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Clients&FriendsMemo

UK Budget 2015 – Key Tax Measures

19 March 2015

The Chancellor of the Exchequer's final Budget of the current Parliament, given on 18 March 2015, was held in the shadow of the UK's general election on 7 May 2015. With the backdrop of the UK's GDP growth increasing, continued low interest rates, rising employment and a reducing national debt, this was never going to be a Budget for surprise announcements. This was a consolidating budget – a "game closer", not a "game changer" as one newspaper reported.

In this context, the key taxation measures were similarly conservative. Unsurprisingly, the usual targets for this Government were firmly addressed: aggressive and artificial tax avoidance, the UK banking sector, contrived cross-border arrangements. But there were no announcements of dramatic changes, no truly innovative measures revealed. It was a steady, predictable and measured (if not always proportionate) Budget as far as taxation developments were concerned.

Indeed, one of the few remarkable points of the Budget was the announcement that the Finance Bill 2015 will be introduced to Parliament on 24 March, debated on 25 March and enacted on 26 March 2015. No matter how measured the proposed legislation might be, such a truncated timetable for important legislation to be enacted gives cause for some concern.

In this Client & Friends Memo 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. These developments are briefly addressed in our "speed read" section which summarises the key points, each of which is expanded in the lengthier commentaries which follow.

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Selected Speed Read

Tax Avoidance: new rules focused on preventing "refreshment" of historic tax losses. Announcement of provisions to be introduced in future Finance Bills to combat and deter "serial" tax avoiders.

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VAT: supplies made to foreign branches will no longer be taken into account when determining the proportion of VAT on incurred on overhead costs which can be deducted for UK VAT purposes.

Diverted profits tax: confirmation that the controversial new "diverted profits tax", announced in December 2014, would be included in Finance Bill 2015.

Entrepreneurs' Relief: restrictions on the availability of Entrepreneurs' Relief in respect of: (a) gains on disposals of privately held assets used in a business; and (b) disposals of shares in a company that is not trading in its own right.

Bank Levy: increase in the Bank Levy rate to 0.21% and the half rate to 0.105% from 1 April 2015.

Tax Administration: New Regulations proposed to implement the UK Government's commitment to automatic exchange of information with counterparty jurisdictions under the Common Reporting Standard.

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Corporation Tax – loss refresh prevention

New provisions will be introduced to counter certain "contrived" tax-focused arrangements under which companies seek to "refresh" brought forward tax losses and reliefs by converting those losses into more versatile current year tax deductions. The arrangements targeted by H.M. Revenue & Customs ("**HMRC**") are those where a group company enters into arrangements, often with other group members, to enable brought forward losses and reliefs to be utilised in an "artificial" manner. This may involve creating taxable profits (which can be eliminated by the accumulated tax losses) or manufacturing in-year tax deductible amounts which can be offset against other profits in the company or in group companies.

The new rule applies to trading losses, non-trading loan relationship deficits and management expenses, and will affect companies within the charge to UK corporation tax which have entered into certain arrangements and met certain conditions. These include where:

- a company has profits as a consequence of arrangements against which it can offset accumulated tax losses;
- new tax deductible amounts arise in the company or a connected company as a result of the arrangements;
- the main purpose, or one of the main purposes, of the arrangements is to secure a corporation tax advantage involving the additional profits, the offset of the brought forward relief against those profits and the new tax deductions; and

- where, at the time that the arrangements in question were entered into, it would have been reasonable to assume that the resulting tax benefits of the arrangements (to the company and its connected companies taken together) would be greater in value than any other economic benefits of the arrangements.

The new provisions have effect from 18 March 2015. Where applicable, the new rules prevent the offset of accumulated tax losses against profits arising on or after that date, even where the relevant arrangements were entered into before that date. The new rules will not affect banks and building societies, which are subject to separate and prioritised targeted anti-avoidance rules regarding loss utilisation in section 269CK of Corporation Tax Act 2010.

A technical note published by HMRC on 18 March 2015 outlines that the new provisions are targeted at "contrived" and "artificial" arrangements. Arrangements whereby companies access historic losses through "shifting profits around the group, or changing the timing of receipts" should not be adversely affected, according to HMRC.

However, HMRC's technical note sets out a number of examples which involve activities which many UK groups might previously have contemplated were acceptable treasury and tax management operations. The distinction drawn in the proposed legislation, and the HMRC technical note, between acceptable and unacceptable tax planning in this area will focus on whether the anticipated tax advantage is greater than the anticipated value of any other economic benefits of the arrangements in question. Where treasury tax management plays a key part in a group's loss utilisation strategy, drawing this distinction will be both critical, and potentially challenging.

As the rules focus on the utilisation of carried forward losses, rather than the circumstances and transactions under which such losses arose, it is possible that tax relief for genuine historic commercial losses might be effectively prevented owing to the means by which a group seeks to utilise such losses. Considerable care will need to be taken in many group reorganisations, joint venture transactions and distressed restructurings, where planning regarding historic loss utilisation forms a key part of commercial negotiations. Safely navigating through the new legislation, and determining whether the "main purpose" and "economic benefits" safe harbours are available, will inevitably add complexity to already challenging transactions. Legal documentation is unlikely to become any simpler or shorter as a result of these new provisions. Drafting relating to the utilisation, or unavailability, of historic tax losses in company sale transactions tax indemnities is likely to be looked at very closely once these provisions are enacted.

Combating Tax Avoidance

Being seen to be effectively combating tax avoidance is a key aim of the current Government. Further announcements were made in the Budget to reinforce the Government's credentials in this area. The two main measures originate from the "*Strengthening Sanctions for Tax Avoidance*" document published in January 2015. Legislation will be proposed in a later

Finance Bill (not the March 2015 Finance Bill, but possibly a second post-election Finance Bill in the Autumn of 2015) to introduce tougher measures for "serial avoiders".

The "serial avoiders" measure is focused on taxpayers who persistently enter into tax avoidance schemes which fail. Sanctions will include surcharges on inaccurate tax returns filed by serial avoiders, and a special reporting requirement. The Government has also proposed to name and identify serial avoiders, a measure which raises considerable issues from the perspectives of social justice, equality and human rights. Coupled with new legislation for Accelerated Payments Notices in Finance Bill 2014, the proposed measures relating to serial avoiders is clearly intended to make aggressive personal tax avoidance unpalatable for all but extraordinarily confident, or poorly advised, taxpayers.

A further proposal involves increasing the deterrent effect of the UK's General Anti-Abuse Rule ("**GAAR**") through the introduction of a specific, tax-geared penalty. This is surprising, given that no cases concerning the GAAR have yet progressed through the tax tribunals or the courts.

VAT deductions relating to foreign branches:
Where a business makes supplies that are exempt for VAT purposes, the business cannot deduct VAT incurred on costs related to the provision of these exempt supplies. Businesses which make supplies that are both exempt for VAT purposes and taxable for VAT purposes (for example, financial institutions such as banks and insurers making supplies both within and outside the UK) are required to determine what proportion of VAT of the business's costs are deductible by using the "partial exemption method".

Under existing UK tax law, businesses making both exempt and taxable supplies for VAT purposes with a foreign branch (in relation to which, supplies to that foreign branch would be taxable for VAT and thus any inputs would be proportionately deductible) could allocate a disproportionate amount of expenses to the foreign branch with the effect of deducting a greater proportion of VAT inputs than would otherwise be allowed.

The Court of Justice of the European Union in *Le Crédit Lyonnais* (C-388/11) held that under the EU VAT Directive (Council Directive 2006/112/EC) ("**EU VAT Directive**") revenue generated by foreign branches could not be taken into consideration when determining the extent to which input VAT would be deductible under the partial exemption method.

In order to ensure that the UK's VAT laws are consistent with the EU Vat Directive, the Government has announced that changes will be made to prevent supplies made by foreign branches from being taken into account for the purposes of the partial exemption for UK tax law, irrespective of any special methods agreed with HMRC.

For most business, this change is proposed to take effect from 1 August 2015. This change will be effected by amendments will be made to the VAT Regulations 1995 (SI 1995/2518).

Diverted profits tax

One of the most eye-catching announcements of the Autumn Statement was the Government's proposals to legislate for a new "diverted profits tax". To be introduced from 1 April 2015, diverted profits tax ("**DPT**") applies where a foreign company has artificially avoided having a taxable presence in the UK or where a UK company (or a UK permanent establishment of a non-resident) has entered into arrangements with a low-taxed entity that lack economic substance.

The Government has announced very little in the Budget regarding DPT, except that the enabling legislation for the new tax will be included in Finance Bill 2015, to be accompanied by further HMRC guidance at a later date. Somewhat vaguely, the Government has stated that certain changes have been made to the draft legislation published at the time of the Autumn Statement, including "clarifications" around DPT tax credits and the operation of the conditions under which a charge can arise.

The breadth of arrangements which could be encompassed by DPT remains uncertain, as does the future status of the tax given the legislative changes which might be generated by the OECD's "base erosion and profit shifting" project. The very limited time allowed for parliamentary discussion of the Finance Bill is unlikely to permit in-depth discussion of the scope of the DPT legislation. Considerable attention will therefore be directed to the HMRC guidance in assisting interpretation of how the new tax is intended to operate.

Entrepreneurs' Relief and associated disposals:

Where the various conditions to the application of the Entrepreneurs' Relief rules are met, the rate of capital gains tax applicable to a disposal of certain assets can be reduced to 10%. Accordingly, for taxpayers ordinarily paying capital gains tax in respect of gains on disposals at 18%, or more likely 28%, Entrepreneurs' Relief can be an extremely valuable tax relief.

Entrepreneurs' Relief does not usually apply to gains on the disposal of assets used in a company's or a partnership's business but owned privately by a shareholder or partner. However, the "associated disposal" rules allow Entrepreneurs' Relief on these personal assets when the disposal is associated with a partial or full withdrawal from the business or company. Prior to the announcements made in Budget 2015, there were no minimum requirements as to the size of this withdrawal.

HMRC has become aware of transactions being entered into by individuals and members of partnerships seeking to take advantage of the Entrepreneurs' Relief rules in relation to the disposal of personal assets used in a business but where no significant disposal of the holding of shares in the company carrying on the business or of a significant share in the assets of the partnership carrying on the business would take place at the same time.

As such, Entrepreneurs' Relief will no longer be available unless the personal assets are disposed of in connection with a disposal of at least a 5% shareholding in the company, or a 5% share in the partnership assets. This change is proposed to take effect in respect of gains

on disposals of personal assets used in a business carried on by a company or a partnership on and after 18 March 2015 (i.e. with immediate effect).

Entrepreneurs' Relief, joint ventures and partnerships:

Also with immediate effect, the Government will deny Entrepreneurs' Relief on a disposal of shares in a company that is not a trading company in its own right. It is the Government's policy intention that in order to benefit from Entrepreneurs' Relief, individuals must have a significant stake in a genuine trading business. Structures have been designed so as to enable individuals with only a small indirect stake in a trading entity to benefit from Entrepreneurs' Relief through the use of companies invested in trading joint ventures or as members of a trading partnership.

Currently, in order for gains realised on the disposal of shares to qualify for Entrepreneurs' Relief, such shares must be in a "trading company or the holding company of a trading group". Legislation will be included in Finance Bill 2015 to amend the Taxation of Chargeable Gains Act 1992 so that the definitions of "trading company" and "the holding company of a trading group" do not take into account of activities carried on by joint venture companies in which a company is invested in or partnerships of which a company is a member.

This will ensure that Entrepreneurs' Relief only benefits those individuals who have a 5% directly-held shareholding in a genuine trading company.

Bank Levy rate change

Yet another increase was announced in the rate of the UK bank levy, the eighth since the introduction of the levy in 2011. The increase announced in the Budget, to 0.21% from 1 April 2015 (with a proportionate increase in the half-rate that applies to long term liabilities, to 0.105%), confirms the Government's political determination that "the banking sector should make a contribution which reflects the risk they pose to the financial sector and the wider economy".

The increased Bank Levy rates will apply from 1 April 2015. At a time when UK banks and banks operating through a branch in the UK are strengthening their balance sheets and raising capital levels, the burden of an increase in the rate of bank levy (charged by reference to the size of banks' balance sheets) is unlikely to materially assist in boosting liquidity and bank lending.

Tax Administration and Compliance

New Regulations will be introduced to implement the UK Government's commitment to automatic exchange of information with counterparty jurisdictions under the global standard on automatic exchange of financial account information, known as the Common Reporting Standard ("**CRS**").

The Government's commitment originates from the UK's obligations under the EU Revised Directive on Administrative Cooperation (EU Council Directive 2014/107/EU) and the UK's obligations under additional Competent Authority Agreements with non-EU jurisdictions.

The new Regulations will create various obligations for financial institutions including identification of account holders resident in certain jurisdictions and the requirement to report account and financial information on such account holders to HMRC annually.

The Regulations will include certain requirements that financial institutions notify account holders of CRS obligations and penalties as well as new disclosure procedures.

The Regulations will have effect from 1 January 2016. The Government estimates that £560 million will be raised over the next five years as a result of the "positive impact on the efficiency of the tax system through the recovery of evaded UK tax". Part of that increased efficiency will constitute an updating of current implementing regulations covering US FATCA, and consolidating requirements for automatic exchange of information in one place. The combination and alignment of US FATCA and CRS reporting requirements in the new regulations, thereby making compliance easier by UK financial institutions, will be a welcome result of the Government initiatives in this area.

In light of these developments, the Liechtenstein Disclosure Facility and the Crown Dependencies Disclosure Facilities will close at the end of 2015 (instead of April 2016 and September 2016, respectively). In addition, the Government has announced a new disclosure facility in advance of the receipt of data in 2017 under the CRS. The new disclosure facility will operate from 2016 to mid-2017 (i.e. before the government receives offshore bank data in 2017) albeit on less generous terms than the existing disclosure facilities, including penalties of at least 30% and no guarantee around criminal investigations.

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