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Global Tax Update

United Kingdom

Deloitte Tohmatsu Tax Co.

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UK Budget 2016 : Japanese Business Tax

1. Introduction

The Chancellor of the Exchequer delivered his Budget on March 16, 2016 with a renewed focus on long term objectives. The Chancellor had the advantage of making today's announcements following a range of positive economic indicators such as record low unemployment and an economy forecasted to grow at a faster rate than that of any other major developed country. However, this must be balanced against growing fears of the state of the global economy and uncertainty over the UK's future in the European Union.

The Chancellor repeatedly stated that the UK is amongst the best prepared to deal with these challenges and reiterated that the country remains 'open for business'.

This Bulletin sets out the key measures for Japanese owned groups. For detailed coverage and comment on the UK Budget 2016 visit Deloitte's dedicated website at http://www.ukbudget.com/

2. Business Tax Roadmap

The Chancellor reaffirmed that the UK will remain a competitive business environment and released a Business Tax Roadmap setting out the reforms by which the Government proposes to achieve this. This includes the measures set out below, as well as the Government's view on and response to each of the BEPS actions.

(1) Further corporation tax rate reduction

The Chancellor reiterated the Government's commitment to ensuring that the UK has the lowest corporation tax rate in the G20. The reduction in the rate of corporation tax to 19% will still take effect from April 1, 2017, but from April 1, 2020 this will be reduced further to 17%. This goes further than the reduction to 18% that had previously been enacted.

This change is likely to be included in the Finance Bill, which will be enacted in July 2016.

The 17% corporation tax rate will be on par with the current corporation tax rate of countries like Singapore. While this further strengthens the UK's international competitiveness encouraging business investment and growth, for Japanese groups in particular, this gives rise to a possible concern under the Japanese anti-tax haven rules ('JCFC'), the threshold for which is set at "less than 20%". In most cases it is likely that the exemption applying to active businesses will apply but some large multinational groups with extensive investment as well as trading activities in the UK will need to review their position, while keeping an eye on possible reforms to the JCFC rules that may be announced in Japan before the rate reductions take effect in the UK from next year.

(2) Changes to interest deductibility

The Chancellor announced the Government's intention to proceed with restrictions on interest deductibility for corporates. The proposals broadly follow the recommendations from Action 4 of the OECD's BEPS project and will take effect from April 1, 2017. Under the draft proposals a fixed ratio rule will be introduced under which deductible interest will be restricted to 30% of UK EBITDA. A group ratio rule will be introduced to allow the group's net interest: EBITDA ratio to be used as an alternative to the fixed ratio, which may allow a greater amount to be deducted for highly geared groups. There will also be an overall cap that will mean that UK net interest deductions cannot exceed the global net third party expense of the group. Rules will be introduced to address volatility in earnings and interest, although no details of these have been provided.

A de minimis threshold will be introduced so that the new measures will only apply to groups with more than £2 million of net UK interest expense. Specific rules will also be introduced to ensure that the restriction does not impede the provision of private finance for certain private infrastructure projects in the UK.

The worldwide debt cap rules will be repealed when the new measures are introduced; all other anti-avoidance measures related to debt will be retained, with the exception of the tax arbitrage rules that are due to be replaced by the new anti-hybrid rules with effect from January 1, 2017 (see below).

The Government has indicated that further consultation on the detailed design of all aspects of the rules will be conducted 'in due course' and draft legislation is not expected before December 2016 for enactment in 2017.

The proposed rules represent a significant departure from the current system under which interest deductibility is determined by reference to a general arm's length test that allows the earnings of overseas subsidiaries of UK borrowing companies to be taken into account. As the new rules operate by reference to UK EBITDA only, the measures will potentially have a significant impact on groups that currently rely on the earnings of non-UK subsidiaries to support interest deductibility on UK debt.

(3) Hybrid mismatch arrangements

In December 2015 the Government released draft legislation to implement the BEPS hybrid-mismatch proposals, that will take effect for payments made on or after January 1, 2017 and which involve a hybrid entity or a hybrid instrument. As a result of these changes the tax effect of certain hybrid mismatch arrangements will alter, potentially leading either to a denial of a deduction in the UK or the taxation of income in the UK.

The Government is now going further by extending the scope of the legislation to eliminate mismatches involving permanent establishments. This expansion will broaden the number of arrangements that will be affected by the new rules including certain common financing structures.

(4) Changes to loss relief rules

Significant changes were announced to the UK tax loss regime that will take affect from April 1, 2017.

Firstly, the existing distinction between different categories of losses will be removed for losses incurred on or after April 1, 2017. This means that companies will be able to utilise carried forward losses against any type of income arising in future periods, rather than needing to stream losses against the same type of profits.

Secondly, the group relief rules will be changed to allow brought forward losses of one group company to be offset against profits of any other UK group company, where the losses are incurred on or after April 1, 2017. This is a significant – and welcome – departure from the current group relief rules that only allow current period losses to be surrendered to other group members.

Thirdly, from April 1, 2017 a restriction will be introduced to reduce the amount of brought forward tax losses that can be offset against taxable profits in excess of £5m. Specifically, whilst full offset will continue to be available for the first £5m of taxable profits, the amount of loss that can be offset against profits in excess of this amount will be restricted to 50% of the excess. For groups, the £5m threshold will apply per group rather than per company.

None of the changes outlined above will apply to the oil and gas fiscal regime.

Separate changes were announced in relation to banks, which are already subject to rules that restrict utilisation of their brought forward tax losses. These bank-specific changes will restrict the amount of brought forward losses that can be offset to 25% of taxable profits with effect from April 1, 2016.

The proposed changes to the UK rules on loss relief are wide-ranging and represent a significant departure from the current system which is based on the old scheduler system of taxation. The restriction on the amount of profit that can be offset through losses carried forward follows the trend set by many other developed countries including Japan. The proposed changes may have a significant impact on the tax payment profile of many Japanese conglomerates with diverse trading and investment activities in the UK with losses carried forward.

(5) Withholding tax on royalty payments

Three changes to the UK's withholding tax rules for royalty payments have been announced:

Firstly, the categories of royalties that are subject to withholding tax will be expanded, to include royalties paid in respect of all intellectual property, which for the first time will include payments made in respect of trademarks and brand names.

Secondly, under current rules withholding tax only applies where the royalty comes from a UK source. The definition of UK source will now be amended, such that withholding will now apply where the payments are connected with a UK permanent establishment of a foreign company.

Thirdly, a new anti-avoidance provision will be introduced to deny access to the UK's double tax treaties where the payment is made by a UK person to a connected party under an arrangement which has a purpose of obtaining access to the treaty, where this is not in line with the object and purpose of the treaty.

The first and second measures will take effect for payments made on or after the date the Finance Bill receives Royal Assent, which is likely to be during July 2016. The third measure will take effect for payments made from March 17, 2016.

Companies should urgently review existing arrangements to assess whether the new rules will cause any impact and to remain compliant. The changes are of course subject to relief under the UK's double tax treaties. The UK-Japan double tax treaty exempts royalty payments from withholding tax, but close review of the new draft legislation to be issued, including the anti-avoidance provision denying access to the treaty, will be needed to ensure that royalty payments to Japan can continue to be paid gross.

(6) Potential changes to the Substantial Shareholdings Exemption

The Chancellor announced that the Government will review the Substantial Shareholding Exemption ('SSE'), which exempts from corporation tax capital gains on qualifying share disposals by UK companies.

No specific proposals for change have been put forward at this stage. The consultation will consider whether the SSE is still delivering on its original policy objectives and whether changes could be made to its design in order to increase its simplicity, coherence and international competitiveness.

(7) Changes to the transfer pricing guidelines

The legislative definition of 'transfer pricing guidelines' will be updated to incorporate the revisions to the OECD Transfer Pricing Guidelines that were published as part of the BEPS package released in October 2015. This is more of a formality as HMRC were already operating in accordance with the new guidance and should have little practical impact.

(8) Business rates

Business rates are one of the largest items of expenditure for many businesses. The Government has recently concluded a business rates review and as a result has announced a new regime that should lead to reductions for all ratepayers.

Small businesses will see cuts in business rates from April 1, 2017, whilst all businesses should see a reduction in rates from April 2020 as a result of a switch in the annual indexation of business rates from the RPI inflation measure to the CPI measure.

The administration of business rates will also be revised to revalue properties more frequently and make it easier for businesses to pay taxes that are due.

(9) Stamp Duty Land Tax ('SDLT')

The Chancellor announced a move to a new SDLT system which replaces the current 'slab' system operating for non-residential property. These changes will take effect from March 17, 2016.

Under current rules a purchaser of non-residential property is charged a fixed percentage on the entire cost of the property (inclusive of VAT where relevant). Under the new rules SDLT will be payable on a graduated basis, defined as 0% for the first £150,000; 2% on the value between £150,001 and £250,000; and 5% on the proportion above £250,000.

The new rules will have the effect of reducing the SDLT burden for properties purchased for £1.05m or less. High value properties could see a significant increase, since the new 5% rate is an increase on the previous 4% top rate.

3. Industry specific measures

The Chancellor made a number of announcements relevant for specific industries, including the following:

- Oil and gas companies – In light of the challenging commercial conditions as oil prices continue to decrease, the Chancellor announced certain methods to support the UK oil and gas industry. These measures include reducing the Supplementary Charge from 20% to 10% and reducing petroleum revenue tax to zero to balance investment between older fields and infrastructure and new developments. These measures will be backdated to take effect from January 1, 2016. The Government also introduced measures to encourage investment in exploration.
- Insurance companies – The rate of Insurance Premium Tax will be increased from 9.5% to 10%, with a commitment that all additional revenues will be spent on flood defence and resilience measures.

4. Compliance

(1) Tax payment dates for large companies – changes deferred

In the 2015 Summer Budget the Chancellor announced that tax payment dates for companies with profits exceeding £20m would be moved forward (with the threshold reduced by the number of companies, where there is a group). Companies within these rules will be required to make payments in the third, sixth, ninth and the twelfth months following the start of an accounting period.

These rules were originally intended to take effect for accounting periods starting on or after January 1, 2017. However, in order to allow companies to adjust to the new payment schedule, this measure has been pushed back and will apply to accounting periods commencing on or after April 1, 2019.

(2) Making tax digital

In the 2015 Autumn Statement the Chancellor announced major changes to tax administration which would integrate electronic record keeping with online tax reporting, with the changes applying to corporation tax from April 2020.

The Government has been consulting on how to improve the way in which businesses and individuals manage their tax payments and has announced that from 2018 businesses who keep digital records and who provide regular digital updates to HMRC will be able to adopt pay-as-you-go tax payments on a voluntary basis. Businesses choosing to adopt this route will be able to choose payment patterns that suit them, so as to optimise their cash flow.

(3) Further measures on tax compliance for large businesses

The Government reaffirmed the announcements made in the 2015 Summer Budget to ensure the UK compliance framework encourages the right behaviours from large businesses. The three key measures are:

- A requirement for large businesses to publish their tax strategy as it relates to UK taxation, which must be available on their website. The strategy must be made available in 2017, the precise date depending on the company’s accounting period;
- A ‘special measures’ regime to tackle businesses that frequently engage in aggressive tax planning and/or refuse to engage with HMRC in a collaborative way;
- A Framework for Co-operative Compliance to manage the tax risks presented by large businesses in order to ensure they pay the right amount of tax at the right time.

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