is enacted.

Fund Taxation and Developments

The Government has included draft legislation in Finance Bill 2011 with a view to enabling UK managers to take advantage of the management company passport in conjunction with the Undertakings for Collective Investment in Transferable Securities (UCITS IV) Directive (Directive 2009/65/EC of the European Parliament and Council). The UCITS IV Directive provides that UCITS funds authorised in an EEA member state under Article 5 of the UCITS IV Directive may be managed by an authorised fund manager resident in a member state other than the home state of the fund. Where a UCITS fund is a body corporate which is treated as tax resident in its home state, the fund will be deemed not to be resident in the UK if it otherwise would be. This will include a situation where the fund is deemed to be a body corporate under ss99 or 103A of the Taxation of Chargeable Gains Act 1992.

Another important fund development is the announcement of legislation to be introduced in Finance Bill 2012 to establish a tax transparent fund vehicle following the introduction of UCITS IV. Although introduction is a long way in the future, an informal consultation will commence in the summer of 2011. The Government will be consulting on this measure in June 2011.

CFC interim improvements

Finance Bill 2011 includes the interim changes announced in the Budget and largely already trailed with draft legislation on 9 December 2010.

The wholesale replacement of the CFC regime is still expected in Finance Bill 2012 and the Chancellor has also announced some general detail in relation to the proposed new regime. The new system will remain largely entity based which brings into charge profits which have been 'artificially diverted' from the UK. The new rules will include, however, a finance company partial exemption which is expected to result in an effective rate of tax of 5.75% on profits derived from overseas group financing arrangements (which is lower than previously expected). Sadly, no further announcements have been made as to the treatment of IP income under the new regime over and above what has already been published.

Patent box

The Government will continue to consult on the introduction of a patent box for patent income in 2013. A consultation document will be issued in May 2011.

Worldwide Debt Cap – Further Modifications and Refinements

The Government wishes to consider making some further amendments to the de minimis provisions applicable under the worldwide debt cap legislation with a view to making the rules easier to apply. An informal consultation with stakeholders will be conducted in June 2011 with publication of draft legislation anticipated in autumn 2011 for inclusion in Finance Bill 2012.

Tax Avoidance Developments and Changes

HM Treasury Document Entitled 'Tackling Tax Avoidance'

Included within the Budget documents is a 22-page document entitled 'Tackling Tax Avoidance' which is the latest instalment of the Government's 'New Approach' to tax avoidance in the UK. There is a broad focus on three 'core elements', namely: preventing avoidance at the outset where possible; detecting it early where it persists; and countering it effectively through challenge by HMRC. The principal points are:

- 'Tackling Tax Avoidance' draws together the different approaches of HMRC in addressing tax avoidance in a single document.
- There will be a rolling programme of reviews on 'high risk areas' of the UK tax code is promised, being areas which have 'repeatedly been subject to

avoidance attack' beginning with income tax losses and the use of unauthorised unit trusts.

- A new proposal is announced to reduce the cash flow benefits that taxpayers can gain from using high risk avoidance schemes. HMRC is concerned that some taxpayers have entered high risk avoidance schemes 'to exploit a cash flow advantage of retaining tax while continuing to dispute a liability', conduct which in future would be countered by an additional charge for late payment where a taxpayer has not paid the disputed tax earlier than currently required by law.
- Targeted tax measures addressing specific risks, such as the group mismatch schemes, disguised remuneration and capital allowances anti-avoidance provisions which feature elsewhere in the Budget announcements.
- The possible implementation in the future of a general anti-avoidance rule, which is currently being considered by the study group led by Graham Aaronson QC which was announced in December 2010.
- Refining the Disclosure of Tax Avoidance Schemes regime and developing more sophisticated litigation and settlement strategies.

SDLT Avoidance

Provisions have been included in Finance Bill 2011, as announced in the Budget, to make three changes to the SDLT rules to 'put beyond doubt' that three SDLT avoidance schemes will no longer be effective. The changes will have effect on or after 24 March 2011, subject to detailed commencement provisions.

The proposed legislative changes are as follows:

- A change affecting the relationship between the rules on sub-sales and the alternative property finance reliefs whereby the exception in s45(3) of Finance Act ('FA') 2003 will be extended to cover all of the SDLT Alternative Finance reliefs at ss71A to 73 FA 2003 (including the alternative property finance relief for Ijara financing), and not only that at s73(3) FA 2003.
- A replacement of the definition of a 'financial institution' for the purposes of the SDLT alternative property finance reliefs, and replacement with a new definition importing the definition of 'financial institution' from s564B Income Tax Act 2007. This will have the effect of excluding holders of a consumer credit licence (by itself) from being a 'financial institution' for the purposes of the alternative property finance reliefs.
- An amendment to the way that consideration is determined when land is exchanged.

These changes are not anticipated by HMRC as adversely impacting financing products which are designed to be compliant with Shari'a law, owing to the changes being aimed at restricting reliefs which have been 'misused to avoid tax'.

Group Mismatches Schemes

Draft legislation has been included in Finance Bill 2011 to prevent tax losses through the asymmetrical tax treatment of loans and derivatives (group mismatch schemes). Following consultation there have been a number of minor changes to the draft legislation published on 6 December 2010, although the purpose and technical provisions of the legislation remains broadly the same. The changes are limited to: clarification that only UK-to-UK transactions will be affected; introduction of a threshold in condition A such that the condition cannot apply unless the expected tax saving from the scheme is at least £2m; and an amendment to condition B so that it contains an objective as well as a subjective element. The objective element is that the scheme must be one that is more likely to produce a tax advantage than a tax disadvantage.

Chargeable gains degrouping – connected groups

Where an asset is transferred between two companies in the same chargeable gains group and both companies subsequently leave the group at the same time, s179(2) of the Taxation of Chargeable Gains Act 1992 disapplies the degrouping charge. Where s179(2) is relied upon to avoid the degrouping charge on leaving the first group, and the transferee company subsequently leaves a second group (which is 'connected' to the first), the degrouping charge applies as if the acquisition had taken place while the companies were members of the second group. The flaw in this roundabout deeming provision appears to be the requirement that the first and second groups should be 'connected' at the time the company leaves the second group. The degrouping charge may therefore have been avoided by ensuring that the first group and the second group are 'connected' at the time of the departure of the relevant companies from the first group but are not 'connected' at the time of the departure of the transferee company from the second group.

This mismatch is to be remedied as announced in the Budget by ensuring that the degrouping charge also applies when the connection between the two groups ceases.

Accounting de-recognition of loan relationships and derivative contracts

The provisions included in Finance Bill 2011 in relation to de-recognition of loan relationships and derivative contracts have been changed slightly (as announced in the Budget) since the draft legislation published on 6 December 2010. The revised provisions (i) clarify that the new de-recognition rules will only apply where

the company is actually party to the loan relationship or derivative contract in question (and continues to be a party after de-recognition); (ii) require an amount to be brought into account where the fair value of a derivative contract is greater than the carrying value; and (iii) fully deny debits on creditor loan relationships and derivative contracts upon which amounts are not fully recognised for the purposes of the de-recognition legislation.

Sale of Lessor Companies

Changes announced in the Budget to the sale of lessor companies legislation have been included in Finance Bill 2011 with a view to widening the scope of the legislation due to a perception of continuing avoidance in this area. The legislation is broadly aimed at ensuring that deferred profits, which occur where capital allowances on fixed assets outweigh depreciation, are eventually brought within charge in certain prescribed circumstances. The changes comprise the following:

- a change in the gateway definition of 'business of leasing plant and machinery' to remove the need for a theoretical entitlement to capital allowances and to include leasing by 'associates';
- the recapture of deferred profits on a change of ownership is for an amount representing the difference between the tax written down value of the relevant plant and machinery and the depreciated value in the accounts of the company. The calculation will be amended to exclude transfers of plant and machinery made to the lessor company on the day a change of ownership occurs (but after the actual change of ownership) to counter certain avoidance schemes;
- a new market value definition will apply ('ascribed market value') which uses the higher of market value of a plant and machinery lease and present value. Certain equipment leases will be valued at present value by default. Market value will still apply to other plant and machinery. The anti-avoidance will also be broadened to cover manipulations in value;
- the option to elect introduced in 2009, which provided for an alternative, ring-fencing treatment for deferred profits will be withdrawn;
- where an election for ring-fencing has been made, disposal values to be brought into account will be calculated by reference to the higher of the 'ascribed value' and the disposal value; and
- corresponding changes have been made to provisions dealing with businesses carried on by companies in partnership.

Proposed Changes to the Disclosure of Tax Avoidance Schemes ('DOTAS') regime

Further changes were announced in the Budget to the DOTAS regime which are in addition to the measures which came into effect from 1 January 2011 in accordance with Sched 17 of FA 2010. The Government has stated its intention to implement a number of proposed changes to the DOTAS 'hallmarks' in 2011-12, following the initial consultation on such changes in 2009 and subsequent postponement of work on the new hallmarks following that consultation.

The proposed changes to the hallmarks will target a number of avoidance risks which have been identified by HMRC. These are:

- Schemes that seek to avoid income tax and NICs on employment income. Such a hallmark had been included in the December 2009 Consultation Document on DOTAS (the '2009 Consultation'). The draft regulations contained in the 2009 Consultation contained a generic description of an employment scheme and a list of excepted arrangements. However, HMRC accepted that the draft regulations needed 'proper targeting' and that 'in particular, the employment scheme hallmark will be recast as a positive list of schemes to be disclosed' in order to allay concerns about the breadth of the initial drafting in the 2009 Consultation. It will remain to be seen how those concerns will now be addressed.
- Schemes that incorporate offshore transactions to avoid corporation tax. In the 2009 Consultation, this proposed hallmark aimed at targeting schemes where the provision of the tax advantage relied upon a transaction with one of the territories recognised by the G20, currently by way of the OECD list and thereafter by the UK as a non-compliant jurisdiction.
- Artificial loss schemes. This appears to be a new hallmark, although one which is perhaps unsurprising given a number of statements made in the 'Tackling Tax Avoidance' document. No specific mention is made of an 'income into capital' hallmark to target schemes that seek to gain an advantage by substituting capital receipt for income. The draft regulations contained in the 2009 Consultation had contained a proposal for such a hallmark, and it remains to be seen whether such a hallmark will still be proposed, or whether it will somehow be subsumed into the other new hallmarks to be proposed by HMRC.

The Government has announced it will be consulting on the changes to DOTAS over the summer of 2011.

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