Client Update
George Osborne's Chocolate Box. UK Budget 2016.

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As Forrest Gump famously drawled, "life is like a box of chocolates, you never know what you're gonna get". Much the same can be said about UK budgets. Recent history has suggested that for those in the investment fund industry the box is most likely to be filled with coffee creams (which, surely no one really likes). It was therefore with bated breath that we listened to the UK Chancellor give his address earlier today. We are still awaiting the draft legislation (to be published on Thursday 24 March), so in many ways today was like looking at a box of chocolates still in their wrappers: you can get a sense of what they are and with some you're pretty certain of the content, but you won't really know until you get your teeth stuck in. This update is therefore by way of an interim guide until we get the full details next week.

INCOME-BASED CARRIED INTEREST

The government confirmed its intention to implement new rules relating to the taxation of carried interest. Some hints were given regarding the scope of these rules, which have been amended from the draft presented at the close of 2015. Notably, the average holding period has been reduced to 40 months (from 48) and special regimes will apply for certain asset classes, including venture capital and real estate. We need to wait for the draft legislation for the detail, to see if any other asset classes are distinguished and find out the scope of the promised "minor technical changes".

For further details on the income-based carried interest rules, please see our prior client update, "HMRC's 'Italian Job': The UK Finance Bill and Taxation of Funds".

REDUCTION IN CAPITAL GAINS TAX RATE

In a surprise move aiming to incentivise individuals to invest in companies over property, the government will reduce the top rate of capital gains tax rate from 28% to 20%. It is disappointing that carried interest and gains on disposals of additional residential property (to the extent that such property does not benefit from private residence relief) will be excluded from these new rates.

NON-DOM STATUS

As anyone who is a UK resident non-domiciled individual is aware, the UK is currently undertaking a major reform of the non-dom regime. Under the new regime, a UK resident non-domiciled individual will be deemed UK-domiciled once they have been resident in the UK for 15 of the past 20 years, or automatically if they were born in the UK.

In today's budget the UK Chancellor has confirmed that non-doms with offshore trusts will not be charged UK tax on income and gains retained in such trust after they become deemed domiciled. A bonus announcement today is that the base cost of non-UK assets will be such assets' market value on the day that the individual becomes deemed domiciled.

A teaser announcement made today is that individuals with offshore funds will be subject to transitional provisions regarding how amounts remitted to the UK will be taxed, but that these provisions will be included in 2017's finance bill.

EXTENSION OF ENTREPRENEURS' RELIEF

In a surprise concession by the government, entrepreneurs' relief will be extended to external investors. This means that gains on shares held by individuals in unlisted trading companies (or unlisted holding companies of a trading group) will benefit from capital gains tax at a rate of 10%, subject to a lifetime cap of £10 million per individual. Certain conditions need to be met to come within this new extension, including that the shares will need to have been issued by the company on or after 17 March 2016 and to have been held for a continuous period of three years before disposal.

UK CORPORATION TAX RATE

Furthering the current government's goal of proving that "Britain is open for business", the UK corporation tax rate will be lowered to 17% from April 2020. This rate will be reached via a staggered drop; it is currently 20%, reducing to 19% in April 2017 and then 17% in April 2020.

BASE EROSION AND PROFIT SHIFTING ("BEPS")

The BEPS project is an international initiative spearheaded by the G20 and the OECD which aims to tax profits in the same country as the activities generating such profits. Unsurprisingly given the UK's commitment to lead the way on tackling tax anti-avoidance by multinational companies, BEPS featured fairly prominently in the budget, with the UK reaffirming its commitment to implement rules relating to:

- interest deductibility;
- hybrids; and
- withholding tax on royalties.

Interest Deductibility

In brief, the UK is seeking to cap the amount of relief for interest payments at 30% of UK EBITDA. In recognition of the fact that some groups need to be highly leveraged for commercial reasons, the UK will also implement a group ratio rule based on the net interest to EBITDA ratio for the worldwide group. There will be a threshold limit of £2m net UK interest expense and carve outs for public benefit infrastructure. The UK government expects that 95% of groups operating in the UK will fall outside of these rules because of these exceptions. These changes are scheduled to commence in April 2017.

Hybrids

In the Autumn Statement 2015, the UK government announced that it would implement the BEPS recommendations in relation to the use of hybrids. The already extensive rules combatting tax advantages gained through the use of hybrid instruments, hybrid entities and dual resident companies will be further extended to include certain tax benefits derived from the use of permanent establishments. These changes are scheduled to commence in April 2017.

Withholding Tax on Royalties

To prevent multinationals avoiding tax by using intra-group royalty payments to shift profits away from the UK to no, or low, tax jurisdictions, the UK will be able to levy withholding tax on a wider range of royalty payments, including those made in respect of trademarks and brand names. This new withholding tax will be required in connection with a business' UK activities, including the activities of a UK permanent establishment. There will be domestic provision made to prevent the UK's double tax treaties being used to circumvent this new tax.

LOSS RELIEF

Currently, a company can apply carried-forward losses that it has incurred to reduce its (but not other group companies') taxable profits in subsequent years. Even then, such relief may apply only to profits derived from certain specific income streams. For losses incurred from 1 April 2017 onwards, these rules will be relaxed so that (i) a company will be able to use its carried-forward losses to reduce the taxable profits of other group companies and vice versa, and (ii) such profits can arise from any income stream.

Restriction for (Groups of) Companies with Substantial Profits

Currently, if it has sufficient carried-forward losses, a company can apply loss relief so as to offset all eligible taxable profits. From 1 April 2017, to the extent that a company's profits exceed £5 million, it will be able to apply the relief to reduce only up to 50% of its taxable profits above £5 million. In the context of a group of companies, the profits of the entire group count towards the £5 million threshold.

Restriction for Banks

Currently, a bank can apply carried-forward losses to reduce up to 50% of its taxable profits. From 1 April 2016, a bank will be able to apply the relief to only up to 25% of its taxable profits.

SUBSTANTIAL SHAREHOLDINGS EXEMPTION ("SSE")

The SSE regime, which is the UK's participation exemption, provides that, in general, where a trading company holds (an interest in) ≥10% of the shares in a company that is part of a trading group, a gain arising on disposal of those shares will not be a chargeable gain. The regime was designed to ensure that tax considerations did not prevent business sales or group reorganisations. The government will consult on the extent to which the SSE regime continues to successfully achieve this aim and whether it is competitive with international regimes, such as (for example) those in certain European jurisdictions that apply an exemption to both chargeable gains and dividend income. We hope that the result of this consultation could lead to the UK's SSE regime's working more effectively for investment funds looking to make investments through UK holding companies.

EMPLOYEE SHAREHOLDER STATUS LIFETIME LIMIT

Employees holding employee shareholder status shares are eligible to receive gains on such shares free of UK tax (subject to meeting various conditions); as such, the regime is increasingly being used to incentivise management teams. From 17 March 2016, a lifetime limit on this benefit of £100,000 will apply and gains in excess of the cap will be subject to CGT, when previously they were not. The lifetime limit only applies to employee shareholder status agreements entered into from 17 March 2016. Certain anti-avoidance provisions will be included, particularly relating to transfers of such shares between spouses.

STAMP DUTY ON COMMERCIAL PROPERTY

Currently, stamp duty land tax ("SDLT") is charged at fixed rates on non-residential property transactions, depending on the band within which the purchase price falls (meaning that £1 can make a disproportionally large difference to the amount of SDLT payable). The new rules abolish this "cliff edge" approach to SDLT liability; from 17 March 2016, SDLT will be charged at each applicable rate on the portion of the purchase price falling within each rate band.

DOUBLE TAXATION TREATY PASSPORT SCHEME

Any UK corporate who has borrowed from a non-UK lender is likely to have come across the UK's Double Taxation Treaty Passport Scheme. The scheme allows a borrower to quickly and easily obtain clearance from HMRC allowing it to pay such lender interest payments free of the UK's usual 20% withholding tax. Given that a borrower is normally on the hook for withholding tax costs, this is an excellent scheme and is used extensively. The UK is going to consult on whether the scheme still meets the needs of UK borrowers and foreign investors and is also considering extending the types of lenders who may benefit from the scheme, which can only be a good thing.

INDIVIDUAL SAVINGS ACCOUNTS

The annual ISA limit has been increased to £20,000 and in an effort to offer more flexible saving options, the government has announced that from 6 April 2017, any adult under 40 will be able to open a lifetime ISA. Savers will benefit from a 25% bonus from the government for every £1 that they put into the account (capped at £1,000 of bonus per year). The funds can be used to buy a first home (up to £450,000) or can be withdrawn from the age of 60 for use in retirement. Savers have the option to make withdrawals at any time for other purposes, subject to certain charges and the loss of their government bonus.

WHERE DOES THIS LEAVE US?

We note that a somewhat incongruous statement in the "Business Tax Roadmap" that "[t]he UK has a thriving investment management sector… Where foreign funds already have investment management activity in the UK, the government wants to build on that presence by encouraging those funds to establish more of their investment activity in the UK." How this statement is borne out by the various and extensive changes implemented over the past 12 months is unclear, but perhaps it indicates that a period of stability is to come, meaning that rather than taking Jenny's advice to Forrest of "Run, Forrest! Run!", we should instead look to Forrest's mamma's advice that "you've got to put the past behind you before you can move on." How easy it will be to follow this advice will depend on what next week's Finance Bill holds. More on that anon.

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Please do not hesitate to contact us with any questions.