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Clients&FriendsMemo

UK Pre-Budget Report 2009: Key Taxation Aspects

10 December 2009

On Wednesday 9 December 2009, the Chancellor of the Exchequer delivered a long awaited and politically charged Pre-Budget Report ("**PBR**") which was dominated by commentary on the state of the UK economy and proposals to provide both fiscal stimulus and to raise taxes through targeted measures. While the PBR was described as the Chancellor as being "fiscally neutral" when viewed overall, the closure of a number of tax mitigation arrangements was supplemented by robust measures to tackle offshore tax evasion, an enhancement to the regime for the disclosure of tax advantaged transactions and the introduction of a bank payroll tax, focused on bonus arrangements provided by banks to certain of their employees.

In this memorandum, we have set out the details of a number of the key changes in legislation and practice that we expect to be relevant to Cadwalader's clients and friends. Please see our "Speed Read" section below which summarises the key points, each of which is expanded in the lengthier commentaries which follow.

Speed read

- *Bank payroll tax.* A new tax of 50 per cent. payable by UK banks and UK branches of foreign banks (and certain members of banking groups) on new bonus awards made between the time of the Chancellor's PBR announcement on 9 December 2009 to 5 April 2010.
- *Patent Box.* New 10 per cent. corporation tax rate to be introduced for income on UK patents registered after April 2013.
- *Worldwide Debt Cap.* A tidy-up of the worldwide debt cap rules. Dealings in derivative contracts which are not "financial instruments" for FSA purposes to be taken into account when applying the "qualifying financial services groups" exemption from the rules. Securitisation companies to be excluded from the rules.
- *Controlled Foreign Companies and the Taxation of Foreign Branches.* Confirmation that proposals on the shape of the UK Controlled Foreign Companies regime will be published in the New Year, together with announcement of a preliminary discussion regarding the possibility of a move to exempt foreign branch profits from tax.

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- *Proposed Code of Practice on Taxation for UK Banks.* Confirmation that the proposed code of practice on taxation for UK banks will go ahead. HMRC guidance has been offered on the meaning of the key phrase "contrary to the intentions of Parliament", and some important amendments made to the proposed code itself.
- *Disclosure of Tax Avoidance Schemes Legislation*. Amendments proposed to trigger disclosure requirements once marketing of schemes begins. New information powers given to HMRC with regard to "introducers" and other intermediaries dealing with scheme promoters.
- *Index-linked gilt edged securities.* Legislation will be introduced in Finance Bill 2010 to prevent avoidance using index-linked gilt edged securities.
- *Stamp duty and SDRT avoidance.* Target measures to prevent stamp taxes avoidance where new shares, intended for a non-EU depositary receipt system or clearance service are routed through a depositary receipt system or clearance service in the EU.
- *Simplifying Unallowable Purpose Tests*. General consensus on standard unallowable purpose test to be considered in the first instance – a "main purpose" of a person.
- *Simplifying Transactions in Securities*. Possible repeal of transactions in securities legislation in relation to companies.
- *Equitable Liability*. HMRC extra-statutory practice of not collecting the full amount of tax legally due, in circumstances where a taxpayer can show that the amount of tax is too high in accordance with the relevant facts and charging provisions, to be put on a statutory footing.

Bank Payroll Tax

One of the heavily advertised announcements in the PBR was the introduction of a new tax, to be known as the "bank payroll tax". The announcement of the new tax by the Chancellor of the Exchequer was supplemented by the publication of a detailed technical note providing draft legislation to be included in Finance Bill 2010.

The tax will be payable by UK resident banks, building societies or investing and financial trading companies within banking groups, but not by bank employees themselves. "Relevant foreign banks" which carry on banking business in the UK though a branch will also be subject to bank payroll tax. To be within the scope of the bank payroll tax, a "bank" will need to be wholly or mainly undertaking a "relevant regulated activity" in the UK. These activities are defined in accordance with FISMA 2000 regulated activities and include accepting deposits, dealing in investments, arranging deals in investments, and administering investments. The draft legislation contains extensive definitions of the terms "UK resident bank" and "relevant foreign bank". Owing to the breadth of regulated activities and the organisations which could fall within the scope of being a "bank" under the draft legislation, the key step of identifying which companies could be subject to the bank payroll tax is more complicated and less clear than might ideally have been the case. In this regard, specific clarification may need to be

sought from HMRC regarding some areas of the financial sector being outside the bank payroll tax including, for example, companies providing discretionary investment management services.

While companies are clearly within the scope of the new tax, based on the draft legislation limited liability partnerships, looked at by themselves, should not fall within the scope of bank payroll tax, although corporate members of an LLP may do so.

The new tax will be charged at a rate of 50 per cent. on "relevant remuneration" awarded to, or in respect of certain banking employees. The tax will be payable on the excess above £25,000 of the aggregate of all relevant remuneration (whether in the form of cash, shares or other benefits) awarded in respect of any "relevant banking employee" (again, defined in the draft legislation) in the period commencing immediately after the announcement on 9 December and ending at the end of 5 April 2010. The cost of the bank payroll tax will not be eligible as a deduction to be taken into account for corporation tax purposes.

Certain remuneration will be excluded from the scope of bank payroll tax, namely regular salary or wages or regular benefits; shares awarded or granted under certain specified share schemes; and anything payable or to be provided by a contractual obligation that arose before the announcement of the new tax on 9 December 2009.

The exemption for remuneration for which a "contractual obligation" arose before the time of the Chancellor's announcement on 9th December is particularly interesting. The British press had contained a number of reports of last minute tax planning arrangements by banks on behalf of employees to try and ensure that bonus entitlements arose under contractual agreements or heads of terms agreed before 9th December. However, the definition of "contractual obligation" in the draft legislation does not extend to an obligation to make a payment, or supply a benefit, if the amount to be paid is subject to any person's discretion by reference to the subject or the amount of the remuneration. It is therefore possible that last minute planning to create contractual bonus entitlements where an element of discretion is still present may not be grandfathered.

The draft legislation is detailed, and covers a variety of employments and relationships under which employees and other individuals may personally provide "banking services" to a banking organisation within the scope of the bank payroll tax. Unsurprisingly, the draft legislation also includes both specific and more general anti-avoidance provisions, perhaps mindful of the complex tax planning which has characterised some employee remuneration structures. Legislation is proposed to prevent avoidance of the bank payroll tax through the use of loans and multiple employments with the same employer and intermediaries. A general anti-avoidance provision applies where the main purpose, or one of the main purposes of entering a "relevant arrangement" is to reduce or eliminate a liability to bank payroll tax. The proposed definition of such "relevant arrangements" is broadly drafted, being any arrangements comprising any reward, payment, benefit or any loan "otherwise than in the form of relevant remuneration" but which "equates in substance to relevant remuneration". The breadth of this provision raises

some immediate questions regarding the quantification of the substance of the arrangements in question, which may well lead to further debate before the legislation is passed.

There appears to be no specific legislation under which the bank is obliged to collect the cost of the bank payroll tax from the employee, although it seems likely that the additional cost of the new tax may well be factored into the amount of the bonus awarded to employees ensuring that the economic cost of the bank payroll tax is borne by the employee concerned. It also seems possible that the new tax may affect the timing of bonuses to a substantial degree, with banks looking to defer bonus entitlement until after 5 April 2010.

Patent Box – Proposed 10 per cent. corporation tax rate on patent income from April 2013

Somewhat surprisingly, one of the more important announcements was accompanied by perhaps the least amount of detail. The Chancellor announced during his speech that a new 10 per cent. corporation tax rate on income for UK patents will be introduced. While it is not acknowledged, the proposal ultimately impacts upon the still unresolved tax policy area that is the taxation of foreign profits.

The announcement may be expected to allay some of the concerns which have been raised regarding the uncertainty surrounding the UK's regime for the taxation of foreign profits. However, as the consultation on the form of the proposed "patent box" regime will only be ready in time for Finance Bill 2011 and the legislation will only apply to income from UK patents granted from April 2013, the measure may be of limited comfort to those businesses which are already considering migrating their tax residence away from the UK.

Despite the commonality which this issue has with the reform of the controlled foreign companies ("**CFC**") rules, it was announced separately that the Government would publish a document outlining the shape of the new CFC rules in the New Year. The central aim of HM Treasury's policy for the new CFC rules is "to distinguish between profit genuinely earned and that which represents an artificial diversion from the UK"[1]. Identifying the source of profits which arise from intellectual property poses a particular difficulty, as the intellectual property of an overseas subsidiary of a UK company may result from the application of resources located in a number of jurisdictions. If the proposed "patent box" is HM Treasury's answer to this problem, it may not provide much comfort for the UK resident parents of worldwide groups with significant existing intellectual property. Whether this is the case is likely to become clearer in the New Year with the publication of the proposed outline of the new CFC rules.

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[1] *Reform of Controlled Foreign Companies (CFC): Policy principles document*, (July 2009), paragraph 31.

Worldwide debt cap

Finance Act 2009 introduced new rules relating to the deductibility of certain financing expenses paid by the UK members of a group of companies with effect for accounting periods beginning on or after 1 January 2010. Very broadly, a group of companies will fall within the scope of the rules if it breaches the fairly arbitrary threshold whereby its "UK net debt" (i.e. the sum of any net finance liabilities or receivables for each UK group company) exceeds 75 per cent. of the "gross debt" of the worldwide group (i.e. the sum of the gross financing liabilities of each group company). Once within the rules, the excess of the 'tested expense amount' (which broadly equates to the net financing expenses of each UK group company which has a net financing expense) over the 'available amount' (which broadly equates to the group's gross external financing expense) is disallowed as a deduction and the disallowed deduction is then allocated amongst the UK tax paying companies. Certain exemptions apply.

Following an announcement on 9 November 2009 by the Financial Secretary to the Treasury, draft legislation has now been released with the Pre-Budget Report with the intention of amending the worldwide debt cap rules in Finance Bill 2010 to address certain problems. The measures include:

- addressing mismatches arising from the accounting treatment of the same amounts in relation to different calculations (e.g. calculating a liability of a UK company for "UK net debt" and the same liability for "gross debt" of the worldwide group);
- ensuring that preference shares are always excluded from the calculation of the liabilities of group companies when applying the 75 per cent. "gateway" test;
- widening the exemption for "qualifying financial services groups" by extending the definition of "relevant dealing in financial instruments" to include all derivative contracts as opposed to just financial instruments (as defined for FSA purposes);
- excluding securitisation companies from the worldwide debt cap rules and allowing group finance companies which, for example, may be formed for the purpose of a whole business securitisation to elect that no interest disallowance is allocated to them;
- excluding "dual resident investment companies" from the disallowance rules;
- creating symmetry by including guarantee fees as financing income when calculating the "tested expense amount" (as guarantee fees are currently a financing expense in relation to the same calculation);
- restricting the scope of the exemption for "group treasury companies" by excluding certain trading companies from accessing the exemption; and
- providing supplementary rules to deal with external borrowings assumed through a partnership of which a UK company is a partner.

Proposed Code of Practice on Taxation for UK Banks

On 29 June 2009, HMRC published a 24-page consultation document setting out proposals for a Code of Practice on Taxation for Banks (the "**Proposed Code**"). HMRC have confirmed in the PBR that the Proposed Code will be introduced, and have published both a summary of responses received during the consultation period which ended on 25 September 2009 (the "**Summary of Responses**") and a set of supplementary guidance notes (the "**Guidance Notes**").

The summary of responses to the consultation document is interesting. One of the key objectives of the Government in the Proposed Code was "*that banking groups, their subsidiaries, and their branches operating in the UK, will comply with the spirit, as well as the letter of the law, discerning and following the intentions of Parliament*". There was significant discussion amongst commentators, and amongst banks, during the consultation period regarding the difficulty in determining whether transactions are, or may be, contrary to the "intentions of Parliament". HMRC's response has been that the Proposed Code "is about behaviour and not about legal relationships".

While stating that the Proposed Code is not a legal document, HMRC has stated that in arriving at a view of whether a transaction is "contrary to the intentions of Parliament", the bank in question should consider two factors: (i) the purposive construction of the legislation; and (ii) "whether Parliament can realistically have intended to give the proposed result in circumstances that are very different from those that existed at the time". While the first factor follows closely the leading decision of the (then) House of Lords in *Barclays Mercantile Business Finance Limited v Mawson* [2005] STC 1, the second factor appears to be HMRC's anticipation as to what the intentions of Parliament would have been were Parliament to have been asked to decide on the use of a tax "loophole" to achieve a desired tax result. Whereas the first factor is rooted in black letter law, the second appears to require a far more subjective, hypothesising approach.

The passages in both the Summary of Responses and the Guidance Notes detailing HMRC's understanding of the phrase "contrary to the intentions of Parliament" will repay careful study, as this meaning lies at the heart of the Proposed Code. However, it is also important to note that HMRC have attempted to be responsive to certain concerns raised by the UK banking sector and have made a number of amendments to the Proposed Code including the following:

- no longer demanding that a bank initiate dialogue with HMRC if that bank is in doubt whether the tax result of the proposed transaction is contrary to the intentions of Parliament. The bank may choose to initiate dialogue, but is not obliged to. This is an important change form the Proposed Code as published in June 2009;

- clarifying circumstances where the test of whether a tax result is contrary to the intentions of Parliament is made by reference to the reasonable belief of the bank concerned; and

- clarifying the application of the Proposed Code to smaller banks.

HMRC have noted in the Guidance Notes that banks may require time to consider the implications of the revised code and the clarifications set out in both the Summary of Responses and the Guidance Notes. Nevertheless, it is also clear from these documents that the adoption and implementation by banks of the Proposed Code is expected to take place "soon after" the PBR.

Disclosure of Tax Avoidance Schemes – new consultation

In the words of the Financial Secretary to the Treasury in the Foreword to the new consultation document, when it comes to identifying and countering tax avoidance schemes, "the disclosure regime is at the heart of [the Government's] efforts". The principal disclosure of tax avoidance schemes ("**DOTAS**") legislation was introduced in 2004 and amended in 2006. The legislation requires "promoters" and, in certain circumstances, users of tax avoidance arrangements to disclose details to HMRC where the arrangements bear certain "hallmarks". "Promoters" are persons who are responsible to any extent for the design of the arrangements or who make the arrangements available for implementation. The penalty for breaching the rules is financial (£5,000, with a daily maximum penalty of £600 thereafter), although a breach of the rules would probably also result in damage to the promoter's relationship with HMRC.

The Government now wishes to consult on five potential changes which will widen the scope of the DOTAS regime.

1. HMRC wants the disclosure obligation to arise *before* the arrangements have become "available for implementation" (the current trigger for the application of the rules). It is proposed that the obligation to notify should now be triggered when the promoter makes a "marketing contact" in relation to a notifiable proposal (i.e. the promoter communicates the "general nature" of the notifiable proposal with a view to anyone deciding whether to ask for further details or to seek to implement the scheme).

2. A new power is proposed to allow HMRC to serve "introducers" (such as accountants and financial advisers) with notices requiring them to name the person who has provided them with the information about the notifiable proposal that is being communicated to potential clients (with penalties for non-compliance).

3. The current penalties under the DOTAS regime are to be increased to address HMRC's perception that promoters have an incentive to deliberately breach the disclosure rules in circumstances where the commercial profit expected to arise from the tax avoidance scheme (which could be closed down if disclosed) exceeds the potential financial penalty for failing to disclose the scheme to HMRC.

4. Promoters will be required to provide HMRC with information about clients to whom the promoters have provided tax avoidance schemes for implementation, as HMRC is

currently concerned that taxpayers are not disclosing the scheme reference numbers which are supplied to them by the relevant promoters upon the schemes being disclosed to HMRC.

5. New "hallmarks" are being introduced to bring schemes which seek to achieve tax advantages (i) in relation to tax on employment income, (ii) through converting income into capital and (iii) through involving persons resident in the "Unco-operative Tax Havens" as identified by the OECD, within the scope of the DOTAS rules as notifiable arrangements.

As such, these proposals represent a significant extension of the rules with, perhaps, the first two having the most potential impact. It is clear that the Government now wants to move from a position where it can only close down tax avoidance schemes after they have been used to a position where disclosure (and potential remedial legislation) is made before a client has even been found to implement the scheme. The potential introduction of information seeking powers in relation to intermediaries passing on information regarding tax avoidance schemes also represents a significant widening of the class of person that might be affected by the DOTAS regime.

Index Linked Gilt Edged Securities

Legislation will be introduced in Finance Bill 2010 to prevent avoidance using index-linked gilt edged securities. Under current legislation, a tax exemption applies for the inflationary return on an index-linked gilt-edged security. In circumstances where the retail prices index ("RPI") increases, the current tax legislation provides for the opening carrying value of the index-linked gilt to be increased by reference to the increase in RPI, with the resultant profit relating to the increase in carrying value not being subject to corporation tax.

As part of the PBR, HMRC have published a technical note, draft legislation and an explanatory note setting out their understanding as to how the exemption from tax on the inflationary return on the index-linked gilt has been abused. HMRC have stated that some companies and groups in the financial sector have entered into arrangements whereby a exposure to the inflation-linked return on index-linked gilt edged securities is created, triggering the exemption from tax, but where that exposure is economically fully hedged (such as through a total return swap economically eliminating the risk and reward in respect of the company holding the index-linked gilt). HMRC have identified the end product of such arrangements as being a "significant tax advantage from no economic exposure".

Accordingly, in respect of index-linked gilt-edged securities held by companies on or after 9 December 2009, the exemption from corporation tax on the inflationary return on the index-linked gilt will not be available where arrangements are present which have resulted in the company or group not being economically exposed to that inflationary return.

The change in law is not intended to have any impact on the corporation tax treatment of companies holding index-linked gilt edged securities as an investment with the attendant economic exposure to inflation embedded within the security. Individuals will not be affected as the change only applies to companies.

Stamp Duty and SDRT Anti-Avoidance

Following the decision of the European Court of Justice in *HSBC Holdings PLC and Vidacos Nominees Ltd v Commissioners for Her Majesty's Revenue & Customs* (C569-07), HMRC announced that it will no longer seek to charge the 1.5 per cent stamp duty or SDRT charge when new shares are first issued into a European Union ("**EU**") depositary receipt system or clearance service. In the current legislation, however, there are exemptions from the 1.5 per cent stamp duty or SDRT charge for subsequent transfers between clearance systems and depositary receipt systems, intended to prevent a double charge.

As announced in October, these exemptions will be removed where companies and issuers arrange a scheme whereby new shares, intended for a non-EU depositary receipt system or clearance service are routed through one in the EU thus avoiding the 1.5 per cent stamp duty or SDRT charge completely. Legislation will be introduced in Finance Bill 2010 to remove these exemptions.

Simplifying Unallowable Purpose Tests - response document

A response document has now been published in respect of the *Simplifying Unallowable Purpose Tests* Discussion Document issued in July 2009. The consultation process falls under the aegis of the Government's Anti-Avoidance Simplification Review. There are no real surprises in the Government's responses.

The response document makes clear that there is some concern amongst practitioners at the proliferation of the use of unallowable purpose tests in tax legislation (there were 28 new unallowable purpose tests introduced in Finance Act 2008 alone) and HMRC appear willing to bind themselves to a more restrictive framework in future when it comes to considering new unallowable purpose tests. There seemed to be a general consensus that the standard unallowable purpose test should be framed by reference to a "main purpose" of a person (as opposed to "arrangements" for example) and this appears to be accepted by HMRC. HMRC were surprisingly frank in reporting the responses received in relation to their draft guidance which, it was said, "could be read as supporting any point of view". Greater clarity in relation to this guidance has been promised by HMRC.

Simplifying Transactions in Securities – response document

A response document has also been published in respect of the *Simplifying Transactions in Securities* Consultation Document issued alongside the *Simplifying Unallowable Purposes Tests* Discussion Document in July 2009.

It appears that HMRC are now considering a wholesale repeal of the rules insofar as they relate to companies. The argument from respondents was that, in light of the new dividend exemption rules, the scope for companies to obtain a corporation tax advantage within the ambit of the transactions in securities rules was either non-existent or so small that it did not warrant retaining the legislation.

The potential breadth of the current provisions derives largely from the wide range of transactions to which they may apply and the order in which the provisions operate has been known to create considerable uncertainty for taxpayers. There were, for example, approximately 6000 clearance applications to HMRC in 2008 of which only 2 per cent. were rejected. The starting point under the existing rules is where the taxpayer has obtained or is in a position to obtain an income tax or corporation tax advantage. In this context, a tax advantage could be a relief or increased relief from tax, a repayment or increased repayment of tax, an avoidance or reduction of a charge to or assessment of tax or the avoidance of a possible assessment to tax. (The relevant taxes are income tax and corporation tax only.) In determining whether a tax advantage has been obtained there is no question as to whether the taxpayer has obtained "advantages over persons of a similar class" but rather a question as to whether "a better position has been achieved vis-à-vis the Revenue".

The question then arises as to whether the tax advantage is obtained in consequence of one or more transactions in securities or in consequence of the combined effect of the transactions in securities and the liquidation of a company. It is then necessary to analyse whether the transaction in securities falls within one of four prescribed circumstances (involving the receipt of abnormal amounts by way or dividend or the receipt of non-taxable consideration), before finally assessing whether an "escape clause" is applicable. This "escape clause" is engaged where the taxpayer can show that (i) the transaction in securities was entered into for *bona fide* commercial reasons or in the ordinary course of making or managing investments and (ii) gaining a tax advantage was not a main or one of the main objects of the transaction.

The principal difficulty of the rules, therefore, is that taxpayers are dragged in by the sheer breadth of scope of the rules and are then faced with attempting to fight their way out using the "escape clause" which requires those taxpayers not only to demonstrate that the transaction had no main tax advantage purpose but that the transaction was entered also into for *bona fide* commercial reasons or in the ordinary course of making or managing investments.

The new draft rules turn this order around with the result that the scope of the rules should, in accordance with the aims of HMRC, be more narrow in its application. The rules would only apply where:

- a person is party to one or more "transactions in securities" (which retains its former breadth) which fall into the remaining prescribed circumstances (two of the existing circumstances will be repealed for both income tax and corporation tax);

- the main or one of the main purposes of that person in being a party to the transaction in securities is to obtain a corporation or income tax advantage; and
- the person actually obtains that tax advantage.

The transactions in securities rules should therefore be narrowed in two important respects. Firstly, it will now be for HMRC to demonstrate that a person has a main purpose of obtaining a tax advantage, as opposed to the taxpayer having to demonstrate that no main purpose of securing a tax advantage existed and that the transaction was carried out for *bona fide* commercial reasons or in the ordinary course of managing or making investments. Secondly, the taxpayer will have to actually obtain the tax advantage, as opposed to merely being in a position to obtain a tax advantage (as is the case under the existing legislation).

Equitable liability

In a welcome move, which was expected in light of a letter addressed to the Chartered Institute of Taxation by the Financial Secretary to the Treasury on 18 November 2009, HMRC's practice of "equitable liability" will be put on a statutory basis. The concept of equitable liability arises where "it would be unconscionable to insist on collecting the full amount of tax assessed and legally due" and was confirmed as an HMRC practice in Tax Bulletin 18 published in August 1995. HMRC are currently reviewing all their extra-statutory concessions ("**ESCs**") in light of the House of Lords judgment in *R (on the application of Wilkinson) v Inland Revenue Commissioners* [2005] UKHL 30 which cast doubt on the scope of HMRC's discretion to grant concessions where tax is legally due.

HMRC recognised in the past that a taxpayer could suffer unfairness where tax was legally due (e.g. because all relevant deadlines had passed) but where the sum of tax due was higher than it should be under the relevant taxing provisions. Applying "equitable liability" is therefore considered where "the liability assessed is greater than the amount which would have been charged had the returns, and necessary supporting documentation, been submitted at the proper time, and acceptable evidence is provided of what the correct liability should have been".

It is expected that HMRC will now be given a statutory power to exercise discretion in the same circumstances to accept a reduced amount of tax based on the evidence provided, and not to pursue its right of recovery for the full amount of tax legally due.

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