International Tax

# United Kingdom Tax Alert

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## Budget 2016 confirms commitment to competitive business environment, but includes BEPS measures


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The UK Chancellor delivered his budget on 16 March 2016 with a renewed focus on long-term objectives. The Chancellor had the advantage of making the 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 EU. 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 alert focuses on the key measures that will affect foreign-owned groups. For detailed coverage and comments on the UK Budget 2016, visit Deloitte's dedicated website at www.ukbudget.com.

### 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 objective. The roadmap includes the measures discussed below, as well as the government's view on, and response to, each of the actions under the OECD base erosion and profit shifting (BEPS) project.

***Further reduction of the corporation tax rate*****:** 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 to 19% still will take effect on 1 April 2017, but from 1 April 2020, the rate would be further reduced to 17%. This goes further than the reduction to 18% that previously was enacted. The new rate change is likely to be included in the Finance Bill that will be enacted in July 2016 (for prior coverage, see the tax alert dated 25 November 2015).

***Changes to the deductibility of interest*****:** The Chancellor announced the government's intention to proceed with restrictions on interest deductibility for corporations. The proposals broadly follow the recommendations from Action 4 of the OECD's BEPS project and would take effect from 1 April 2017. Under the draft proposals, a fixed ratio rule would be introduced, under which deductible interest would be restricted to 30% of UK EBITDA. A group ratio rule would be introduced to allow the group's net interest-to-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 also would be an overall cap that would mean that UK net interest deductions could exceed the global net third-party expense of the group. Rules would be introduced to address volatility in earnings and interest, although no details have been provided.

A de minimis threshold would be introduced so that the new measures would apply only to groups with more than GBP 2 million of net UK interest expense. Specific rules also would 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 would be repealed when the new measures are introduced; all other anti-avoidance measures related to debt would be retained, exception the tax arbitrage rules that are due to be replaced by the new anti-hybrid rules with effect from 1 January 2017 (see below).

The government has indicated that further consultation on the detailed design of all aspects of the rules would 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 would operate only by reference to UK EBITDA, the measures potentially would have a significant impact on groups that currently rely on the earnings of non-UK subsidiaries to support interest deductibility on UK debt.

***Hybrid mismatch arrangements**:* In December 2015, the government released draft legislation to implement the BEPS hybrid-mismatch proposals that would take effect for payments made on or after 1 January 2017 and that involve a hybrid entity or hybrid instrument (for prior coverage, see the tax alert dated 11 December 2015). As a result of these changes, the tax effect of certain hybrid mismatch arrangements would alter, potentially leading either to a disallowance of a deduction in the UK or the taxation of income in the UK.

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

***Changes to loss relief rules***: Significant changes have been announced to the loss relief rules:

- The existing distinction between different categories of losses would be removed for losses incurred on or after 1 April 2017, which would mean that companies would be able to utilize carried forward losses against any type of income arising in future periods, rather than needing to stream losses against the same type of profits.
- The group relief rules would 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 1 April 2017. This is a significant—and welcome—departure from the current group relief rules

that allow only current period losses to be surrendered to other group members.

- As from 1 April 2017, a restriction would be introduced to reduce the amount of brought forward tax losses that may be offset against taxable profits in excess of GBP 5 million. Specifically, while full offset would continue to be available for the first GBP 5 million of taxable profits, the amount of loss that could be offset against profits in excess of this amount would be restricted to 50% of the excess. For groups, the GBP 5 million threshold would apply per group rather than per company.

None of the changes would apply to the oil and gas tax regime.

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

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

- The categories of royalties that are subject to withholding tax would be expanded to include royalties paid in respect of all intellectual property, which for the first time would include payments made in respect of trademarks and brand names.
- The definition of UK source would be amended, such that withholding would apply where the payments are connected with a UK permanent establishment of a foreign company (under current rules, withholding tax applies only where the royalty comes from a UK-source).
- A new anti-avoidance provision would be introduced to deny access to the UK's tax treaties where the payment is made by a UK person to a connected party under an arrangement that 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 would 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 would take effect for payments made as from 17 March 2016.

*Companies should urgently review existing arrangements to assess whether the new rules would have an impact and to remain compliant.* The changes would be subject to any relief granted under the UK's tax treaties.

***Potential changes to the substantial shareholdings exemption (SSE)***: The Chancellor announced that the government would review the SSE, which exempts from corporation tax capital gains on qualifying share disposals by UK companies. No specific proposals for change have been put forward; the consultation will consider whether the SSE continues to deliver on its original policy objectives and whether changes could be made to its design to increase its simplicity, coherence and international competitiveness.

***Changes to transfer pricing guidelines***: The legislative definition of "transfer pricing guidelines" would 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 (for prior coverage, see the tax alert dated 5 October 2015). This is more of a formality since the UK tax authorities (HMRC) already are operating in accordance with the new guidance and should have little practical impact.

***Business rates***: Business rates are one of the largest items of expenditure for many businesses. The government 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 would see cuts in business rates from 1 April 2017, while 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 also would be revised to revalue property more frequently and make it easier for businesses to pay taxes that are due.

***Stamp duty land tax (SDLT)***: The Chancellor announced a move to a new SDLT system that would replace the current "slab" system operating for nonresidential property. These changes would take effect from 17 March 2016.

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

The new rules would reduce the SDLT burden for property purchased for GBP 1.05 million or less. High-value property could see a significant increase, since the new 5% rate is an increase on the existing 4% top rate.

## Industry-specific measures

The Chancellor made 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 would be backdated to take effect from 1 January 2016. Measures also are proposed to encourage investment in exploration.
- *Insurance companies*: The rate of the insurance premium tax would be increased from 9.5% to 10%, with a commitment that all additional revenue would be spent on flood defense and resilience measures.

## Compliance

The Chancellor has announced several compliance-related measures:

- In the 2015 Summer Budget, the Chancellor announced that tax payment dates for companies with profits exceeding GBP 20 million 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 12th months following the start of an accounting period. These rules were intended to take effect for accounting periods starting on or after 1 January 2017. However, to allow companies to adjust to the new payment schedule, this measure has been pushed back and would apply to accounting periods commencing on or after 1 April 2019.

- The announcements made in the 2015 Summer Budget to ensure the UK compliance framework encourages the right behaviors from large businesses were reaffirmed. 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 websites. The strategy would have to 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 that refuse to engage with HMRC in a collaborative way; and
  - A framework for cooperative compliance to manage the tax risks presented by large businesses to ensure they pay the right amount of tax at the right time.
- In the 2015 Autumn Statement, the Chancellor announced major changes to tax administration that would integrate electronic recordkeeping 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, as from 2018, businesses that keep digital records and provide regular digital updates to HMRC would be able to adopt pay-as-you-go tax payments on a voluntary basis. Businesses choosing to adopt this route would be able to choose payment patterns that suit them, so as to optimize their cash flow.

## Value added tax

The Chancellor announced a package of measures aimed at tackling rapidly growing online VAT evasion. Two key areas that are being targeted are overseas businesses and online marketplaces. HMRC is strengthening existing VAT legislation that would require overseas businesses that should be registered for VAT in the UK to appoint a UK-established VAT representative and giving HMRC greater flexibility in relation to when it can require some form of security to cover the VAT likely to be payable. HMRC also would be given new powers to make online marketplaces jointly and severally liable for the unpaid VAT of overseas businesses that are noncompliant with UK VAT rules.