

UK Pre Budget Report Newsflash

Clarity

Gain a precise view of the Pre-Budget Report



In the Pre Budget Report the Government announced major changes to how the UK taxes international activity. These changes potentially have major implications for foreign parented groups investing in the UK.

Other key announcements include the headline grabbing 2.5% reduction in the standard rate of VAT, a rise in National Insurance Contributions from April 2011, further draft legislation on financial products anti-avoidance and changes to the connected party loan relationships rules.

International matters - key measures

A package of reforms was announced following a two year consultation on the taxation of foreign profits in the UK, including:

- A tax exemption for dividends from overseas companies (with a targeted anti-avoidance rule to protect against exploitation of the new exemption);
- A 'worldwide cap' restricting UK interest deductions by reference to a group's consolidated net external debt;
- An extension of the current unallowable purpose test (which applies to deny tax deductions for interest on loans which have an unallowable purpose) to apply to a scheme or arrangement;
- Changes to the UK controlled foreign companies (CFC) regime;
- Replacement of the Treasury consent and notifications rules for certain types of transactions with a quarterly reporting system for transactions over £100m.

The Treasury are aiming to publish draft legislation in early December 2008 in order to implement the reforms in the Finance Bill 2009. It is unclear exactly when the package will take effect; the earliest date is likely to be 1 April 2009, although it could be deferred until the Finance Bill becomes law, in July 2009.

Foreign dividend exemption

A foreign dividend exemption has been announced for large and medium groups (subject to certain restrictions). This represents a welcome resolution to over two years of debate on the introduction of an exemption from UK corporation tax for overseas dividends.

Any foreign dividend received on an ordinary share and most dividends on non-ordinary shares will be exempt from UK corporation tax, with no minimum ownership period or minimum ownership level currently proposed. In contrast to some European countries, no part of the dividend will be taxable. The exemptions will be subject to a Targeted Anti-Avoidance Rule (TAAR) which will apply where there is a scheme which is tax motivated and carries certain characteristics. No detail has been published on this, though we understand that four or five prescribed schemes have been identified by the Treasury for inclusion in the draft legislation.

UK as a holding company regime

The new dividend exemption from 2009 combined with the existing substantial shareholding exemption, extensive treaty network system, nil rate of withholding tax on dividends paid and broadly based deduction for financing costs (subject to the anti-avoidance rules mentioned above) makes the UK an increasingly attractive location for investors to establish a holding company.

Interest

Worldwide cap on UK interest deductions

With effect from 2009, UK tax relief for interest and other finance costs (e.g. discounts and finance charges on leases) claimed by UK companies in a multinational group will be capped by reference to the worldwide group's net external borrowing costs in its consolidated accounts (or equivalent). This aims to target situations where a UK group bears more debt than is required for the worldwide group to operate. It is primarily viewed by the Treasury as an effective way of targeting upstream loans to the UK used to repatriate overseas cash. The Treasury still intends that there will be a set-aside provision whereby the cap will not apply in certain circumstances where the group is in a temporary cash surplus position, e.g. following the sale of a business.

We understand from the Treasury that there will be no restriction on deductions for borrowings by UK companies from third parties, e.g. banks, with a 'back to back' rule to counteract abuse of the cap involving such third party borrowings. The treatment of guaranteed third party debt has not yet been resolved and will be discussed during consultation. There will be a 'carve out' for the effects of foreign exchange where this is the only reason for the cap restricting deductions. No special provisions are expected for cash pooling arrangements.

The definitions used and the precise mechanics of how this cap will operate have not yet been published, so a number of significant uncertainties remain and will be the subject of further consultation. Even if this does not result in additional tax cost it is likely to be a compliance burden, though we understand that the Government are considering EU law compliant options to reduce the compliance burden for groups. There will, for example, need to be some kind of proxy for the worldwide group's external borrowing costs where consolidated accounts are not produced, e.g. for sovereign wealth funds. The Treasury envisage groups with specific computational issues entering into early discussion with HMRC to resolve them, probably facilitated by the taxpayer's Customer Relationship Manager. The UK last year introduced a system of informal clearances, which will apply here.

Unallowable purpose

The current unallowable purpose test (which applies to deny tax deductions for interest on loans which have an unallowable purpose) will be extended to apply to a scheme or arrangement to bring it in line with other existing anti-avoidance rules. Currently this test is applied on an entity by entity basis to the party entering into the loan. As this test applies to each accounting period where an entity is party to such a relationship or contract this change will affect existing as well as future arrangements. It is not clear whether the Treasury intends to issue guidance on how the extended test will be applied in practice. It should however be possible to seek clearances on specific points on uncertainty should taxpayers wish to do so.

Connected party loans

Two changes are being introduced in respect of connected party loans, both of which are expected to apply to companies for accounting periods beginning on or after 1 April 2009. Draft legislation will be published before the end of the year.

Interest payable to overseas connected parties

The first proposal is in relation to the timing of interest deductions for interest payable by UK companies to overseas connected parties. Companies are connected where one controls the other or both are under common control.

Currently a deduction for interest payable by a UK company to an overseas connected party can only be claimed in the accounting period in which it accrues if the interest is paid within 12 months of that period end; otherwise it is deductible on a paid basis. However HMRC announced in July that it would not seek to apply this late interest rule and would consult on how the law should be amended. The consultation is based on the need for UK tax law to comply with the EU Treaty, though the current "concession" is not limited to interest paid to EU/ EEA lenders.

Release of a trade debt between connected companies

The second proposal is not to tax the debtor on the release of a trade debt between connected companies. Currently if a trade debtor is released there is no deduction for the creditor but the debtor may be taxed. This provision is expected to be helpful for groups looking to tidy up their group structure and eliminate surplus legal entities.

Controlled foreign companies rules

The Chancellor has announced that he will set up a new consultation on the reform of the UK's controlled foreign company legislation (laws which charge UK tax on the profits of overseas subsidiaries of UK groups).

In the meantime, some of the current avenues available for offshore subsidiaries to qualify as exempt CFCs will be abolished. The current CFC exemption for companies which pay at least 90% of their chargeable profits back to the UK via a taxable dividend (the Acceptable Distribution Policy Exemption or ADP) is being abolished in light of the introduction of the dividend exemption. In addition, the current exemption from CFC status provided under the

Exempt Activities Exemption for holding companies will also be abolished. This is subject to a 24 month transitional period to allow existing holding company structures to be unwound.

A wider reform of the CFC rules has been deferred. The replacement of the CFC rules with a passive income Controlled Companies regime has, as expected, been taken off the agenda. The Government has now accepted that it is appropriate to move UK taxation onto a territorial system - that is, only taxing UK source profits. No timetable has been suggested for wider CFC reform, but as this is unlikely to be complete before 2010, which is widely expected to be an election year, it is unclear how this will impact the prospects for CFC reform. It is nonetheless hoped that CFC reform will link in to the 24 month transitional period for holding companies.

Treasury consent regime

The Treasury consent rules will be abolished. These require advance consent to be obtained from HM Treasury for certain cross-border transactions and require notification of these transactions where they take place within the EU.

In place of these rules, a new post-transaction quarterly reporting requirement will be introduced for high risk transactions with a market value of £100m or more. It is currently not clear what level of information will be required to be reported.

Other key announcements

UK VAT rate

The standard rate of UK VAT will be reduced from 17.5% to 15%, with effect from 1 December 2008 until 31 December 2009. The rate will revert back to 17.5% on 1 January 2010. The change is likely to create a number of commercial headaches for retailers who now have to deal with some major systems changes to account for the new VAT rate at one of their busiest times of the year.

National Insurance Contributions proposals

There will be a major rise in National Insurance Contributions (NICs) from April 2011. Employer, employee and self-employed rates increase by 0.5 per cent from that date. That means the employer rate will go up from 12.8% to 13.3%.

Principles Based Approach to Financial Products Avoidance

Revised draft legislation and associated commentary has been released in relation to tax avoidance involving 'disguised interest' intended to have effect for arrangements entered into on or after 1 April 2009. Further comments on the revised consultation need to be made by 11 February 2009. The purpose of the provisions is to tax any amount or return which is economically equivalent to interest as if it were a profit arising to the company from a loan relationship. This will generally capture disguised interest in non-loan transactions and is intended to replace the existing 'shares as debt' legislation. The new draft legislation is intended, amongst other things, to avoid the duplication of charges at more than one tier within a group (where the rules apply) and to remove an overlap with the CFC rules. Preference shares have also now been taken out of the disguised interest rules.

The latest consultation document also provides updated draft legislation on the transfers of income anti-avoidance proposals. It is anticipated that this will apply to transfers on or after 1 April 2009.

If you have any queries please contact your usual Deloitte UK contact, or alternatively one of the following:

London - John Bird

Tel: +44 20 7007 0832

Email: jwbird@deloitte.co.uk

Reading - Phil Richards

Tel: +44 118 322 2108

Email: pdrichards@deloitte.co.uk

Leeds - Nick Marsden

Tel: +44 113 292 1588

Email: nmarsden@deloitte.co.uk

London - James Wright

Tel: +44 20 7007 3979

Email: jnwright@deloitte.co.uk

Reading - Lisa Stott

Tel: +44 118 322 2312

Email: lstott@deloitte.co.uk

Scotland - John Macintosh

Tel: +44 141 304 5011

Email: jmacintosh@deloitte.co.uk

London - Zubin Patel

Tel: +44 20 7007 1293

Email: zpatel@deloitte.co.uk

Birmingham - Tom Downing

Tel: +44 121 6955585

Email: tdowning@deloitte.co.uk

Manchester - Andrew Wilde

Tel: +44 161 455 8556

Email: awilde@deloitte.co.uk

For further information visit our special Budget Report web site at www.ukbudget.com

This publication has been written in general terms. Deloitte & Touche LLP would be pleased to advise readers on how to apply the principles set out in this publication to their specific circumstances. Deloitte & Touche LLP accepts no duty of care or liability for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

In this publication reference to Deloitte are references to Deloitte & Touche LLP. Deloitte & Touche LLP is a member firm of Deloitte & Touche Tohmatsu.

Deloitte Touche Tohmatsu is a Swiss Verein (association), and, as such, neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each member firm is a separate and independent legal entity operating under the names "Deloitte", "Deloitte Touche Tohmatsu", or other, related names. The services described herein are provided by the member firms and not by the Deloitte Touche Tohmatsu Verein.

Deloitte & Touche LLP is authorised and regulated by the Financial Services Authority.

© Deloitte & Touche LLP 2008. All rights reserved.

Deloitte & Touche LLP is a limited liability partnership registered in England and Wales with registered number OC303675. A list of members' names is available for inspection at Stonecutner Court, 1 Stonecutner Street, London EC4A 4TR, United Kingdom, the firm's principal place of business and registered office. Tel: +44 (0) 20 7936 3000. Fax: +44 (0) 20 7583 1198.

Member of
Deloitte Touche Tohmatsu