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UK Summer Budget 2015 – Key Tax Measures

9 July 2015

The Chancellor of the Exchequer's first Budget of the new Parliament, delivered on 8 July 2015, will be remembered as a reforming Conservative budget, including significant changes to the United Kingdom's welfare provisions such as limiting the availability of personal working tax credits and introducing the new National Living Wage. The bulk of the funds made available by the Chancellor for tax cuts and giveaways will come through targeted measures, including additional taxation on high-earners receiving dividend income above £5,000, changes to insurance premium tax and an acceleration of the date of payment of corporation tax for large companies.

In this Client and Friends Alert 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

Corporation Tax: Reduction in the main rate of United Kingdom ("**UK**") corporation tax from 20% in the financial year beginning 1 April 2016 to 19% for the financial year beginning 1 April 2017, with a further reduction to 18% in the financial year beginning 1 April 2020.

Banking Taxation: New corporation tax surcharge levied on the profits of UK banking companies, and a significant reduction in the rate of the existing UK bank levy.

Loan Relationships and Derivative Contracts: Various new legislative provisions, including the introduction of an important new corporate rescue exemption which will facilitate the debt restructuring of companies in genuine financial distress.

Taxation of Performance-Linked Rewards Paid to Asset Managers: Provisions to ensure that the capital gains tax treatment of the performance element of a fund manager's reward (including "carried interest") is taxed at the full rate of capital gains tax. Consultation announced on other tax measures relating to asset manager's performance-linked rewards.

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Tax Avoidance: Various measures including new legislation concerning the use of losses against a controlled foreign company charge and attaching a penalty for falling within the scope of the general anti-abuse rules. Changes announced to the UK regime for non-UK domiciliaries, including a new "deemed domicile" rule for individuals resident in the UK for 15 out of the previous 20 years.

Tax Administration: Additional measures concerning the automatic exchange of information under the Common Reporting Standard.

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Corporation Tax

One major announcement in the Summer Budget was the planned reduction in the main rate of UK corporation tax from 20% in the financial year beginning 1 April 2016 to 19% for the financial year beginning 1 April 2017, with a further reduction to 18% in the financial year beginning 1 April 2020. The UK main corporation tax rate would therefore (on current rates) be the lowest within the G20, and sends a strong signal to potential inbound investment that the UK couples an attractive tax regime with legal and political stability.

Loan Relationships and Derivative Contracts

A number of technical measures have been announced involving the taxation of loan relationships and derivative contracts. These measures follow directly from the lengthy and productive public consultation by H.M. Revenue & Customs ("HMRC") on the loan relationships and derivatives regimes, which has involved businesses and professional services firms including Cadwalader. The main changes proposed in the second Finance Bill of 2015 can briefly be summarised as follows:

- Various amendments regarding the recognition of taxable amounts arising from loans and derivatives, including changes to ensure that taxation will be based on amounts recognised as items of accounting profit or loss, rather than on amounts recognised anywhere in the accounts (such as in reserves or equity).
- A new corporate rescue exemption to exclude from taxation amounts which would otherwise be taxed where arrangements are made to restructure the debts of companies in genuine financial distress with a view to ensuring continued solvency. The exemption will cover circumstances where debt is released, or where the terms of debt are modified, supplementing the existing tax rules which exclude credits arising in debtor companies when creditors effect a debt-for-equity swap. The new corporate rescue exemption, to be contained in a new section 323A of Corporation Tax 2009, will come into force for releases and modifications of debt on or after Royal Assent of the second Finance Bill of 2015 (expected to be in September 2015). The measure is a valuable addition in facilitating the corporate restructuring of United Kingdom companies and is to be warmly welcomed.

- A targeted anti-avoidance rule to be included in both the loan relationships and derivatives regimes, to counteract arrangements entered into with a main purpose of obtaining a tax advantage.

Banking and Finance

The Summer Budget included a number of important provisions regarding the UK's banking and financial services sector. From 1 January 2016, a corporation tax surcharge will be levied on the profits of UK banking companies. The surcharge has been set at 8% on the profits of banking companies, and will operate alongside the existing UK bank levy (which operates as a charge on bank balance sheets as opposed to bank profits). The Government has stated that this new measure "is not expected to have any significant long-term macro-economic impact"; the revenues to be raised by the corporation tax surcharge are intended to replace reduced bank levy revenues in the period to 2021 (as discussed in the following paragraph). The proposed corporation tax surcharge legislation will include measures for internal bank group transfer pricing, provisions applying different rates to banking and non-banking companies and rules governing the interaction between the surcharge and other bank taxation legislation (such as the loss carry-forward reduction rules in Finance Act 2015). There is no indication of whether the surcharge is only a temporary, or a permanent, measure.

In tandem with the new corporation tax surcharge, the UK bank levy will decrease from 0.21% to 0.18% from 1 January 2016 for short-term chargeable liabilities and will continue to decrease each calendar year thereafter until 2021, when the bank levy will only apply to UK banking operations. Large banks, subject to the bank levy, are likely to welcome the predictability which should come with the rate of the bank levy being set for the term of this Parliament. Previous Government policy appeared at times to be to set the bank levy rate in tandem with the degree to which public hostility towards the United Kingdom banking sector was evident through the media (and presumably opinion polls).

The UK banking sector is understood to have favoured the reform of the bank levy, which was a tax on the size of bank balance sheets as opposed to banking profits. With banks' balance sheets being reduced, and fewer liabilities resulting in higher banking profits, the Government's introduction of the corporation tax surcharge for banks is unsurprising.

However, from a tax policy perspective it is at least slightly concerning that barely five years after the introduction of the bank levy (which, as mentioned above, has been subject to nine amendments to the prevailing levy rates during those years), it is now being materially reduced, almost to the point of being phased out. The Government's claim that the new corporation tax surcharge on banks is required because "it is now appropriate to reform how banks are taxed" rings a little hollow at a time when at least one major investment bank has publicly stated its intention to review its current domiciliation in the United Kingdom. Whether the reduction of the bank levy will assist with preventing significant bank redomiciliation from the UK remains to be seen.

Away from the UK's banking sector, the increasing size of the UK's alternative finance industry has been one of the financial success stories of recent years. Following a public consultation last year, the Government has announced that peer-to-peer loans will be included in the list of qualifying investments which are eligible for an Individual Savings Account ("**ISA**"). A separate third category of ISA, an "Innovative Finance ISA", will accommodate peer-to-peer loans. Draft legislation will be published later in 2015 for technical consultation with a view to introducing enabling legislation to permit peer-to-peer loans to be held in an ISA from 6 April 2016. A separate consultation has been launched on whether to include debt securities and equity offered via a crowd-funding platform as an ISA qualifying investment. These measures will be welcomed by the United Kingdom's rapidly expanding alternative finance sector.

Controlled Foreign Corporations

Following the Budget 2015 changes in relation to the use of various losses (for example, restrictions on "loss refreshment" arrangements), Summer Budget 2015 has identified further instances of corporation tax losses being used in a manner contrary to the Government's tax policies.

With immediate effect, the Summer Budget announced that UK companies will not be able to offset UK losses and surplus expenses against any Controlled Foreign Corporation ("**CFC**") charge to which that UK company may be liable. The off-setting of carried-forward losses against profits apportioned under the CFC rules will also be similarly restricted.

By restricting the availability of UK losses and surplus expenses to be offset against any CFC charge, this measure will increase the deterrent effect of the CFC regime by ensuring that any CFC charge is more fully borne by UK companies.

The relevant amending legislation will provide for an apportionment of profits in respect of the periods before and after 8 July 2015 so that UK losses and expenses can still be offset against CFC profits (and related CFC charges) arising before 8 July 2015.

Taxation of Performance-Linked Rewards Paid to Asset Managers

For a number of years, HMRC have expressed concern with certain arrangements entered into by asset managers of private equity and other funds regarding both annual fees and performance-linked rewards. Section 21 of the Finance Act 2015 introduced measures earlier this year providing for the income tax treatment of sums that asset managers receive for their investment management services through partnerships or other tax transparent vehicles. The measures were focused on preventing managers converting trading income into capital receipts (which would be taxed at a lower rate). The new disguised management fee rules in the Finance Act 2015 applied to fees arising to an individual from an investment trust or a collective investment scheme, such fees being channelled through a partnership or other transparent vehicle.

In the Summer Budget, HMRC have announced additional provisions to ensure that the capital gains tax treatment of the performance element of a fund manager's reward (including "carried

interest") is taxed at the full rate of capital gains tax, and not at a reduced effective rate (as is sometimes possible through certain tax mitigation techniques, which the Government views as being "aggressive tax planning"). Changes to be made in the second Finance Bill of 2015 will include provisions to ensure that capital gains tax deductions will only be permitted in respect of sums actually paid (if any) by individual managers as consideration for acquiring the right to the carried interest. The amount of consideration which an individual manager would be deemed to have provided pursuant to the long-standing HMRC Statement of Practice D12 (under the so-called "base cost shift rules) will no longer form the basis of a deduction against the taxable sum received by the manager for the carried interest. The intention of the Government is stated as being "to ensure that individuals are charged to tax on their true economic profit". No grandfathering provisions have been announced in tandem with this legislative change. The announcement, and the absence of grandfathering provisions, indicate that the Government has the asset management and private equity sector under the spotlight. As with the "loss refreshment" legislation announced in the March 2015 Budget, the tax planning being counteracted with the changes to the taxation of performance-linked rewards is long-standing and commonplace. Indeed, the tax planning now being counteracted by the Government would not be prevented by the UK's general anti-abuse rule.

Furthermore, the Government has announced a public consultation regarding the tax rules applicable to investment managers based in the United Kingdom, focusing on the taxation of performance-linked rewards (including carried interest) under the United Kingdom's capital gains tax regime. The Government has, however, announced that carried interest historically taxed as a capital gain should continue to be taxed as a capital gain and not income, a confirmation which will be welcomed with significant relief by UK asset managers.

The consultation is likely to be keenly monitored by the UK's asset management sector, not least owing to the political sensitivities which are present concerning the taxation of carried interest and the taxation of the asset management sector generally.

Goodwill Amortisation

The Summer Budget also announced the removal of corporation tax relief for companies who write off the cost of purchased goodwill and certain customer related intangible assets. This will impact upon acquisitions structured as a business and asset purchase (rather than a share purchase, where such relief is generally unavailable).

This change will take effect in relation to accounting periods beginning on or after 8 July 2015 (i.e. immediately) but will not apply in respect of acquisitions made before 8 July 2015.

Tax Avoidance and Tax Evasion

The Government has announced a number of anti-avoidance measures in the Summer Budget, including a consultation on introducing a penalty for falling within the scope of the UK general anti-abuse rule. Legislation to implement any GAAR penalty would be enacted in Finance Bill 2016.

However, the number of tax avoidance schemes and arrangements being counteracted in the Summer budget is far fewer than in previous years. It is likely that this is a direct result of the disclosure of numerous (frequently ineffective) avoidance schemes through the Disclosure of Tax Avoidance Schemes legislation introduced in the Finance Act 2004. Instead, the Government has concentrated in the Summer Budget more towards operational initiatives, instead of legislative changes. Foremost among the operational changes is the provision to HMRC of an £800 million package to counteract tax avoidance and tax evasion, tripling the number of serious and complex criminal investigations into tax fraud and to widen the net of HMRC investigations to encompass a greater number of high-net-worth individuals.

In addition and further to the announcements in Budget 2015 concerning the implementation of the UK Government's obligations in relation to the automatic exchange of information under the Common Reporting Standard ("**CRS**"), the Summer Budget announced further measures by which financial intermediaries, tax advisors and other professionals may be required to notify UK resident customers and clients that:

(i) the UK will begin to receive information about offshore (non-UK) accounts and share information about UK accounts from 2017;

(ii) there will be a time-limited disclosure facility in early 2016 to enable non-compliant taxpayers to correct their tax affairs prior to HMRC receiving information under the CRS; and

(iii) HMRC may seek to enforce against non-compliant taxpayers through the existing offshore penalty regime, the civil penalties provisions and the new criminal offence for failing to declare taxable offshore income and gains.

Non-Domiciled Individuals

The Summer Budget also set out the Government's intentions to consult on changes to the non-UK domiciliary ("**non-dom**") rules. The proposed changes will affect the extent to which an individual is subject to UK income tax as non-doms are subject to tax on the "remittance basis" (i.e. on income remitted to the UK) whereas a UK resident individual is subject to tax on their worldwide income and gains.

The Government is proposing to make the following two changes to the non-dom rules:

(i) a "deemed domicile" rule for long-term resident non-doms (the "15 year rule"); and

(ii) a "returning UK dom" rule.

The 15 year rule would deem an individual who has been UK resident for more than 15 of the past 20 years but who is foreign domiciled to be deemed to be UK-domiciled for UK tax purposes. The "returning UK dom" rule would make it harder for an individual to claim non-dom

status where such an individual was UK-domiciled at birth but subsequently obtained a domicile of choice in another country, but then returns to the UK.

These changes are intended to be introduced in Finance Bill 2016 and to take effect from 6 April 2017. The Government has also announced plans to consult on changes to the inheritance taxation rules on UK residential property held indirectly by non-doms or by excluded property trusts.

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Adam Blakemore
Partner, Cadwalader, Wickersham & Taft LLP
T. +44 (0) 20 7170 8697
adam.blakemore@cwt.com

Catherine Richardson
Associate, Cadwalader, Wickersham & Taft LLP
T. +44 (0) 20 7170 8677
catherine.richardson@cwt.com

Michelle Chan
Trainee Solicitor, Cadwalader, Wickersham & Taft LLP
T. +44 (0) 20 7170 8515
michelle.chan@cwt.com