Clients&FriendsMemo

UK Budget 2017 – Key Tax Measures

23 November 2017

The Chancellor of the Exchequer delivered the UK Budget for 2017 on 22 November 2017. Delivered against the backdrop of the UK's ongoing negotiations to exit from the European Union, the Budget featured a significant downgrading of UK economic growth forecasts alongside a more encouraging reduction of public borrowing to less than 2 per cent of national income by 2020-2021.

In this challenging economic situation, the Chancellor's Budget navigated a careful passage in tax policy terms. While there were some eye-catching proposals, including the abolition of stamp duty on real estate purchases of up to £300,000 for first-time buyers, the Government's overall message in the Budget to the UK's corporate and financial sectors was one of continuity rather than radical change.

In this Client and Friends memorandum we have outlined the key tax measures in the Budget that we expect to be of interest to Cadwalader's clients and friends.

Corporate Tax Measures

Depreciatory Transactions within a Group

Where a company disposes of shares or securities at a loss (including through liquidation or a negative value claim) and the value of these shares or securities has been materially reduced by a depreciatory transaction (which can include intra-group disposals of assets or payments in excess of market value for services provided), HMRC may reduce the loss by a just and reasonable amount under the depreciatory transaction rules in the Taxation of Chargeable Gains Act 1992 ("**TGCA**"). Currently, for disposals on or after 19 July 2011, the depreciatory transactions rules apply only if the disposal is made within six years of the depreciatory transaction. The Government has announced in the Budget that the time limit of six years will be removed, so that the depreciatory transactions legislation will now apply where the value of shares disposed of has been materially reduced by a deprecatory transaction effected at any time on or after 31 March 1982. While the measure is targeted at companies which retain valueless subsidiaries for six years before making a claim for an inflated amount of loss relief, it would be surprising if the circumstances of this happening in practice are widespread. Indeed, the amount raised by the measure is relatively small in the context of the Budget (only £55 million in the period 2017 to 2023). By contrast, the work which will be needed within corporate groups to due diligence loss-making share disposals back to 1982 will be potentially onerous.

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Amending provisions: Hybrid Instruments and Corporate Interest Restriction Legislation

Perhaps unsurprisingly, given the complexity of both regimes, a considerable number of amendments have been proposed by the Government in respect of the rules for hybrid instruments (enacted in Finance Act 2016) and the corporate interest restriction ("**CIR**") legislation (enacted in Finance (No.2) Act 2017). These measures include amendments in the hybrid rules to disregard taxes charged at a nil rate (such as under a "designer" tax regime) and, under the CIR rules, to legislate that derivatives hedging a financial trade that is not a banking business are not inappropriately excluded from the ambit of the regime. It is anticipated that the current complexity of these regimes will not be reduced by the new proposed changes.

Capital gains assets transferred to a non-resident company

The Government intends to introduce legislation in Finance Bill 2018 to correct an anomaly in the capital gains tax regime which arises where the trade and assets of a UK company's foreign branch is transferred to an overseas company in exchange for shares in that company. It is intended that any capital gains on the disposal of shares should be postponed until the assets are sold or the UK company disposes of shares in the overseas company, other than in exchange for further shares during a corporate reconstruction (i.e. such that the group still owns the shares of the overseas company). However, where such reconstruction is within the Substantial Shareholding Exemption, the provisions of Chapter II of Part IV and Schedule 7AC TCGA may cause the tax charge to be payable rather than being postponed, as is intended. The Government intends to correct this anomaly in relation to disposals of shares in, or securities of, a company made on or after 22 November 2017.

Bank Levy

As part of the Government's phasing out of the Bank Levy (in favour of the Corporation Tax surcharge on banking sector profits), the Government is also intending to make other changes and administrative simplifications. As previously announced, the Government will include a re-write of Part 4 of Schedule 19 of Finance Act 2011 to provide for a single set of Bank Levy rules that will apply from 2021. In addition and among other measures, the re-write will attempt to simplify the calculation of the Bank Levy and providing for a deduction from a group's equity and liabilities that are chargeable to the Bank Levy for certain loss-absorbing instruments issued by an overseas subsidiary of a UK resident group member.

Debt traded on a multilateral trading facility

As previously announced, the Government intends to exempt debt issued on a multilateral trading ("**MTF**") facility operated by a European Economic Area-regulated recognised stock exchange from the obligation to withhold on account of UK income tax. The definition of "alternative finance investment bonds" will also be widened to include securities that are admitted to trading on such an MTF. This is intended to make the UK a more competitive location for MTFs and put such instruments on a similar footing as instruments which benefit from the UK's Quoted Eurobond exemption.

The Digital Economy

The Government has published a "position paper" concerning the corporation taxation of the digital economy. The focus in the document is ensuring that the UK corporation tax payments of digital businesses are commensurate with the value such businesses generate form the UK market, and specifically the participation of UK users of digital services. The paper outlines a number of ways in which the UK Government intends to advocate reform of the international tax framework (building on measures within the OECD's Base Erosion and Profit Shifting ("**BEPS**") Report) to ensure that the value created by the participation of users in digital businesses is recognised in determining where those businesses' profits are subject to tax. In this context, the paper states the intention of the Government in monitoring the progress of US tax reform, while

noting a concern that such reforms are unlikely to "address the more fundamental concerns about the failure of the international tax regime to align profits with value creation in certain digital businesses". The paper should be considered alongside the announcement by the Government that, with effect from April 2019, withholding tax obligations will be extended to royalty payments, and payments for certain other rights, made to some low or no tax jurisdictions in connection with sales to UK customers, regardless of where the payer is located.

Individual Taxation and Venture Capital

Carried interest and Capital Gains Tax

Legislation will be introduced in Finance Bill 2018 to remove certain transitional provisions in the recently introduced carried interest legislation in section sections 103KA to 103KH TCGA. The proposed legislation will remove the transitional provision which excluded sums of carried interest arising on or after 8 July 2015 and in connection with the disposal of a partnership asset before that date. This change is an important alteration to the rules for the taxation of carried interest where the carried interest is not an employment related security. The announcement will mean that the carried interest provisions in sections 103KA to 103KH TCGA will apply to all carried interest arising after 22 November 2017, a significant and material change for individuals involved in investment management for private equity or other investment funds who are eligible to receive amounts of carried interest after 22 November 2017. As the announcement is broadly revenue raising (with £650 million estimated by HM Treasury to be collected in tax in the 2018-2023 period), and appears to signal a change in policy of the Government as opposed to being an anti-avoidance measure.

Venture Capital Trusts ("VCTs") and Enterprise Investment Scheme ("EIS") Investments

A new measure has been introduced which affects certain investments made by Venture Capital Trusts. The measure will insert the date of 6 April 2018 as the final date in relation to the applicability of certain "grandfathering" provisions and will also extent the timeline from 6 months to 12 months within which the VCTs have to reinvest gains from investments. The new measure introduces the requirement that 30 per cent of the funds raised in an accounting period should be invested in qualifying holdings within 12 months after the end of the accounting period and that qualifying loans should be unsecured and returns on loan capital above 10 per cent represent no more than a commercial return on the principal.

New legislation will be introduced which impact the investments limits and add flexibility for companies receiving investments under the EIS rules and the VCT rules under Part 5 and respectively Part 6 of the Income Tax Act 2007 ("**ITA 2007**"). The EIS investment limit will be increased to £2 million provided that any amount over £1 million is invested in knowledge-intensive companies while the annual investment limit for a knowledge-intensive company will be increased to £10 million. Amendments have been made to the operating costs provisions for companies that have existed less than three years and the permitted maximum age rules will allow knowledge-intensive companies to use the date from which the annual turnover exceeded £200,000 instead of the date of the first commercial sale. The definition of "relevant investment" under Part 5 and 6 of the ITA 2007 has also been amended to encompass all EIS, VCT and other risk finance investments.

Another proposed amendment to Part 5, 5A and 6 of the ITA 2007 is the introduction of a new qualifying condition which determines whether at the time of the investment a company is a genuine entrepreneurial company. There are various factors which will be taken into account, including whether the company has objectives to grow, whether there is significant risk of loss of capital or whether the amount of the loss could be greater than the net return to the investor.

Finally, section 264A of the ITA 2007 will be amended to limit the scope of an anti-abuse rule relating to share buy-backs by VCTs. When the date of the restructuring or merger is more than two years after the date of the subscription of shares or when such date is less than two years but at the time of the subscription the individuals subscribing for the shares could not reasonably be expected to know that the merger or restructuring was likely to take place or if obtaining a tax advantage is not one of the main purposes of the merger, section 264A(5)(b) will not apply.

Tackling Tax Avoidance

The Government's document "*Tackling Tax Avoidance, evasion and non-compliance*", published alongside the Budget documentation, is a remarkable, if sobering, read. The publication charts over 100 anti-avoidance measures introduced by the Coalition and Conservative Governments since 2010. To those provisions might also be added the numerous anti-avoidance changes introduced by the Labour Government in the period 1997 to 2010, although these are, unsurprisingly, absent from what is an overtly political document. The Government states that there are four areas in which tax avoidance has been tackled aggressively: marketed tax avoidance structures; offshore evasion and the use of offshore structures; cross border tax arrangement of multinational businesses; and data-gathering powers. An investment in HMRC of around £2 billion has complemented these measures.

What is not stated in the document is whether the enactment of the anti-avoidance measures listed has resulted in the creation of a simpler, more stable and more predictable tax system. It is doubtful that this has been achieved. Certainly the proliferation of anti-avoidance provisions has led to a far longer code than existed in 2010, let alone 1997. The challenge for companies which have paid "their fair share" of taxation (using the Government's terminology) is to navigate the highly complex network of frequently overlapping anti-avoidance provisions which successive Government have created. In this regard, the consequences of tax avoidance, and the measures against it, have been socialised across the entire taxpayer base, and not merely the tax avoiders in isolation.

International Tax

Double Taxation Relief and Permanent Establishments

The Government has proposed a restriction for the amount of double taxation credit allowed in the UK for foreign tax suffered by a UK company with a non-UK permanent establishment ("**PE**") in circumstances where the losses of the PE have been set off against profit other than those of the PE in that non-UK jurisdiction. Such a situation might occur where, for example, the financial results of the PE are consolidated for the purposes of the foreign tax rules with the results of other entities by means of a fiscal consolidation, or where the foreign jurisdiction permits the losses of the PE to be relieved against income of another group company.

Double taxation relief for foreign tax incurred by a PE will, with effect from 22 November 2017, be determined by reference to the amount of foreign (non-UK) taxation incurred by the non-UK PE, less the amount of the reduction in foreign tax which results from the PE's losses being relieved against non-PE profits in that foreign jurisdiction in the same or earlier periods. The draft legislation published in the Budget is complex and will repay carefully study for the corporate groups affected.

OECD Base Erosion and Profit Shifting Project

The UK signed the OECD's BEPS multilateral instrument (the "**MLI**") on 7 June 2017. However, in order to modify the UK's double taxation agreements, the MLI must be given effect in UK law. Accordingly, the Government will introduce legislation in Finance Bill 2018 to give effect to the modification of the UK's double taxation agreements in accordance with the provisions of the MLI. The measure is intended to take effect on the date of Royal Assent to Finance Bill 2018.

Double taxation relief – changes to targeted anti-avoidance rule

The Chancellor announced that legislation would be introduced in Finance Bill 2018 to amend the targeted anti-avoidance rule ("**TAAR**") applicable to double taxation relief at sections 81 through 95 of Taxation (International and Other Provisions) 2010. Specifically, the Government will remove the requirement for HMRC to issue a counteraction notice before the TAAR applies and to also widen the scope of schemes or arrangements to which this TAAR can apply to also include the tax payable by any connected persons for one of the categories of prescribed schemes or arrangements to which the TAAR can apply.

Value Added Tax

The Chancellor took the opportunity to respond to the Office of Tax Simplification's ("**OTS**") recent report into the UK VAT regime. In an expected move, the Government has declined to act on the OTS's recommendations in respect of VAT simplification at present. In particular, the Chancellor confirmed that the Government will maintain the VAT registration threshold at £85,000 but with the design of the VAT threshold to be consulted on during the two year period ending 31 March 2020.

Taxation of Partnerships

The Government has previously announced that following a public consultation and pursuant to already published draft legislation, various changes to the taxation of partnerships will be made. Specifically, the Government intends to provide clarification relating to the taxation of partners in nominee or bare trust arrangements or partnerships with partnerships as partners. The allocation of partnership profits for tax purposes will be required to be allocated in the same ratio as the commercial profits as well as clarifying that the allocation of partnership profits shown on the partnership return is the allocation that applies for tax purposes.

Gains on immovable property made by non-residents

The Government has announced proposals which would significantly affect the taxation of immovable property held by non-residents. Very broadly, the Government intends to bring both residential and non-residential property held by non-resident or by "property rich" entities within the scope of UK taxation. The scope, commencement date and core features are noted by the Government as being "fixed". However, the detail relating to these measures will be subject to public consultation until 16 February 2018 with the relevant legislation intended to come into force with effect from April 2019 (subject to an anti-forestalling rule for arrangements entered into on or after 22 November 2017).

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Adam Blakemore	+44 (0) 20 7170 8697	adam.blakemore@cwt.com
Catherine Richardson	+44 (0) 20 7170 8677	catherine.richardson@cwt.com
Anca Moldovan	+44 (0) 20 7170 8650	anca.moldovan@cwt.com