Weil

UK Tax Update:
It's not all about Brexit!

There has rightly been a great deal of attention paid to the UK's decision to leave the EU and what that may mean from a business (including tax) perspective. However, until the UK comes closer to leaving the EU (which is unlikely to be for at least two more years) Brexit is not expected to change the UK's tax system. Indeed, even planning for tax changes that will ultimately arise as a result of Brexit is difficult until more is known about the manner of the UK's departure, and the shape of its continuing relationship with EU member states.

However, over the past few months, we have seen an unprecedented number of material amendments and proposed changes to the UK tax regime. Some of these changes began in the UK, while others are a result of the OECD's "Base Erosion and Profit Shifting" ("**BEPS**") proposals. The changes, often fuelled by a perceived need to counter various UK and international tax avoidance strategies, are likely to have an impact on ongoing compliance costs for businesses and will need to be taken into account when raising funds, making and realising investments, and determining incentive structures for managers and other key personnel.

Concentrating on divining the possible effects of Brexit risks a business losing focus on many significant tax changes taking place in the UK in the short and immediate term.

You will see from the below that a number of the areas subject to change are the subject of current consultations with the Government. Weil is participating in those consultations: please let us know as soon as possible if you would like us to raise any particular points of relevance to you in our comments and/or would like to see a copy of any of the Government's consultation documents.

The developments

Some Detail

1. Restrictions on the deductibility of interest expense

The Government is consulting on proposed new rules that would restrict the tax deductibility of interest payments, with implementing legislation to be included in Finance Bill 2017 and the rules expected to apply from 1 April 2017.

If the proposals are enacted in the form currently suggested by the Government, the deductibility of net UK interest expense would be restricted to 30% of UK EBITDA, or (if higher) an amount determined by reference to the ratio of net interest expense to EBITDA for the worldwide group (this later ratio may allow greater deductions for international groups that are highly leveraged with third party debt), although all groups will be able to deduct net UK interest expense of up to £2 million per year before the new rules apply.

Net interest expense is widely defined but broadly means financing (including interest) payments less financing (including interest) receipts.

The new regime will apply after other existing UK rules which restrict interest deductibility (such as the transfer pricing rules). The worldwide debt cap regime is to be replaced with a new debt cap regime and specific rules will be introduced in relation to public benefit infrastructure projects, banking and insurance.

2. **Introduction of "secondary adjustments" for transfer pricing purposes**

The Government has issued a consultation document proposing to introduce new transfer pricing rules to realign the economic benefits of certain related party transactions with the "arm's length" position applied under existing UK transfer pricing rules. Comments are sought by 18 August 2016, with implementing legislation to be included in Finance Bill 2017 and the rules expected to apply from 1 April 2017.

At present, transactions between related parties are treated, for UK tax purposes, as being undertaken at an arm's length price (that is, the price that would have applied in comparable transactions between non-related parties). Because this adjustment (the "primary adjustment") only applies for tax purposes it does not alter the actual amount paid and can, where the actual price does not match the arm's length price, result in one of the parties benefiting from holding more cash than would have been the case in an arm's length scenario.

To counteract the cash benefits arising to the person retaining the "extra" cash (that person will typically be in a low-tax jurisdiction) HMRC is considering imposing a further tax charge in respect of that excess cash (a "secondary adjustment") and is seeking views on how any secondary adjustment should work. Suggestions include the excess cash being treated as:

- a taxable dividend payment and for the payer to be required to withhold an amount on account of tax on that dividend payment;
- an equity contribution by the payer, taxable on disposal; or
- (and this seems to be favoured by HMRC) a loan notionally subject to interest (at a rate which, as a deterrent, may be "well above" market rates), and for a tax charge to apply to the deemed interest until the 'loaned' excess cash is repatriated to the UK entity.

Such new rules would be consistent with the approach taken by other leading economies, such as the US, Canada and various EU Member States, and would also be in line with OECD guidelines on transfer pricing.

3. **Reforms to the way losses may be "carried forward" to shelter future profits**

Under current rules the use of carried forward corporation tax losses is restricted – broadly, carry forward losses can only be used by the company that incurred them and then only against profits arising from certain types of income. The Government is consulting on two major proposed reforms in this area. Comments are sought by 18 August 2016, with implementing legislation to be included in Finance Bill 2017 and the rules expected to apply from 1 April 2017.

The first proposed reform would increase flexibility by allowing losses arising from 1 April 2017 to be carried forward and set against both the taxable profits of a company's group members and the taxable profits arising from different types of income within the company.

The second proposed reform would limit the use of carry forward losses. For companies other than banks there is currently no limit on the quantum of profits that can be relieved by carried forward losses in any year. The Government proposes to change this from 1 April 2017 such that, for profits over £5 million, only 50% of annual profits can be relieved by carried forward losses in any given year. The £5 million allowance will apply per group and can be allocated at the companies' discretion. Banks are already subject to a 50% restriction on the use of certain carried forward losses accruing before 1 April 2015; from 1 April 2016 that restriction increased such that only 25% of annual profit can be relieved by such losses.

4. **Reforms to the Substantial Shareholding Exemption ("SSE")**

The Government is consulting on proposed reforms to the UK's SSE regime; comments are sought by 18 August 2016. The SSE (the UK's "participation exemption" from corporation tax on chargeable gains arising on the disposal of shareholdings) is an important relief which is often a factor in determining whether the UK will be used as a holding jurisdiction. However, access to the SSE involves navigating various complex qualifying conditions (including certain "trading" requirements) and these conditions can sometimes be difficult to apply (and meet) in practice.

The stated purpose of the proposed reforms is to introduce changes that will make it "simpler, more coherent and more internationally competitive". This is a positive development: the UK Government has acknowledged the difficulties that may arise in applying the SSE, and a simplification of the qualifying conditions would be welcome and strengthen the case for holding investments through the UK. That said, the consultation document refers to a wide range of potential reforms and it remains to be seen whether the final proposals will result in significant improvements to the regime or more modest progress.

5. Extensions to the Double Tax Treaty Passport ("DTTP") Scheme

The Government has issued a consultation document proposing reforms to the DTTP scheme. Comments are sought by 12 August 2016.

The DTTP scheme was introduced in September 2010 to simplify the process for applying for relief from interest withholding tax under the UK's tax treaties. The scheme enables certain overseas corporate lenders to apply to HMRC for a five year "treaty passport". Unlike traditional UK treaty relief applications, which typically take between six weeks and six months, HMRC will consider an application for a treaty passport within 30 days. In addition, as its name suggests, a treaty passport can be "passported" across multiple loans to UK borrowers, thus removing the need for separate treaty relief applications each time the passported lender makes a loan to a UK borrower.

At present, the DTTP scheme only covers corporate-to-corporate lending into the UK. HMRC's proposals include making the scheme available to UK partnership borrowers and overseas non-corporate lenders such as pension funds, sovereign investors and partnerships.

The review of the DTTP scheme (along with the introduction of the new private placement exemption) is timely if for no other reason than, following the UK's 23 June vote to leave the EU, there is a real prospect of an increase in the number of treaty (and DTTP) applications by EU-based lenders in respect of loans to connected party UK borrowers that would currently benefit from the EU Interest and Royalties Directive.

6. Requirement for businesses to publish their tax strategies

Certain businesses are now required to publish, free of charge and available to all on the internet, their UK tax strategy. Most businesses will not need to publish their first strategy until 2017.

The publication requirement is primarily aimed at larger enterprises (companies, groups and partnerships with a turnover above £200 million and/or balance sheet assets over £2 billion, and multinational enterprises/groups that are already subject to country-by-country reporting (that is, those with a turnover of £586 million or more)), but the legislation may impact private equity houses, funds, and other entities which might not expect to be caught.

The strategy to be published is limited to matters of UK taxation and should cover the entity/group's: (i) approach to tax risk management and governance arrangements, (ii) attitude towards tax planning, (iii) view on the level of tax risk that it is prepared to accept and (iv) approach towards dealings with HMRC. See our separate briefing on these rules published in January of this year *here*.

7. New criminal liability for the facilitation of tax evasion

The Government continues to express its commitment to eradicating offshore tax evasion and "safe havens". A new corporate offence of failing to prevent tax evasion (modelled on the Bribery Act 2010 offence of failing to prevent corruption) is a central part of the Government's strategy.

In anticipation of the G20 Anti-Corruption Summit held in London in May 2016 and as a reaction to the publication of the Panama Papers, the Government promised to have legislation in place by the end of 2016 requiring companies to have reasonable procedures in place to prevent tax evasion by others. Draft legislation and guidance was published on 17 April 2016 and the consultation process closed on 10 July 2016. Despite the turmoil caused by the result of the Brexit referendum there have been no announcements changing the current timetable.

The draft legislation applies to the evasion of all UK taxes and any foreign tax (subject only to the condition that the foreign tax must have an equivalent tax in the UK). The new offence of failing to prevent the evasion of UK taxes will apply to any corporates (or similar entities – including partnerships) wherever formed and wherever they do business, while the offence of failing to prevent foreign tax evasion will apply to all UK corporates (or similar entities, again including partnerships) and any corporate, wherever formed, carrying out some part of its business in the UK.

Liability of a company for an offence can be triggered by the actions of any "associated person" of the company who performs services for or on behalf of the company (whether for reward or not) and in whatever capacity. Any activity by the corporate or an associated party that facilitates the evasion of an applicable tax in any way will trigger liability. In common with the Bribery Act, liability is strict and does not require knowledge of the evasion or of the acts of facilitation by an association, although a defence is available where the company can show that it had in place "reasonable prevention procedures".

The draft guidance has confirmed that reasonable prevention procedures "will be proportionate to the risk of criminal facilitation faced by the corporation [and] will depend on the nature, scale and complexity of the corporation's activities." The guidance states that the new offences "do not require corporations to undertake excessive due diligence but does demand more than mere lip-service to preventing the facilitation of tax evasion."

8. The common reporting standard ("CRS")

Banks and other financial institutions (including, for example, certain funds and treasury companies) will be familiar with the annual reporting requirement under FATCA which became effective in the UK from the calendar year 2014 onwards. A similar information reporting obligation (known as "CDOT FATCA" or "UK FATCA") also took effect for the calendar year 2014 onwards for banks and other financial institutions resident in any one of the UK's Crown Dependencies or its Overseas Territories with respect to their UK financial account holders.

For the calendar year 2016 onwards, banks and other financial institutions will be required to comply with information reporting obligations under CRS.

The reporting obligations (and information exchange mechanisms) under CRS are broadly similar (but, unfortunately in terms of compliance complexity, not the same) to those of FATCA, except that CRS will have a global impact (with the notable non-participant in CRS being the US which has preferred to retain its FATCA regime) and does not carry withholding tax consequences for non-compliance. In broad terms, CRS will require banks and other financial institutions to report certain information regarding all financial account holders from "reportable jurisdictions" to the relevant tax authority by the 31 May each year following the relevant calendar year of reporting. It is expected that financial institutions in affected jurisdictions will have dual reporting obligations under both CDOT FATCA and CRS for 2016 but not for 2017, at which point CDOT FATCA will be repealed in full and replaced by CRS.

9. Recovery by holding companies of their VAT costs

Historically HMRC has adopted a restrictive view as to whether a holding company is able to recover VAT incurred in relation to the management of its subsidiaries. This includes whether a typical private equity "BidCo" is able to recover VAT on deal fees incurred when buying a target group. Recent case law suggests that HMRC's practice is too restrictive, and HMRC is currently engaged in discussions with stakeholders about updating its policy.

However, latest reports suggest that the much hoped for clarity is unlikely to be forthcoming. On the contrary, it appears that HMRC is looking to scrutinise "BidCo" arrangements more closely; including where the deal advisers are initially instructed by a different entity, with those arrangements later novated or assigned to the "BidCo". To minimise the risk of any HMRC challenge it remains advisable to ensure where possible that any "BidCo" is established at the outset of any transaction and directly instructs the advisers.

10. Disclosure of Tax Avoidance Schemes ("DOTAS"): the new financial products hallmark

The DOTAS rules, initially introduced over a decade ago, comprise a regime which requires promoters (and, in some situations, users) of tax planning arrangements to disclose details of certain of those arrangements to HMRC.

Broadly, to be disclosable, a tax planning arrangement must:

i. enable a person to obtain a tax advantage (or lead to an expectation that they will do so);

ii. be such that (one of) the main benefit(s), expected to arise is the obtaining of that advantage; and

iii. fall within one of a number of specified categories of arrangement (or "**hallmarks**").

A new "financial products" hallmark was introduced in February 2016. The new hallmark applies to arrangements involving specified financial products (which include shares and loans) where an informed observer could reasonably conclude both that (a) (one of) the main benefit(s) of including such a product in the arrangements is to confer a tax advantage; and (b) either the financial product contains at least one term that is unlikely to have been entered into by the parties were it not for the tax advantage, or the arrangement involves one or more "contrived or abnormal" steps, without which the advantage would not have arisen.

The breadth of the definition of "financial product" means that the hallmark is potentially wide enough to capture various commercial transactions (particularly those entered into with a view to securing a relief or exemption). Although HMRC have published a white list setting out a number of products and arrangements that are not caught, that list is narrowly drafted.

HMRC is expected to issue further guidance on the new hallmark but, at least for the interim, some arrangements which may previously have been thought of as "market standard" are now potentially subject to disclosure requirements under the DOTAS regime.

11. Changes to the way termination payments are taxed

The Government announced at Budget 2016 that the rules regarding the taxation of employment termination payments would be clarified and tightened "to prevent manipulation" by employers seeking to avoid tax and/or National Insurance contributions ("**NICs**").

At present, certain termination payments can be made free of NICs (both employees' and employer's) and the first £30,000 can often be paid free of income tax. We understand that forthcoming legislation will include provisions that align the income tax and employer's NICs treatment of termination payments. The Government will also enter into a technical consultation on other proposed changes to the rules that:

i. remove foreign service relief; and

ii. clarify that payments made "in lieu of notice" ("PILONs") and certain damages payments will be taxable as earnings.

The changes, which are proposed to be legislated in 2018, follow a government consultation in 2015, although many of the changes suggested in that consultation have not been reflected in the latest proposals. Nonetheless, the proposed amendments will result in increased costs to employers making termination payments and may, as a consequence, reduce the amounts employers are ultimately able to pay to employees in such circumstances.

12. Carried interest and the new disguised investment manager fees ("DIMF") rules

The taxation of carried interest and other sums received by fund managers has recently undergone a series of radical changes, one of the biggest being the introduction of the disguised investment management fee rules (the "**DIMF rules**") and the proposed introduction of the income based carried interest rules ("**IBCI rules**").

The purpose of the DIMF rules is to try to ensure that any amounts that arise to those involved in fund management in respect of their investment management services are subject to income tax (tax rate 45%) unless the amounts qualify as co-investment returns (tax rate 20%), a return of an amount invested (non-taxable return of capital) or carried interest (tax rate 28%) (all as defined, relatively narrowly, in the legislation). The DIMF rules and the definition of "arising" are drafted to try and ensure that amounts cannot be sheltered from tax by way of payment to a third party where the individual manager may effectively obtain certain direct or indirect benefits from such amount – broadly, if the amount arises to another person and that person is either connected with the relevant manager or the fee enures for the benefit of the individual manager it will be treated as arising to the manager and income tax will be payable on the relevant amount (unless the amount qualifies as carry or co-investment return). Further, the DIMF rules make fundamental changes limiting the access of individual managers to remittance basis (non-dom) taxation on their remuneration and returns.

The Government also proposes (as part of the current finance bill) to introduce further changes to the taxation of managers. Specifically, the introduction of the IBCI rules aims to ensure that only carried interest relating to "long-term" investment activities is eligible for capital gains tax treatment with other carry (that is, IBCI) taxed as income. Broadly, if the weighted average holding period of a fund's investments is:

i. at least 40 months, carried interest may be subject to capital gains tax if the underlying return generating the carry is of a capital nature;

ii. between 36 and 40 months, a portion of the carried interest will be subject to income tax (and NICs) even if the underlying return generating the carry is of a capital nature; and

iii. below 36 months, all carried interest will be subject to income tax (and NICs) regardless of the nature of the underlying return generating the carry.

13. Hybrid tax mismatches

New rules counteracting so-called "hybrid mismatches" are to apply from 1 January 2017.

Hybrid mismatches are arrangements that, as a result of a difference in the tax treatment of an entity or instrument under the laws of two or more jurisdictions have the effect of lowering the aggregate tax burden of the parties to the arrangement. It is important to note that these new rules will apply to counteract hybrid mismatches even where the UK company being examined (and taxed) is not itself a hybrid entity or a party to a hybrid instrument (that is, the "imported mismatch" rules can apply even if no UK tax is at stake).

The rules may affect many common international structures involving loans or shares; including, for example, where the receipt of a payment by one entity is an exempt distribution for the payee (because the payee treats the financial instrument as equity) but gives rise to a tax deduction for the payer (because the payer treats it as debt). Any structure with a hybrid mismatch should, if a UK entity sits in the ownership chain, be reviewed in light of these rules.

14. Brexit

Finally, as promised, some thoughts on key Brexit related UK tax issues.

No change: The decision to leave the EU has not triggered any change to existing tax law and any consequential changes are not expected for at least two years. Even following the decision (and the eventual exit from the EU), the UK should remain a competitive jurisdiction, with corporation tax reducing to 17% in 2020.

Exit charges: To the extent that any business is considering migrating out of the UK, the migration could trigger corporation tax exit charges which will need to be factored into the economics when evaluating whether to migrate.

Withholding taxes: When the UK eventually leaves the EU, it may lose the benefit of certain EU laws which prohibit withholding tax on cross-border payments of dividends, interest and royalties. Against this, however, the UK has one of the world's largest double tax treaty networks which should help mitigate any impact. Any transactions or arrangements which involve dividend, interest or royalty payments between the UK and the EU which have more than two years of the term remaining should be reviewed to determine whether a double tax treaty would be available to relieve any withholding, which party bears the withholding tax risk and whether and when to consider restructuring if the terms of the UK's exit from the EU do not include replacement "no withholding" regimes.

Taxation of dividends: When the UK leaves the EU, groups may also lose the benefit of a rule which requires that, where a subsidiary pays a dividend to its parent, the parent's jurisdiction must not tax the dividend receipt if the taxation would give to a double tax charge (i.e. both in the subsidiary's and parent's Member States). To the extent that you have a European holding structure with a UK subsidiary making dividend payments to a different EU member state, you may wish to analyse whether the loss of this rule would impact the economics of the structure, and if so, whether there might be a more efficient alternative structure which can be put in place.

Indirect taxes: We anticipate that the biggest changes (some of which may be welcomed by UK industry) will be to indirect taxes (VAT, insurance taxes, customs duty, and excise duty). However, it is impossible to determine now what those changes will be as they will fundamentally depend upon the exit deal and future deals negotiated by the UK Government.

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