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Clients&Friends Memo

The Emergency UK Budget 2010: Key Taxation Aspects

23 June 2010

Introduction

On Tuesday 22 June 2010, the 'Emergency' Budget of the UK's new Coalition Government was delivered by the Chancellor of the Exchequer.

Given that the Government has decided to achieve its aim of eliminating the bulk of the UK's public sector structural deficit by 2014/15 through spending reductions (as to 80 per cent.) and tax increases (as to 20 per cent.), the changes announced to the UK's tax regime appeared relatively mild in comparison and, indeed, in some cases quite encouraging. The decision to begin lowering the headline corporation tax rate from 28 per cent. to 27 per cent., (and thereafter by a percentage point per tax year until the rate is 24 per cent. in 2014) can only be welcomed from the perspective of international competitiveness and sends a clear signal regarding the Government's priorities. Less welcome, of course, will be the increase in the standard rate of VAT from 17.5 per cent. to 20 per cent. with effect from 4 January 2011. It will also remain to be seen as to whether the severe reductions in public spending announced can be delivered and consequently whether further tax rises will be needed.

Needless to say, the press releases, budget notes and supporting documents still weighed in at no less than the usual load. A number of the changes announced were simply re-announcements of changes already announced by the previous Government in the 2009 pre-Budget report and the Budget on 24 March 2010 but which did not survive the "wash-up" and make it into Finance Act 2010. Other announcements merely expressed an intention to consult in future (or continue consulting) or related to proposals which have yet to be published in any detail. For example, the Government will continue to consult in relation to group mismatch schemes, with a focus on possible principles-based legislation in this area. However, there are some significant new changes which may be relevant to Cadwalader's clients and friends, which we have considered below.

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 levy: proposals announced for a UK bank levy to be introduced from 1 January 2011 to apply to the UK banking sector and closely following the proposals in the US for the Financial Crisis Responsibility Fee.

- Changes in the Government's approach to tax policy: a discussion document has been published inviting comments on the Government's proposals to develop a more structured and principled approach to tax policy. The proposals cut both ways with the Government proposing greater opportunity for consultation on one hand, but entertaining the idea of a general anti-avoidance rule on the other.

- New higher rate of capital gains tax for individuals: a new higher rate of capital gains tax will apply with effect from 23 June 2010 at 28 per cent. to the extent that a taxpayer's other taxable income and gains exceed the higher rate income tax threshold of £37,400. The lifetime limit for entrepreneurs' relief has been increased to £5 million and a flat rate of 10 per cent. will apply where the relief applies.

- Changes to the rules on deduction of income tax at source: new regulation making powers will be enacted to allow HMRC to prescribe in more detail how non-corporate entities must withhold and account for income tax to HMRC in relation to payments of interest, 'annual payments' and certain other payments made subject to withholding.

- Anti-avoidance in respect of de-recognition of loan relationships and derivative contracts: More generic anti-avoidance legislation will be introduced in response to a perception of continued tax avoidance in relation to amounts that fall outside the scope of corporation tax as a result of the de-recognition of financial assets for accounting purposes.

- Capital Distributions: HMRC has published draft legislation to extend the exemption from corporation tax for income distributions received by UK corporation tax payers to also encompass capital distributions.

- Changes to the worldwide debt cap and capital distributions re-announced: changes already announced in relation to the worldwide debt cap and capital distributions (on the Budget on 24 March 2010 and in the 2009 pre-Budget report) will be included in the second Finance Bill of 2010 to be published in the Autumn.

- Removal of requirement for 'link companies' to be UK tax resident for consortium relief purposes: HMRC has announced that, following the First-tier Tribunal decision in Philips Electronics UK Limited v HMRC, legislation will be introduced to permit any company established within the European Economic Area to be a "link company" for consortium relief purposes.

- Authorised Investment Funds: anti-avoidance legislation to be enacted to prevent manipulation of deemed tax credits on distributions from authorised investment funds to UK corporate investors.

- Increase in the standard rate of VAT and anti-forestalling provisions: the standard rate of VAT will increase to 20 per cent. with effect from 4 January 2011 and anti-forestalling legislation will be introduced.

UK Bank Levy

Proposals have been set out in the Emergency Budget for a UK bank levy to be introduced from 1 January 2011 and to apply to the UK banking sector.

Notwithstanding that the announcement is of very significant importance to both the UK banking sector and the UK economy generally, many of the details of the proposed bank levy are currently absent pending the outcome of a consultation during the course of the summer and, it may be assumed, the need to dovetail the UK bank levy with similar proposals in other jurisdictions. As an expression of the need to co-ordinate levies, contributions and taxation on the financial sector across national boundaries, a joint statement was also released by the UK, French and German Governments on 22 June 2010 in which each Government acknowledges their intention to introduce bank levies based on banks' balance sheets.

The joint statement follows from the conclusions of a European Council meeting on 17 June 2010 in which the EU declared its determination to lead efforts to set a global approach for introducing systems for levies and taxes on financial institutions, including the exploration of a global financial transaction tax. The decision of the UK, French and German governments in making a joint statement in advance of the G20 Summit in Toronto on 26th and 27th June 2010 has clear political overtones as well as acknowledging "the need to ensure a level playing field" and to avoid capital flight.

The UK bank levy is stated by the Government to apply to the consolidated balance sheets of UK banking groups and building societies, the aggregated subsidiary and branch balance sheets of foreign banks and banking groups operating in the UK and the balance sheets of UK banks in non-banking groups. These institutions and groups will only be liable for the UK bank levy where their "relevant aggregate liabilities" amount to £20 billion or more. While the precise details of the computation of the UK bank levy are absent from the information given in the Emergency Budget, the levy will be based on the "total liabilities" of a bank excluding:

- Tier 1 Capital (to be calculated using the principles applied to the capital attribution methodology used for corporation tax purposes);

- insured retail deposits;
- sale and repurchase agreements secured on sovereign debt; and
- policyholder liabilities of retail insurance businesses within banking groups.

Both short and long term liabilities are included in the computation, and the Government has proposed that derivative liabilities will be taken into account where they are net derivative positions (subject to further technical review over the summer).

It is interesting to note that the genesis of a number of the attributes of the proposed bank levy appears to be the proposals made by President Obama in January 2010 for the US Financial Crisis Responsibility Fee (the "US Fee"). Although the US Fee has not, at the date of writing, been enacted into US Federal Law and was not included in the US Financial Reform Bill that was passed by the House of Representatives and Senate earlier this year, the proposed provisions of the US Fee appear to have been influential the Government's plans for the UK bank levy. However, unlike the US Fee, which is proposed as being limited to a ten year period at a slightly higher rate of 0.15 per cent. of covered liabilities, the UK bank levy is not stated to be temporary and is charged at a lower rate of 0.07 per cent (0.04 per cent. in 2011) for a period which might well be substantially longer. While the expected finance to be raised by the UK bank levy of £2 billion annually is very material, it does not appear to have been computed with the express intention of achieving repayment of a specific amount of UK Government financial support provided to the UK banking sector. One inference which might be drawn in this regard is that whereas the proposed US Fee is motivated by obtaining repayment of the projected costs of the US TARP programme, the UK bank levy is motivated by a policy objective of steering the UK banking sector towards funding sources which are perceived to carry a lower systemic risk profile. There is a general acceptance of this in the Emergency Budget, with the Government accepting that "[t]he levy is intended to encourage banks to move to less risky funding profiles".

Accordingly, and like the proposed US Fee, the computation of the UK bank levy is based on the total short and long term liabilities of a banking group but excludes Tier 1 capital and insured retail deposits. Significantly, there will be a reduced rate for longer-maturity wholesale funding (namely, greater than one year remaining to maturity) to be set at 0.02 rising to 0.035 per cent. The stated policy objective appears to be to encourage the UK banking sector towards retail depositors and to discourage an over-reliance on wholesale funding which has been identified by the International Monetary Fund and several commentators as being a source of vulnerability in the financial crisis. The relative expense of wholesale funding (relative to Tier 1 capital, insured retail deposits and sovereign debt repos) will, consequently, be increased on an after-tax basis owing to the UK bank levy not being deductible for UK corporation tax purposes.

Perhaps understandably at this early stage of the proposals for the UK bank levy, a number of significant questions remain. While the levy applies to the consolidated balance sheet of a UK banking group, it is unclear as to whether the balance sheet in question is that of the worldwide group or merely the UK group.

Very significant questions also exist regarding whether the UK bank levy be introduced in a form which enables it to qualify for a foreign tax credit in the home jurisdiction of a non-UK resident bank which is subject to the UK bank levy. This is far from a point of technical detail. The experience from the previous UK Government's drafting of the definition of a "taxable company" in the bank payroll tax legislation in Finance Act 2010 was that the legislative language evolved considerably before the final form definition was enacted, and only then after significant contributions from the banking industry and associated representative bodies. It is therefore likely that different jurisdictional definitions of a "bank" for the purposes of any jurisdiction's bank levy legislation may lead to overlap and the risk of double taxation. In the event that such bank levies are not eligible for foreign tax credits or relief under double tax treaties or domestic legislation, the cost to multinational financial institutions may well be very substantial. On the other hand, the complexity of drafting the definition of a "bank" for the relevant jurisdictional legislation will almost inevitably lead to the possibility for arbitrage and tax mitigation.

In either scenario, the process of drafting the legislation for the UK banking levy and ensuring a "level playing field" and fairness for both the Government and UK financial institutions is unlikely to be straightforward.

Tax Policy

A discussion document has been released which states the Government's aim to "restore the UK tax system's reputation for predictability, stability and simplicity".

To achieve, predictability, when embarking on significant areas of reform, the Government proposes to set out its policy objectives, detail how the reforms will be taken forward (including the approach to consultation) and set out a timetable.

To achieve stability, the Government proposes to slow down the rate of change to the tax code and reduce the number of piecemeal changes. (In this regard it is, perhaps, a happy coincidence that the Tax Law Rewrite Project has been completed this year.) A statement will also be published later in the year on how tax consultations will be approached in future.

In relation to implementation of new legislation, a convention is proposed that will require changes in tax to be confirmed no later than three months prior to the tax year in which they come into effect (or three months prior to the publication of the Finance Bill as applicable) with the confirmation being accompanied by draft legislation and explanatory and technical notes. Comments would then be considered within an eight-week window (with a four week window for statutory instruments). The rationale of these changes is to allow a dedicated window of pre-legislative scrutiny. Understandably, the proposals would not apply in relation to revenue protection measures and changes which pose a risk of forestalling.

A significant area that is singled out for attention, is that of anti-avoidance legislation. The Government has expressed a desire to take a more strategic approach to legislative changes combating tax avoidance and is looking at a number of options including:

- building in better defences against avoidance when undertaking policy reform (this might include setting out the intended effect of the legislation expressly, in an echo of what seems to have been considered before as part of the consultation on "principles-based" anti-avoidance legislation);

- reviewing areas of the legislation which have been the subject of repeated changes as a result of anti-avoidance measures and rethinking them;

- considering a general anti-avoidance rule ("GAAR");

- developing a protocol regarding changes that are announced with immediate effect.

The re-awakening of the GAAR idea, while understandable (it was proposed in the Liberal Democrat manifesto), is likely to prove the most controversial of these proposals. A GAAR was considered by the Government in 2003 and eventually dropped in favour of the introduction of the disclosure of tax avoidance schemes rules. While other Commonwealth countries have introduced GAARs (such as Australia, New Zealand and Canada) there is a concern that they do not promote stability but rather create greater uncertainty in relation to the tax treatment of transactions.

And finally, in respect of simplicity, the main proposal is for a new Office of Tax Simplification to be established (further details are expected to be published on this shortly). There will also be greater scrutiny in relation to the creation of new reliefs in future to ensure that there is a strong and proven case for them (where they might otherwise overcomplicate the relevant legislation).

Capital Gains Tax for Individuals

In a widely anticipated move, the Chancellor has announced an increase in the tax rates applicable to capital gains realised on disposals by individuals with effect from 23 June 2010 (including where gains have been deferred until on or after that date). The surprise, however, was that the new higher rate of capital gains tax is only 28 per cent. (as opposed to bringing the rates into line with income tax at, say, 40 and 50 per cent. respectively). This move should emolliate much of the popular irritation that has arisen in the run-up to the Budget in respect of this tax rise since, when compared to the old non-business asset taper relief available prior to the introduction of the 18 per cent. rate with effect from 6 April 2008, the 28 per cent. rate is relatively generous (the maximum taper relief for a disposal of a non-business asset held for 10 years or more prior to 6 April 2008 would have given an effective rate of 24 per cent.). The original rate of 18 per cent. will still apply where the taxpayer's total taxable gains and income are within the basic rate band and pre-23 June 2010 gains will not use up a taxpayer's remaining basic rate band for the purposes of this calculation. The higher rate will apply automatically to gains realised by trustees. The annual exempt amount remains at £10,100.

From the Chancellor's statement, the suggestion was that this measure is not primarily designed to raise new tax revenue but rather to reduce the incentive for taxpayers to engage in tax planning which converted income (potentially taxable at the current top rate of 50 per cent.) to capital gain.

Coupled with the introduction of the new higher rate of 28 per cent., the amount but not the scope of entrepreneurs' relief available during a taxpayer's lifetime has been increased from £2 million to £5 million. Entrepreneurs' relief, where it applies, currently operates by reducing the applicable gain by 4/9ths and taxing at 18 per cent. in order to give an effective rate of tax of 10 per cent. Since this manner of calculation will no longer work correctly in relation to the new 28 per cent. rate, the legislation will simply be amended to apply a 10 per cent. rate of tax to gains which qualify for relief.

Entrepreneurs' relief is generally available for disposals of (i) the whole or part of a business (including partnership interests) and (ii) assets in use by a business upon cessation, where the business is owned by the individual for the year prior to sale or cessation (and, in the case of asset sales, the asset is sold within three years of cessation). Relief is also available in respect of disposals of shares and securities issued by companies where, for the year prior to disposal, the taxpayer is a director or employee of the company and holds at least 5 per cent. of the ordinary share capital and voting rights in the company. A more restrictive relief is available for certain assets which are in use by a business which are sold as part of the withdrawal of the taxpayer from the business.

The new rate will therefore have the greatest (perhaps 'psychological') most impact on those assets which qualified for business asset taper relief prior to 6 April 2008 (resulting in an effective rate of tax of 10 per cent. after two years of ownership) but which do not qualify for entrepreneurs' relief, such as shares in unquoted trading companies where the shareholder is not a director or employee.

Changes to the rules on the deduction of income tax at source

Companies, individuals and other non-corporate persons are required to deduct basic rate income tax from interest, 'annual payments', and certain other payments such as royalties. It has been announced that a regulation-making power is to be granted to HMRC which will permit HMRC to make regulations governing the time and the manner in which taxpayers (other than companies) must report and remit income tax deducted at source from certain payments.

The new power follows on from a consultation published on 5 March 2010, which invited views on potential reforms to the UK's withholding tax regime. It is notable that, while the consultation invited views in relation to the withholding requirements applying to both companies and other persons, it is stated that the regime as it affects companies will remain the same. It is likely therefore that companies will continue to withhold income tax at source and account to HMRC in respect of income tax withheld each quarter by the submission of forms CT61 as before.

Currently, where a person other than a company is required to withhold income tax from a payment, that person is required to deliver an account of the payment 'without delay' to HMRC. HMRC may then raise an assessment on that person in respect of the income tax required to be deducted. However, the statutory wording goes no further than that, and there is nothing to prescribe the timing and manner in which an account must be made to HMRC and the manner in which an assessment may be made. It is highly likely that HMRC intend to make regulations that will require taxpayers (other than companies) to use a designated form on which to deliver an account to HMRC of tax deducted and that the tax will be payable without an assessment in the same way as is currently the case for companies.

De-recognition of loan relationships and derivative contracts

The general rule in determining the debits and credits to be brought into account for corporation tax purposes in relation to a company's non-trading loan relationships and derivative contracts is that the amounts of those debits and credits are those recognised in determining the company's profit or loss for the period in accordance with generally accepted accounting practice ("GAAP").

As a result, it has been possible for some companies to claim that because an amount is not recognised in determining their profit or loss, it should be left out of account for corporation tax purposes. With effect from 22 March 2006, in relation to loan relationships only, rules were introduced to bring amounts fully within charge where the company is a party to a creditor relationship and where either (i) the company is party to a debtor relationship and an amount is not fully recognised as a result of the application of GAAP to the debtor relationship and the creditor relationship or (ii) there is a contribution to the company which forms part of its capital and an amount is not fully recognised as a result of the application of GAAP to the contribution and the creditor relationship. In such cases, an assumption is made that an amount in respect of the whole of the loan relationship is recognised in determining the company's profit or loss for the period.

Further changes were introduced in Finance Act 2009. This resulted in an expansion in the scope of the anti-avoidance rules, previous application in relation to capital contributions combined with loan relationships to include amounts not recognised under derivative contracts as a result of the application of GAAP to the capital contribution and a derivative contract. A new provision was also introduced, covering both loan relationships and derivative contracts to deal with circumstances where a company issues securities which form part of the capital of the company and an amount is not fully recognised as a result of the application of GAAP to the securities and the derivative contract or loan relationship in question.

New anti-avoidance measures will now be introduced which will cover de-recognition of amounts arising from both derivative contracts and loan relationships which will be broader in scope than the current rules. Amounts will, with effect from 23 June 2010, have to be fully recognised for corporation tax purposes where de-recognition arises as a result of the acquisition or variation of a capital interest in a company, partnership or trust or where de-recognition is triggered by an event that occurs in a later accounting period to that in which the de-recognition takes place. The proposed changes appear to be more general in scope than those already enacted. A Technical Paper is expected in early July 2010 with the resulting changes to be included in Finance Bill 2011 with effect from a date to be announced.

Capital Distributions

Further details have been announced in the Emergency Budget of HMRC's intention to legislate to extend the rules on the taxation of income distributions received by UK corporation tax payers to capital distributions.

This intention was previously announced in the UK Budget of 24 March 2010 which was held before the General Election, although the relevant legislation was not enacted in Finance Bill 2010. The Emergency Budget contains details of both the proposed legislation to enact HMRC's intentions in this area, together with draft legislative clauses.

Until 2005 is was possible to argue that all UK source distributions were of an income nature unless treated as capital under specific legislation. An example of this would be a distribution in the course of a winding up, which was specifically treated as a capital distribution under section 209(1) of the Income and Corporation Taxes Act 1988 ("ICTA 1988"). However, under the provisions of section 383(3) of the Income Tax (Trading and Other Income) Act 2005 ("IT(TOI)A 2005"), all distributions of a UK company were treated as income for income tax purposes, irrespective of whether the distribution was of a capital nature. Although HMRC's long standing practice was to treat UK source distributions as income, that practice was difficult to sustain after the enactment of IT(TOI)A 2005 and not possible after the reforms of the taxation of dividends in Corporation Tax Act 2009.

Under section 931A(2) of the Corporation Tax Act 2009 ("CTA 2009") distributions of a capital nature received by a UK resident company were clearly excluded from the general exemption from corporation tax available for income distributions made by UK or non-UK resident dividend paying companies. Capital distributions would therefore be subject to corporation tax on chargeable gains, except where falling within an exemption such as the substantial shareholdings exemption or some other relief. Considerable uncertainty arose as a consequence of this treatment of capital distributions, particularly where the boundary line between income distributions and capital distributions was unclear. One example of this uncertainty was a series of arguments which HMRC were understood to have made that dividends paid out of distributable reserves which had been created on the reduction of share capital were capital in nature and would therefore not benefit from the exemption from corporation tax in CTA 2009.

HMRC announced on 24 February 2010 that Finance Bill 2010 would contain provisions to enable UK source capital distributions to fall within the exemption from corporation tax, thereby "making it unnecessary to consider difficult boundary issues between income and capital" (HMRC Budget Notice 5, "Capital Distributions", 24 March 2010). This legislative proposal was not enacted in Finance Act 2010 owing to the truncated form of Finance Bill placed before Parliament in the period between the 24 March Budget and the commencement of the General Election campaign.

The Government has now announced in the Emergency Budget that a distribution to a UK company will not be excluded from the general corporation tax exemption in CTA 2009 solely on the grounds that the dividend is made out of a reserve arising from a reduction in share capital or because the dividend is of a capital nature. The existing treatment of distributions arising to a UK company on a transaction in share capital being subject to corporation tax on chargeable gains (subject to available exemptions and reliefs) is retained. Any distribution in respect of shares which falls within the scope of Chapter 9A of CTA 2009 (irrespective of whether the distribution is (i) of an income or capital nature; or (ii) exempt from corporation tax or not) is also stated as being exempt from being treated as producing a capital gain within section 122 of the Taxation of Chargeable Gains Act 1992.

The changes announced in the Emergency Budget will be enacted in the second Finance Bill of 2010 and have retrospective effect from the date of introduction of the exemption from UK corporation tax for distributions received by UK companies with effect from 1 July 2009. Draft legislation has also published. UK companies will be able to elect for the legislation not to apply retrospectively, such as where a retrospective application would lead to an increased tax liability. The starting date for the mandatory, non-retrospective aspect of the proposed legislation, being the "clarification" of the meaning of "distribution" for corporation tax purposes, has effect from, and including, 22 June 2010.

The treatment of capital distributions by non-UK companies will not be changed, and this will continue to depend on the identification of whether the distribution being paid is of an income or capital nature (as was considered in the recent decision in First Nationwide v HMRC [2010] UKFTT 24).

Changes to the worldwide debt cap and capital distributions re-announced

Changes announced in the 2009 pre-Budget report (in relation to the worldwide debt cap) and the Budget on 24 March 2010 (in relation to the worldwide debt cap and capital distributions) will be included in the second Finance Bill of 2010 to be published in the Autumn.

Currently a group which is "large" (i.e. it includes a member which has not less than 250 employees and an annual turnover of €50 million or more and/or an annual balance sheet total of €43 million or more) is subject to rules which restrict the deductibility of interest for UK corporation tax purposes, where the "UK net debt" of the worldwide group exceeds 75 per cent. of the "gross debt" of the worldwide group.

The 'UK net debt' of the worldwide group is, essentially, the aggregate of the net indebtedness of each company which is resident in the UK or carrying on a trade in the UK through a permanent establishment. The "gross debt", in similarly broad terms, is the sum of all indebtedness of the group, as disclosed by its balance sheet.

Once within the rules, the excess of what is termed the "tested expense amount" over the "available amount" is disallowed as a deduction against income for corporation tax purposes. The disallowance may then be allocated to particular UK companies within the group at the option of the group. The tested expense amount is the sum of the excess of the financing expenses over the financing income for each UK company (or UK permanent establishment). The "available amount" essentially equates to the gross consolidated finance expense of the group.

The changes will all take effect from 1 January 2010 and comprise:

- excluding securitisation companies from the scope of the definitions of "UK group company" and "relevant group company" (thereby removing securitisation companies from the scope of the 75 per cent. gateway test);

- excluding the financing expense amounts of securitisation companies from the scope of the "available amount" calculation;

- a power to make regulations which permit UK companies (or companies with UK permanent establishments) which are party to capital market arrangements to transfer any corporation tax liability arising as a result of the worldwide debt cap to another group company;

- widening the 75 per cent. "gateway test" to include "long term arrangements" (which do not have the legal form of loans) which give rise to an interest like return;

- widening the definition of "financial instruments" for the purposes of the "qualifying financial services groups" exemption to include all options, futures and contracts for differences (as defined for the purposes of Part 7 of Corporation Tax Act 2009);

- including guarantee fees within the "financing income amounts" of a company;

- correcting a drafting error in relation to the group treasury company exemption;

- further restricting the type of entity that can be an "ultimate parent" of the worldwide group (i.e. excluding LLPs or bodies corporate that would otherwise be collective investment schemes but for the fact that they are bodies corporate from being "ultimate parents");

- preventing groups from allocating a debt cap disallowance to a dual resident investment company;

- excluding distributions by industrial and provident societies (which are normally treated as interest for tax purposes) from the "financing expense amounts" of those companies;

- narrowing the definition of "ancillary expenses" to bring it more into line with the corresponding meaning for loan relationships purposes; and

- removing interest paid to non-department public bodies from the calculation of "financing expense amounts".

Consortium Relief

Consortium relief can be claimed where both the consortium claimant company and the consortium surrendering company are resident in the UK (or are non-resident companies carrying on a trade in the UK through a permanent establishment). In addition, if a consortium claimant company claims consortium relief (such as unused losses) through a "link company" (within section 406(1)(a) ICTA 1988), the link company must, broadly speaking, also be resident in the UK (or non-UK resident but carrying on a trade in the UK through a permanent establishment: section 406(2) ICTA 1988).

The Government has announced its intention in the Emergency Budget to legislate in the second Finance Bill of 2010 to permit any company established within the European Economic Area to be a link company. This legislative change is unsurprising. The Tax Chamber of the First-tier Tribunal determined in Philips Electronics UK Limited v HMRC [2009] UKFTT 226(TC) that the denial of UK consortium relief in cases where a link company within a greater than 50 per cent. joint venture (and possibly where the joint venture interests are 50 per cent. or less) was not resident in the UK, or carrying on a trade in the UK through a permanent establishment, constituted a restriction on the EC freedom of establishment that could not be justified. The change announced to the permitted residence of the link company therefore aligns the UK legislation with the First-tier Tribunal's interpretation of EU Law.

A further announcement made by the Government in the context of consortium relief is a change regarding the maximum amount of losses that may be claimed from a consortium company under section 403C(2) ICTA 1988. Currently, the maximum amount of losses is determined as being the lowest result from three tests relating to the respective percentages of ordinary share capital held, entitlement to profits and entitlement to assets on a winding up. These three tests will be augmented by additional tests based on the proportion of voting rights and the extent of control that a member holds in the consortium. The HM Treasury Budget 2010 Press Notices refer to the measure as being required in order to counter the "manipulation of the consortium relief rules" caused by members accessing relief "for a greater share of consortium losses than their actual involvement should entitle them to". As the non-consortium group relief rules use a similar series of tests as the consortium rules, the possibility of commensurate legislative changes in the context of the group relief rules cannot be ruled out. Draft clauses for the changes to the consortium relief rules have not yet been published.

Authorised Investment Funds – New Anti-Avoidance Measures

Measures have been announced in the Emergency Budget to ensure that a corporate investor in an authorised investment fund ("AIF") cannot use the AIF to create a UK tax credit in circumstances where no underlying tax has been paid.

The Authorised Investment Funds (Tax) Regulations (SI 2006/964) (the "AIF Regulations") have been amended by statutory instrument (The Authorised Investment Funds (Tax)(Amendment No.2) Regulations 2010 (the "Amendment Regulations")) made on 22 June 2010 and having effect for distributions made by an AIF at or after 1.45pm on that date.

The Amendment Regulations introduce two changes to the AIF Regulations, both motivated by HMRC's belief that authorised investment funds have been used in conjunction with tax avoidance arrangements.

First, the Amendment Regulations ensure that where an AIF declares and pays an interest distribution, that interest distribution is not to be treated as deductible for corporation tax purposes to the extent that the distribution is derived from dividends which are exempt from corporation tax.

Second, a further series of provisions in the Amendment Regulations ensure that where all or part of a dividend distribution is ultimately derived from overseas dividend income, a corresponding proportionate part of that distribution will be treated, when received by the investor in the AIF, as foreign income arising from a territory with which the UK does not have a double tax treaty. Broadly, under the AIF Regulations, a distribution paid by an AIF to a corporate investor is treated by the investor as an annual payment made after withholding with an associated deemed tax credit referable to the part of the distribution derived from the taxable income of the AIF. This has the effect of ensuring that the investor pays UK corporation tax at the correct rate with a deemed tax credit (thereby avoiding double taxation on the same income profit). The new provision (which is now legislated as paragraph 48B of the AIF Regulations) has the effect of eliminating the deemed foreign tax credit referable to the foreign proportion of the distribution made by the AIF with effect from 22 June 2010.

VAT: Change of standard rate and anti-forestalling legislation

Perhaps the most austere measure in the Emergency Budget (and the most important in macro-economic terms) was the announcement that legislation will be introduced in the second Finance Bill of 2010 to increase the standard rate of VAT from 17.5 per cent. to 20 per cent. to take effect from 4 January 2011. The change affects any VAT registered business that sells or purchases goods or services made on or after 4 January 2011 that are subject to the standard rate of VAT.

This change in the standard rate of VAT does not affect zero rated supplies such as basic foodstuffs, children's clothing and books; exempt supplies, such as education and health; and supplies subject to VAT at the 5 per cent. reduced rate, such as domestic fuel and power.

The Government also announced that in order "[t]o protect the public finances from artificial avoidance aimed at exploiting the VAT rate where there is no current economic activity", anti-forestalling legislation will be introduced in the forthcoming Finance Bill to ensure that the VAT change is fully effective. Very broadly, forestalling occurs where arrangements are in place to account for VAT at a rate of 17.5 per cent. in advance of 4 January 2011 in respect of goods or services to be provided afterwards.

The legislation may also apply where a supplier arranges for the supply of rights or options from themselves on or after 4 January 2011 either free of charge or at a discount. For these purposes a "right" shall include an option or an interest deriving from a right or an option. In such circumstances the legislation will not apply if the customer can recover the VAT on that supply in full.

The anti-forestalling legislation introduces a "supplementary charge" to VAT of 2.5 per cent. which will apply to transactions that span the date of the VAT change on 4 January 2011. Where the legislation applies, VAT of 17.5 per cent. shall be due on the date of issue of the VAT invoice (or receipt of prepayment) before 4 January 2011 which creates the actual tax point, with the "supplementary charge" to VAT of 2.5 per cent. becoming due on 4 January 2011.

The supplementary charge will apply where the customer cannot recover VAT in full on the supply and at least one of the following conditions is met:

- the supplier and the customer are connected with each other at any time between the date that the invoice is issued, or payment received, and 3 January 2011;

- the supplier or a person connected to the supplier finances a prepayment by the customer;

- the supplier issues a VAT invoice to a customer that does not have to be paid for at least six months of the invoice date (except hire purchase invoices issued in accordance with normal commercial practice); or

- the consideration for the supply and any related supply amounts to more than £100,000 (including any other supplies made as part of the same scheme or arrangements), and this is not normal commercial practice.

The supplementary charge will not apply to certain excepted supplies, including for example (i) real estate lease premiums which are paid on a grant of a lease prior to 4 January 2011 relating to a lease term extending beyond that date; and (ii) prepayments and advance invoicing of rental or hire charges for the leasing of any assets under commercial arrangements, provided that the period does not exceed one year.

The Government has stated that the scope of the legislation is such that it is likely to affect very few businesses owing to it being targeted at "artificial arrangements". The change is unlikely to affect suppliers making standard rated supplies who conduct their business as they normally do when no VAT rate increase is anticipated. The legislation will have effect on or after 22 June 2010. However, the supplementary charge to VAT will be due on 4 January 2011 and must be accounted for on the supplier's VAT return covering that date.

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If you have any questions regarding the foregoing, please contact:

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