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Clients&FriendsMemo

UK Budget 2011: Key Taxation Aspects

23 March 2011

The Chancellor of the Exchequer's second budget, held on 23 March 2011, was perhaps most notable for the attention placed on fiscal neutrality, coupled with plans for the stimulation of economic growth. The technical tax developments and announcements echoed this approach. One document described a "coherent framework" within which HMRC could tackle perceived tax avoidance, an approach supplemented by the closure of a number of loopholes and schemes and a general focus on measures to "shut down the open abuses that have been allowed to continue for too long". Other provisions focused on encouraging investment in UK enterprise and in developing the competitiveness of the UK economy.

In this memorandum we have set out the details of a number of key changes in legislation and practice that we expect to be of interest 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 below.

Speed Read

"*Tackling Tax Avoidance*": HM Treasury document setting out a "new anti-avoidance strategy". While the number of specific new initiatives being proposed are small, the document is notable for the coherent description of a number of previously disparate initiatives and approaches by HMRC.

Avoidance - SDLT: Closure of three avoidance schemes

Avoidance - Group Mismatches: Minor changes to the draft legislation published in December 2010 and due for enactment in Finance Bill 2011.

Avoidance - Closure of chargeable gains loophole on de-grouping: A gap in the chargeable gains rules created by an exemption from the de-grouping charge for transferee and transferor companies leaving a group at the same time has been closed.

Avoidance - Disguised Remuneration: While there is not a great deal more detail in respect of this ongoing consultation, it is clear that the Government are pressing ahead with these controversial new rules to charge income tax and collect national insurance contributions on certain arrangements involving third parties which are used to reward employees and directors. Not much more detail has been made available, although certain arrangements not used for avoidance will be excluded.

Avoidance - Accounting de-recognition of loan relationships and derivative contracts: More anti-avoidance provisions are to be introduced to prevent the accounting treatment of derivatives and loan relationships resulting in anomalous tax results.

Avoidance – DOTAS regime: Consultation on new "hallmarks" re-started.

Financial sector taxation - Loan relationships and Derivative Contracts Disregard Regulations: Relaxation of rules to allow a company to be taxed on the basis of the economic outcome of certain loan relationship and derivative contract hedges entered into to reduce the exposure to foreign exchange movements that arise as a result of that company owning foreign currency assets.

Financial sector taxation - UK Investment Companies and Functional Currency: Revised draft legislation published.

Financial sector taxation - Taxation of Banks: Bank Levy and Code of Practice on Taxation: Revised bank levy rate announced; confirmation of extensive adoption of the Code of Practice.

Financial sector taxation - Bank Capital Instruments under Basel III: Consultation announced on tax features of Basel III compliant "Additional" Tier 1 and Tier 2 instruments.

Financial sector taxation - Retrospective Tax Treatment of Alternative Finance Investment Bond: Retrospective statutory changes to correct earlier mistakes in secondary legislation.

Financial sector taxation - Index linked gilt-edged securities: Minor changes.

Financial sector taxation - Fund Taxation and Developments: Management company passports and consultation on a new UK transparent fund vehicle announced.

Corporate tax reform: No real surprises in the shape and direction of the corporate tax reform programme. Previously trailed legislation intended to make the UK's CFC rules more user-friendly will be implemented as planned with some further minor changes. An elective exemption for overseas branch profits of UK companies is also expected to be implemented, as planned, from April 2011 subject to a number of minor improvements.

Non-domicile taxation: A new £50,000 remittance basis charge for non-domiciles tax resident in the UK for 12 or more years will be introduced. An exemption from income tax or capital gains tax on remittances made to fund commercial investment in UK businesses.

Statutory residence test for individuals: A consultation on introducing a statutory residence test has been announced. This is probably long overdue, given recent uncertainty and controversy over the UK tax residence status of individuals.

Worldwide debt cap: Yet more changes are expected in relation to the de minimis provisions to make the rules easier to apply.

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*". The document follows from two documents published by HM Treasury in 2010 which examined (among other things) the Government's strategic approach to tax avoidance in the UK. "*Tax Policy Making: The New Approach*" was published in June 2010, and was followed in December 2010 by "*The New Approach to Tax Policy Making: A response to the Consultation*". Both documents made brief reference to the Government's commitment to tackling tax avoidance, and the need for a more strategic approach to the risks of avoidance.

"*Tackling Tax Avoidance*" expands considerably on the statements made in the two documents from 2010 and is a more comprehensive review of the components of the Government's "new anti-avoidance strategy". 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 stated strategy of HMRC is described as "providing a coherent framework for all the strands of HMRC's anti-avoidance activity that together help ensure that avoidance is tackled robustly." The overall impression throughout "*Tackling Tax Avoidance*" is of the desire for a consistent, comprehensive and determined campaign to "get to grips with this problem".

While the document will doubtless replay careful study, some preliminary points are immediately apparent:

- "*Tackling Tax Avoidance*" draws together the different approaches of HMRC in addressing tax avoidance in a single document. This serves the purpose of unifying a number of sometimes disparate initiatives and approaches and at least attempts to marshal these in a common cause and approach. In this regard, the document is helpful, as there is a consistency of theme when certain approaches are seen side by side.

- The document contains some new approaches as well as articulating old methods and initiatives. These are set out in the second section of the document, entitled "Tackling Avoidance at the Root".

  (i) 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". Income tax losses (presumably including those generated through partnership arrangements) and the use of unauthorised unit trusts for tax avoidance are the first two areas to be considered, with other reviews to follow in the future.

  (ii) A new proposal is announced to reduce the cash flow benefits that taxpayers can gain from using high risk avoidance schemes. The concern of HMRC is that some taxpayers are perceived to have entered high risk avoidance schemes "to exploit a cash flow advantage of retaining tax while continuing to dispute a liability", an action 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. However, the numbers of taxpayers following such an aggressive, even cavalier, approach is likely to be very small, not least because of the material risks of being required to pay interest, penalties and HMRC's costs in any failed litigation. It is difficult to reconcile the prominence given to this approach by HMRC with the low number of taxpayers who might regularly even contemplate using such a cash flow device.

  (iii) Targeted tax measures addressing specific risks, such as the group mismatch scheme, disguised remuneration and capital allowances anti-avoidance provisions which feature elsewhere in the Budget announcements.

  (iv) The possible implementation in the future of a general anti-avoidance rule ("**GAAR**"), which is currently being considered by the study group led by Graham Aaronson QC which was announced in December 2010. While "*Tackling Tax Avoidance*" is careful to give no suggestion of any HMRC pre-disposition in favour of (or adverse to) a GAAR, the impression is given in the document through its language and tone that any GAAR (if one is introduced at all) would fit comfortably as a key component of the "new anti-avoidance strategy".

- Equal prominence is given to the early detection of avoidance and to the challenging of avoidance once detected as to the prevention of avoidance at the "root". This is an unsurprisingly pragmatic approach, building on the work of HMRC in refining the Disclosure of Tax Avoidance Schemes regime and the development of sophisticated litigation and settlement strategies.

- However, notwithstanding the examples given in "*Tackling Tax Avoidance*" of schemes, arrangements and transactions which are perceived as constituting tax avoidance, considerable discussion is likely to continue concerning the proportion of the so-called "tax gap" of £42 billion which is attributable to avoidance (and which the Government's statistics estimate is 17.5%)[1]. Moreover, there is clear room for at least some debate concerning the type and nature of the perceived avoidance comprised in that proportion. For example, a distinction can be drawn between the highly artificial, circular, contrived schemes referenced in "*Tackling Tax Avoidance*" and arrangements which are merely alleged at some point in time in correspondence or negotiations by HMRC to constitute "avoidance".

As noted above, "*Tackling Tax Avoidance*" is an important document which will repay study. While the majority of what is included is not new, the vigorous manner in which the "new anti-avoidance strategy" is proposed may yet signify a new chapter in evolution of tax avoidance (and measures aimed to prevent it) in the UK.

SDLT Avoidance

Legislation will be introduced in Finance Bill 2011 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. For arrangements spanning 24 March 2011, careful consideration of the commencement provisions will be necessary. However, broadly speaking, where transactions have been entered into before 24 March 2011, but are completed afterwards, the SDLT legislation should apply as it did before the announcement of these changes.

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 section 45(3) if Finance Act ("**FA**") 2003 will be extended. Currently, the substantial performance or completion of an original contract in a sub-sale is disregarded only by reference to where the secondary contract gives rise to a transaction which is exempt from charge by virtue of section 73(3) FA 2003, namely where the financial institution sells the property on to an individual under an alternative property finance arrangement. The change will extend the disregard to all of the SDLT Alternative Finance reliefs at sections 71A to 73 FA 2003 (including the alternative property finance relief for Ijara financing), and not only section 73(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 new definitions importing the definition of

1 "*Measuring Tax Gaps 2010*", HMRC Publication (Official Statistic release), 16 September 2010, page 66.

"financial institution" from section 564B 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; and

- 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".

It is interesting that HMRC have not relied on combating the perceived avoidance in the sub-sale scheme using the general anti-avoidance rule for SDLT in section 75A FA 2003. The Chief Secretary to the Treasury at the time section 75A FA 2003 was introduced noted in the Finance Bill Committee debates that the provision was introduced to counter schemes which use sub-sales "that have been developed specifically to avoid payment of the tax". There may be a number of technical reasons for such reticence, some of which may be embedded in the specific facts and circumstances of the arrangements and schemes in which the sub-sale relief has been allegedly abused. It is also possible that the recent decision of the First Tier Tribunal in *DV3 RS Limited Partnership* [2011] UKFTT 138 (TC) in favour of the taxpayer, being the first SDLT avoidance case considered by the Courts (and which itself involved eligibility for sub-sale relief in conjunction with the transfer of land to a partnership), may have refocused HMRC's attention on preventing further avoidance through introducing new legislation. While is seemed highly likely that *DV3 RS Limited Partnership* will be appealed by HMRC, and while section 75A FA 2003 was not considered in that case (as it post-dated the planning utilised), the announcement by HMRC of SDLT legislative changes serves to reinforce the message made in the "*Tackling Tax Avoidance*" document on preventing avoidance through legislative change as well as through litigation.

Group Mismatches Schemes

Legislation will be introduced 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.

The legislation will have effect in relation to group mismatch schemes to which a company is party on or after Royal Assent to Finance Bill 2011. HMRC has informed those involved in the consultation on the group mismatch scheme (including the London Tax Team from Cadwalader, Wickersham & Taft LLP) that a memorandum explaining these changes will be available from the HMRC website shortly after publication of Finance Bill 2011.

Chargeable gains de-grouping

A perceived loophole in the de-grouping charge has been closed with immediate effect. It appears that companies have been structuring inter-company transfers in such as way as to take advantage of a certain exemption from the de-grouping charge under section 179(2) of the Taxation of Chargeable Gains Act 1992. The exemption applies 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. Where section 179(2) is relied upon to avoid the de-grouping charge on leaving the first group, and the transferee company subsequently leaves a second group (which is "connected" to the first) the de-grouping charge applies as if the acquisition had taken place while the companies were members of the second group.[2] The flaw in this round-about 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.[3] The de-grouping 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 has been remedied by ensuring that the de-grouping charge also applies when the connection between the two groups ceases.

Disguised Remuneration

The Government will be pressing ahead with its proposed new rules on "disguised remuneration" in what is one of the most contentious reforms of this Budget in the eyes of tax practitioners. The rules will apply with effect from 6 April 2011. The initial draft legislation published on 9 December 2010 was widely criticised in the tax press as unworkable and, in some cases, punitive and HMRC has since published some useful "frequently asked questions" with a view to allaying some of the more serious concerns.[4]

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2 I.e. it reinstates what would otherwise have been the original de-grouping charge.

3 An interpretation which is reinforced by the definition of "connected" in section 179(2B).

4 Notwithstanding the FAQs, it appears that non-commercial loans (involving the use of a third party loan provider) to employees other than those specifically exempted (e.g. season ticket loans) will be treated as remuneration under the new rules. Since there will be no rebate of income tax upon repayment of loans, this may be seen as an effective bar to making non-exempt loans of any sort to employees. Additional FAQs are expected soon.

The rules are intended to apply to arrangements involving a third party to reward employees and directors which seek to avoid, defer or reduce income tax and national insurance contributions (as well as applying to arrangements used as a tax-advantaged way of saving for retirement). In particular, the Government appears to be targeting the large scale tax planning which has been entered into as a contingency for those individuals whose annual or lifetime pensions allowances have been fully utilised. Certain tax planning regarded as inoffensive by the Government, such as the use of registered pension schemes and approved employee share schemes, and ordinary commercial transactions will not be covered. Benefits packages available to all employees will also not be covered and it has subsequently been announced in the FAQs that deferred remuneration packages vesting within 5 years will not be covered either. It is expected that the definition of “third party” will be revised to largely exclude companies which are members of the same group as the employer, further narrowing the scope of the proposed rules. Anti-forestalling legislation is to apply from 9 December 2010 (even though it is unclear as to what the final legislation will cover).

The trigger for the tax charge will be (i) payment or transfer of an asset, (ii) making an asset available, or (ii) “earmarking”. The concept of “earmarking” is not defined but it would not currently seem to cover discretionary trusts structures where no allocation to any single beneficiary within a class has been made.

The Budget Tax Information and Impact Note on the subject does not add much more to what has already been said by HMRC but revised legislation is expected soon.

Accounting de-recognition of loan relationships and derivative contracts

Further changes are anticipated in relation to the draft legislation published on 6 December 2010 in respect of the de-recognition of loan relationships and derivative contracts for accounting purposes.

Since, as a general rule, the tax treatment of loan relationships and derivative contracts follows the accounting treatment, HMRC has faced continual problems in adapting the loan relationships and derivative contracts tax regime to anomalies which arise from generally accepted accounting practice. Draft legislation was published on 6 December 2010 with a view to replacing the prescriptive conditions, under which de-recognition of loan relationship and derivative contract amounts are ignored, with a wider reaching tax avoidance test.

No detail has been given as to the further changes to the existing draft legislation announced in the Budget other than that the changes are expected: (i) to clarify that the loan relationships and derivative contracts tax regimes only apply where a company is actually party to the loan relationship or derivative contract in question; (ii) to require credits to be brought into account where a difference between the carrying value and the fair value of a derivative arises as a result of tax avoidance arrangements[5]; and (iii) to deny certain debits on creditor loan relationships and derivative contracts.

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 Schedule 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 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.; and
- 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 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. It is also important to note that the DOTAS regime will also be extended to include inheritance tax, as it applies to transfers of property into trust, with effect from 6 April 2011.

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[5] This change will have effect from 23 March 2011.

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 legalisation 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 derivative 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 current rules provide that in certain circumstances the debits and credits on a company' loans and derivative contracts are not brought into account until a later date. Forex gains and losses on the loans and derivative contracts are "matched" with the equal and opposite forex gains and losses on the forex asset and are not recognised for tax purposes until the forex asset is disposed. However, the current rules on matching of own share capital do not provide for tax to follow the economic outcome where companies invest in foreign currency assets through a partnership or where a company sells foreign currency shares but expects to receive the proceeds at a later date. The proposed changes to the Disregard Regulations are therefore focused on allowing companies to replicate for tax purposes their economic position in these specific circumstances. These circumstances are where companies:

- issue their own foreign currency preference share capital to raise foreign currency finance. The proposed new rules will allow companies to ignore exchange gains and losses on loan relationships and derivative contracts where the loan relationship or derivative contract reduces the company's foreign exchange exposure in relation to its own foreign currency preference shares issued to non-connected entities and which are accounted for as liabilities. The changes will apply 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. The new rules will allow a company to defer exchange gains and losses on its loan relationships and derivative contracts where the loan relationship or derivative contract reduce the company's foreign exchange exposure in relation to the underlying foreign currency assets in the partnership until either the partnership disposes of the assets or the company disposes of its interest in the partnership. The changes will apply for accounting periods beginning on or after 1 January 2012; or

- agree to sell foreign currency shares and receive the proceeds at some future date. The proposals will allow a company to match the full disposal proceeds on the sale of foreign currency shares and defer the resulting exchange gains and losses until the company receives the disposal proceeds. The changes will apply 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. (The draft legislation also provided for such investment companies to elect, prospectively and depending on circumstances, for a different a functional currency for tax purposes than the currency used in the statutory accounts. The intention regarding the anti-avoidance element of the proposed changes was to ensure that, when a UK resident investment company changes its functional currency, no foreign exchange losses (or gains) arising from loan relationships or derivative contracts will be brought into account for tax purposes in the first period of account using the new functional currency. The stated intention was to ensure that companies could not retrospectively choose their functional currency to gain a tax advantage.

Following consultation, the Government has announced in the Budget that the draft legislation published on 9 December 2010 has been amended 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 to make provision for newly incorporated companies. 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 Government has announced that the rate of the Bank Levy will be increased from 1 January 2012 onwards from the rate announced by the Chancellor on 8 February 2011. The further increase of the Bank Levy rate has been described as offsetting the benefit for the UK banking sector of the further decrease in corporation tax announced in the Budget, and is highly likely to be seen as a political gesture at a time when UK public sentiment remains unfavourable towards the banking industry. The rates for 2012 onwards will now be 0.078 per cent for short-term chargeable liabilities and 0.039 per cent 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 two hundred 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 announcement that HMRC will work with industry and representative bodies to explore the tax treatment of new capital instruments which banks may create as a result of the Basel III proposals on banks' capital requirements is to be welcomed. The proposals regarding relating to quality of capital have recently been finalised in "*Basel III: A global regulatory framework for more resilient banks and banking systems*", published in December 2010.

Basel III introduces measures intended to strengthen the definition of capital, so that there is a greater emphasis on higher quality capital which should be more able to absorb losses. Basel III requires banks to start increasing their Tier 1 Capital (being Common Equity and "Additional" Tier 1 capital) and either replace or issue new Tier 2 capital. The Basel III "loss absorbency" requirement raises numerous complicated questions from a practical and legal standpoint which will need to be considered from the perspective of existing tax legislation (both in the UK and in other jurisdictions), as well as in the context of accounting treatment, banking regulations and company law. It is likely that as the market for such instruments develops, a number of new types of capital instruments will be developed which operate more like equity in the circumstances of a financial crisis, including contingent capital securities.

A number of Basel III-compliant "Additional" Tier 1 and Tier 2 instruments which may be developed are 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

The Government has announced that it will introduce retrospective legislation in Finance Bill 2011 to reverse the unintended tax consequences which resulted from the making of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 (the "**2010 Order**") in February 2010. On 19 November 2010, the government issued a statement acknowledging that 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.

The Government announced its intention in legislating retrospectively for the unintended result, in addition to stating publicly that any tax liability arising from the unintended consequence would not be enforced or collected. 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. The Budget announcement is therefore the final stage before Finance Bill 2011 in restoring the position retrospectively to where it should have been in early 2010, subject to an opt out to ensure the retrospective application of new legislation does not increase tax liabilities.

Index linked gilt-edged securities
A minor change is to be made to the corporation tax treatment of index-linked gilts. Currently, amounts to be brought into account under the loan relationships rules for gilts linked to the retail prices index ("RPI") are determined using a fair value basis of accounting. The carrying value of the security at the start of an accounting period is adjusted for any movements in the value of the RPI during the accounting period, so that the debits and credits which are brought into account for tax purposes for that accounting period do not include those movements. However the rules applying to index-linked gilts (at sections 399 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 rules will be extended to comprise any gilt which is linked to a price index published by the Office for National Statistics.

Fund Taxation and Developments
The Government has confirmed its intention to legislate in Finance Bill 2011 to enable 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 The 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. Under law some foreign funds may be held to be tax resident in the United Kingdom when centrally managed and controlled here. Legislation will be included in the Finance Bill to treat a UCITS IV fund that is established and regulated in another EEA state as not being resident in the United Kingdom solely by reason of having a United Kingdom resident fund manager. This measure will be included in the Finance Bill and will have effect on and after the date that Finance Bill 2011 receives Royal Assent.

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.

Tax competitiveness

One of the main messages the Chancellor of the Exchequer wants to get across, and it is not a new message, is that he wants the UK to be the most competitive tax system in the G20 group of nations. In this vein, he will be hoping to turn heads with a larger than expected reduction in the main rate of corporation tax from 28 per cent. to 26 per cent from April 2011 and reducing by 1 per cent. each financial year thereafter to 23 per cent. in April 2014.

Other headline changes in the UK's corporate tax regime to be included in Finance Bill 2011 include the interim improvements to the controlled foreign companies ("CFC") regime and the exemption for overseas branch profits, with the lower rate of taxation for patent income still expected in 2013.

CFC interim improvements

The CFC interim improvements have largely already been trailed, with the publication of draft legislation on 9 December 2010 and, helpfully, are intended to take effect for accounting periods beginning on or after 1 January 2011.

The main thrust of the improvements have not changed and include:

- An exemption for trading companies with no "significant"[6] UK connection. Trading in this context requires no substantial "non-exempt activities"[7] and not more than 5 per cent. of the company's gross income to be derived from finance income or certain IP income.
- An exemption for CFCs, the business of which is mainly that of exploitation of intellectual property with no "relevant UK connection".[8] A company will not qualify if more than 5 per cent. of its income is derived from financing income or if it has substantial secondary activities. The potential CFC must not otherwise have any "significant UK connection".[9]

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6 This is closely defined to encompass certain situations where more than 10 per cent. of gross income or expenditure is "UK related" (i.e. received directly or indirectly from or by UK taxpayers).

7 Defined to include "passive" types of income derived from holding and managing shares and securities, holding IP, leasing property and other similar income streams.

8 Broadly meaning that the IP has (i) not been held by a UK tax resident person within the accounting period or the previous 10 years or (ii) not been created, maintained or enhanced by a UK tax resident person which is "related" (which extends to connected and associated persons, persons with a 25 per cent. assessable interest in the company and persons connected or associated to persons controlling the company under the 40 per cent. tests).

9 The definition of which is based on certain factors including (i) the funding of the CFC by related UK persons (aimed at preventing the exemption from applying where the funding gives rise to offshore IP income for the CFC but inadequate corresponding financing income for the UK entity providing the funding), (ii) a substantial proportion of gross income arising from the exploitation of IP deriving from UK taxpayers and (iii) the existence of expenditure on R&D sub-contractors or IP development which forms part of the income of a related UK person.

- Where the either of the above two exemptions is failed solely because there is a significant UK connection or the 5 per cent. threshold is breached (in the case of the first, "trading companies" exemption) or the 5 per cent. threshold is breached (in the case of the second exemption for companies exploiting IP), an application can be made to reduce the UK apportioned profits where the work giving rise to the profits is not attributable to certain transactions with UK taxpayers.
- A three year exemption for companies becoming controlled from the UK as a result of a reorganisation or a change in ownership (to replace the current non-statutory "period of grace" practice). This was originally intended to exclude companies which had previously been treated as CFCs, but this exclusion now appears to have been relaxed. This may be a "carrot", in practice, to tempt former UK-headed groups to redomicile to the UK (and indeed other overseas groups to migrate to the UK) without ever having to be subject to the existing CFC regime.
- New rules for large groups[10] increasing the *de minimis* exemption to £200,000 and changing the computation of CFC profits for both the *de minimis* exemptions from a UK tax-based computation to an accounts-based computation.
- An extension of the transitional rules for superior and non-local holding companies until July 2012.

The wholesale replacement of the CFC regime is 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 per cent.[11] 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.

Overseas branch profits

A similar story to that for CFCs may be told in respect of the proposed overseas branch profits exemption, for which draft legislation was also published on 9 December 2010. The main features of the new regime are as follows:

- Participation in the regime is optional and is effected by an election which, if not revoked before the company tax return filing date, becomes irrevocable.

[10] Using the EC Recommendation 2003/361/EC of 6 May 2003 (i.e. the group is not an SME).

[11] I.e. one quarter of the main rate of corporation tax in 2014.

- Allocation of profits or losses to permanent establishments is to be made in the same way as would be allocated under the relevant double taxation treaty (where one exists) provided that the permanent establishment is located in a "full treaty territory"[12] or, for any other territory, the allocation is to be made as if an OECD model tax convention were in place. In each case, this results in the "relevant profits amount" or "relevant losses amount".
- The "relevant profits amount" and "relevant losses amount" from permanent establishments in those territories are then aggregated to find the "foreign permanent establishments amount". If the foreign permanent establishments amount is positive, it has the effect of reducing profits or increasing losses but if it is negative, it has the effect of increasing profits or reducing losses.
- A transitional rule will have the effect of delaying the application of the rules so that any loss-relief granted in respect of accounting periods ending in the six years prior to the accounting period in which the election is made, is recaptured. It appears that there will be further changes in this area, as the rules in their current draft form do not appear to be easily workable. In particular, the open-ended clawback for large losses (previously set at more than £50 million) has not been finally settled.
- CFC-style protections are to be enacted[13] in the form of an "anti-diversion rule". Where a permanent establishment is located in a jurisdiction which has a lower level of tax[14] and there is a relevant profits amount (excluding profits and losses within the chargeable gains rules), the relevant profit amount is brought within the exemption aggregation if the "motive test" is met. The motive test requires, broadly, that (i) transactions (the results of which are reflected in the company's profits) must not be entered into by the permanent establishment to achieve a more than minimal reduction in UK tax and (ii) it must not reasonably be supposed that the receipts reflected in the profits of permanent establishment would have been received and taxed in the UK if the permanent establishment did not exist. The "anti-diversion rule" is, however, a work in progress. The Government has expressed a desire to make the rule "more targeted and proportionate".

It is expressly anticipated that some life assurance business may now qualify for the branch exemption whereas HMRC had previously aired concerns that including life insurers in the regime would distort the proxy taxation of policy holders' profits inherent in their current basis of taxation. While the anticipated changes to the draft legislation published on 9 December 2010 have not been published with the Budget Report, there may be other further "significant changes" to the draft legislation in Finance Bill 2011. It also remains to be seen whether the anti-diversion rule can

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[12] A territory with which the UK has made double taxation arrangements including a non-discrimination provision.

[13] A *de minimis* limit for large companies of £200,000 branch income profits and, for small companies, £50,000 will apply in relation to each territory.

[14] Being less than 75 per cent. of the corporation tax which would have been payable in the UK.

be made to work in a way which both does not unduly discourage participation in the regime and which aligns the proposed regime with the equivalent, but shifting, protections against base erosion under the existing and proposed CFC regimes.

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.

Other items

Taxation of non-domiciles

In one of the more politically-charged announcements in the Budget, the Chancellor has unveiled plans to increase the remittance basis charge for non-domiciles who have been resident in the UK for 12 or more years from £30,000 to £50,000 per year.[15]

While this will be less than welcome news for non-domiciles, it comes with a promise that no further changes will be made to the rules regarding the taxation of non-domiciles for the duration of the Parliament. This at least precludes the possibility of any “deemed domicile” rule (such as that used for inheritance tax purposes) being introduced as had been rumoured.

To encourage investment by non-domiciles in UK businesses, an exemption from income and capital gains tax on income and capital gains remitted to the UK for the purpose of commercial investment in UK businesses will be introduced. The Government has also promised to simplify some aspects of the current extremely complex remittance basis rules to ease the associated administrative burden. A consultation document will be issued in June 2011 with a view to enactment with effect from April 2012

A statutory residence test

One slightly surprising, but welcome, announcement is the proposal to consult on a statutory definition of tax residence for individuals. The proposal is topical given the recent spate of judicial review cases arising from IR20[16], among them *R (Davies, James and Gaines-Cooper) v HMRC [2010] EWCA Civ 83*, and the mistaken impression of taxpayers that they could rely on HMRC guidance as to their UK tax residence status. There have been a number of calls for a statutory residence test over the years and it will be interesting to see whether the Government can find an acceptable statutory formulation. A consultation document is expected in June 2011.

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15 The £30,000 charge will continue to apply for periods of residence below 12 years.

16 HMRC’s obsolete guidance on residence (now replaced by HMRC6).

Worldwide Debt Cap – Further Modifications and Refinements

The worldwide debt cap applies to groups comprising a "large" member where the UK net debt of a worldwide group exceeds 75 per cent. of the gross debt of the worldwide group. Where the rules apply, the excess of the aggregated financing costs of each UK company in the group over the net external financing cost of the worldwide group is generally disallowed. The rules are highly complex and prescriptive and have already been the subject of numerous revisions since their introduction with effect for periods of account beginning on or after 1 January 2010.

The Government now wishes to consider making some further amendments to the de minimis provisions applicable under the rules 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.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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