

# Clients & Friends Memo

## UK Budget 2018 – Key Tax Measures

30 October 2018

*The Chancellor of the Exchequer delivered the United Kingdom (“UK”) Budget for 2018 on 29 October 2018. The Budget was delivered against the backdrop of the UK’s negotiations with the European Union concerning Brexit. Perhaps unsurprisingly in such an environment there were few eye-catching announcements, with the approach of the Government being to send a consistent message of the UK being a top-tier jurisdiction in which investment can be made effectively and business activities undertaken with a competitive tax regime. Alongside this approach, however, a number of measures in the Budget focus on counteracting the mitigation of taxation by structural fragmentation – including profit diversion, utilisation of low tax jurisdictions to split supply-and-service chains and business fragmentation to avoid permanent establishment identification. The sophistication and complexity of these anti-avoidance measures is a counterweight against the more outward-facing message of the Government that the UK is “open for business”.*

*In this Client and Friends Alert we have outlined the key tax measures that we expect to be of interest to Cadwalader’s clients and friends.*

### **Corporation tax rate**

Media speculation and rumors prior to the Budget, fueled by an uncertain situation regarding Brexit negotiations, that the current UK corporation tax rate might be frozen at 19 per cent. proved to be unfounded. The UK corporation tax rate is therefore scheduled to fall to 17 per cent. on 1 April 2020, as previously announced in 2016.

### **Corporation Tax: changes to the definition of permanent establishment**

Changes have been announced to the definition of a permanent establishment to prevent groups artificially fragmenting their business to avoid creating a permanent establishment.

Mechanically, the changes will be introduced by amending section 1143 of the Corporation Tax Act 2010, thereby denying the exemption from a permanent establishment in the UK if the UK activities are part of a fragmented business operation. A number of examples are provided by HM Revenue & Customs (“**HMRC**”) of how this provision might operate in practice. These include (a) where the company (alone or with related entities, whether in the UK or otherwise) carries on a cohesive business operation, either at the same place or at different places in the

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UK; (b) where at least one of those entities has a permanent establishment that engages in complimentary functions; and (c) where the activities, taken together, would create a permanent establishment if the entities were a single company. Thematically, HMRC therefore appears to be keen to target situations where low-value activities have been carried out in different companies or different locations such that the activity does not rise above the threshold needed to create a permanent establishment in the UK.

This amendment is specifically identified as containing some of the changes that can be made by a country in its double-tax treaties through the ratification of the BEPS multilateral instrument (“MLI”), which entered into force in the UK on 1 October 2018. The Budget announcement reflects the MLI and enables the consequent amendment to tax treaties to become effective on 1 January 2019.

#### **Taxing income from intangible assets received overseas in low tax jurisdictions**

On 1 December 2017, the government issued a public consultation paper on its proposal to extend UK withholding tax to royalties (and certain other payments for the use or exploitation of rights over intellectual property and other intangible assets) paid by non-UK residents who make sales in the UK without having a taxable presence (such as a permanent establishment) in the UK.

The Chancellor has now proposed that, instead of imposing UK withholding tax on such payments, the recipient of the payments will be directly subject to UK tax on the income that is “referable” to the sale of goods or services in the UK. The measure announced will include in its scope embedded royalties and income from the indirect exploitation of intangible property in the UK through third parties.

The provisions target multinational groups which generate significant income from intangible property through UK sales, and have made arrangements which ensure that income is received in offshore tax jurisdictions where tax is borne at no- or low-effective tax rates. The measures will generally apply to entities resident in jurisdictions which either do not have a tax treaty with the UK, or which have one that does not include a non-discrimination provision. Unusually (but commensurate with an anti-avoidance provision), the income-tax charge will be on the gross amount of the payments, rather than on profit after the deduction of expenses. The Government has proposed a number of exemptions from this taxing measure, including an exemption for income that is subject to overseas tax at a rate of at least 50 per cent. of the UK tax that would be payable otherwise (but for the avoidance arrangement), and a £10 million *de minimis* UK sales threshold. Again, these exemptions reflect the targeted nature of the measure, namely large multinational groups that hold intangible property in low-tax jurisdictions.

Importantly, any unpaid UK income tax assessed on a non-resident entity can be recovered from connected parties, who will be jointly and severally liable in the event of any failure to pay tax by a non-UK resident entity.

The Government has proposed that the measure will take effect on 6 April 2019. A targeted anti-abuse rule will apply from 29 October 2018 to counteract forestalling arrangements and measures such as transferring ownership of intangible property to a company resident in a jurisdiction that has a suitable double-tax treaty including a non-discrimination article.

The measure is ambitious. It has the capacity to significantly increase the scope of UK taxation, albeit in a manner targeting the use of no- and low-effective tax rate jurisdictions to minimise multinational companies' worldwide group effective tax rates. Significant evidential issues will likely arise regarding which income is "referable" to the sale of goods and services in the UK.

#### **Diverted Profits Tax ("DPT")**

A number of amendments have been announced to the DPT regime introduced in 2015 to counteract certain artificial arrangements that result in the diversion of profits from UK taxation and the erosion of the UK tax base. The changes announced will take effect on 29 October 2018.

The changes extend the "review period" during which HMRC and taxpayers are encouraged to work together to determine the amount of any "diverted profits" going back from 12 months to 15 months, and clarify that profits liable to DPT can be reduced by amending the tax return during the first 12 months of the review period.

The Government's announcement also closes a loophole that allowed companies to make changes to the corporation tax return after the DPT review period ended and the DPT time limits expired. Legislation also will make clear that diverted profits will either be subject to DPT or corporation tax, but not both.

#### **Digital Services Tax**

As anticipated, the Chancellor has announced the introduction of a Digital Services Tax ("**DST**") that will take effect in April 2020. The tax will be charged at a rate of 2 per cent. on revenues exceeding £25 million that are derived by social media platforms, online marketplaces and search engines from providing certain services that are "linked" to UK users. DST will not be a tax on the online sales of goods, nor will it be a generalized tax on online advertising or the collection of data.

DST will apply only to businesses that are profitable and that generate more than £500 million a year in global revenue from these activities. This is similar to the European Commission's proposed digital services tax proposals, which only apply to businesses whose turnover exceeds both worldwide and European Union thresholds. As the tax will apply only to income generated from UK users in excess of £25 million, the Government clearly intends that only larger amounts of revenue generated from UK users will be subject to DST.

The DST legislation will include provisions that reduce the effective rate of tax on businesses with very low profit margins, thereby creating an effective alternative minimum tax – and potentially addressing concerns about using an excise tax to act as a proxy for tax on profits.

Although DST will be an allowable expense for UK corporate tax purposes (but based on normal corporation tax principles of deductibility), it will not be creditable against corporation tax.

The UK Government has made clear its preference for a global tax framework relating to digital services. This has proven challenging to coordinate, with a number of legislative initiatives being followed at the same time by the OECD, European Union, the UK and other national governments. Owing to lack of current consensus, the UK Government intends to introduce DST unilaterally as an interim measure, with the intention that DST will cease to apply when a comprehensive global solution is in place. The government will issue a consultation on the detailed design of DST rules and intends to legislate in Finance Bill 2019-20.

#### **Amendment of interest deductibility restriction rules**

The Government has announced that Finance Bill 2019 will contain provisions amending the corporate interest deductibility restriction rules to ensure that they operate "as intended". The Government stated in the Budget that the draft legislation published on 6 July 2018 has been revised but, unfortunately, it did not specify the nature of these revisions.

The government has also confirmed that the Finance Bill 2019 will include provisions amending the interest deductibility restriction rules to accommodate the introduction of IFRS 16 (Leases). Draft legislation published on 6 July 2018 has been revised to include a number of "minor changes" to the rules for structured-finance arrangements, writing down allowances for finance lessors and the treatment of long funding leases on adoption of IFRS 16. Details are, however, currently absent of the changes being proposed.

#### **Hybrid capital instruments**

The government has proposed changes to the tax legislation concerning hybrid capital instruments. At present, the Taxation of Regulatory Securities Regulations 2013 (SI 2013/3209) provide that interest under particular "hybrid" instruments with certain equity-like features are deductible in the same manner as interest costs (rather than being non-deductible in the manner of a distribution on equity). Recent finalisation of rules on loss-absorbency requirements for banks, building societies and investment firms by the Bank of England in June 2018 could potentially result in those financial-sector entities issuing hybrid securities which are not covered by the Taxation of Regulatory Securities Regulations 2013.

The Government is therefore intending to legislate regarding the tax treatment of instruments within this wider category of hybrids, and is seeking to replace the Taxation of Regulatory Securities Regulations 2013 with a new set of Regulations covering the wider set of hybrid capital instruments which can now be created. The Government has published a technical note providing guidance on the proposed changes, and the new legislation is intended to take effect for accounting periods beginning on or after 1 January 2019.

**UK property interests of non-UK residents**

Following previously announced measures, which have been the subject of consultation processes, the Budget confirmed three particular changes relating to the taxation of UK property for non-UK residents.

First, and further to draft legislation published in July 2018, non-UK resident companies carrying on a UK property business will be taxed under the UK corporation tax provisions rather than the UK income tax provisions. This measure is aimed at ensuring consistent tax treatment of UK property businesses whether carried by a UK resident company or a non-UK resident company. The differing tax treatment otherwise permitted those carrying on a UK property business to use non-UK resident companies to minimise UK tax liabilities. Various transitional provisions have been reflected in the draft legislation to facilitate the move out of the income tax regime and into the corporation tax regime (excluding such profits from the scope of income tax so as to avoid double-taxation, not creating a disposal event for capital-allowances purposes and allowing the carry forward of income-tax losses against relevant profits chargeable to corporation tax). These measures will be aligned with the end of the income-tax year on 5 April 2020 and thus take effect from 6 April 2020.

Second, gains on disposals of interests in non-residential UK property by non-UK residents are proposed to be brought within the scope of UK tax. Gains by diversely held companies on disposals of interests in UK residential property and gains by non-UK residents on interests in UK property-rich entities are also proposed to be brought within the scope of UK tax. These measures are also aimed at ensuring a consistent tax treatment between UK residents and non-residents in respect of UK immovable property.

These measures will take effect for disposals made on or after 6 April 2019 but subject to anti-forestalling rules applying to arrangements entered into on or after 22 November 2018 and a new targeted anti-avoidance rule applying to arrangements entered into on or after 6 July 2018.

In addition, the Government intends to consult on proposals for a stamp-duty land-tax surcharge of 1% for non-residents buying residential property in England and Northern Ireland.

**EU Anti-Tax Avoidance Directive**

Changes to both the UK controlled foreign companies (“CFC”) rules and the UK hybrid and other mismatch rules have been made to ensure compliance with the EU Anti-Tax Avoidance Directive (“ATAD”).

In relation to the changes to the CFC rules, amendments to the definition of control and the treatment of certain profits generated by UK activity. These amendments are proposed to take effect from 1 January 2019.

For the purposes of the UK hybrid rules, permanent establishments that had previously been disregarded (as a result of being recognised in the jurisdiction where the company is resident but not recognised in the jurisdiction of the permanent establishment) will be brought within the

scope of the UK's hybrid rules so as to reflect the position under ATAD. Additional changes to enable regulations providing for a revised definition of regulatory capital that is ATAD compliant are also proposed. These amendments are proposed to take effect from 1 January 2020.

#### **VAT reverse charge anti-avoidance amendments**

Certain VAT anti-avoidance provisions have been found to have unintended consequences for small businesses otherwise trading below the VAT registration threshold. Under current VAT legislation, a recipient of any supplies within the scope of a VAT reverse charge must aggregate those supplies with the value of their own supplies for the purposes of assessing an obligation to be VAT registered. The changes, first announced as part of the Budget, will allow this requirement to be set aside in certain circumstances, which will be prescribed in regulations.

#### **Stamp-duty and stamp-duty reserve tax ("SDRT"): transfers of listed securities and connected persons**

The government has announced that it will consult on aligning the rules for treating transfer-and-sale consideration for stamp-duty and SDRT. The proposals to be addressed in the consultation include introducing a general "market value" rule for transfers between connected persons. The proposed consultation is to be published on 7 November 2018.

To prevent avoidance in advance of any new legislation following the consultation, the government has published draft legislation introducing a targeted "market value" rule, applying if listed securities are transferred to a connected company and if stamp-taxes group relief is unavailable. "Listed securities" are stock or marketable securities regularly traded on a regulated market, a multilateral trading facility or a recognised foreign exchange, while the definition of "connection" has the meaning set out in section 1122 of the Corporation Tax Act 2010.

There are separate provisions for stamp-duty and SDRT. Where, for stamp-duty purposes, the consideration for a transfer consists of money, stock or security, or the release, assumption or satisfaction of debt, the stampable consideration is deemed to be the higher of that consideration and the value of the transferred listed securities (being the price that they might reasonably be expected to fetch on a sale in the open market at that time). In the event that the transfer is made for other non-monetary consideration or for no consideration, the consideration is deemed to be the value of the listed securities.

Equivalent provisions are enacted for SDRT. The provisions will ensure that where an agreement is to transfer securities for consideration in money or money's worth, the consideration is deemed to be the higher of that consideration and the value of the transferred securities. If no consideration is identified in the transfer agreement, the consideration is deemed to be the value of the listed securities.

While these anti-forestalling provisions are to be included in the Finance Bill 2019, for stamp-duty purposes, they are effective for instruments executed on or after 29 October 2018. For SDRT purposes, in the case of conditional agreements to transfer, the provisions are

effective for conditions satisfied on or after 29 October 2018, and in other cases, for agreements to transfer on or after 29 October 2018.

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