Plus ça Change, plus c'est la Même Chose?

Pete Miller, Tax Director at Ernst & Young, discusses corporate changes in the Budget

No surprises there, then! Pretty much everything in the Budget Speech and press releases had been trailed in the Pre-Budget Report or in subsequent announcements. Long gone are the days when the Budget was a surprise package and woe betide a Chancellor who lets slip any of the contents even an hour before his speech!

What's New

So, what's new? Well, probably the major piece of news is the announcement of the EU-friendly extension to the UK group relief rules, following the decision in *Marks & Spencer v Halsey*. And we also have more hints about the extended regime for disclosure of 'tax avoidance schemes' (DoTAS).

*Marks & Spencer loss relief*

The decision by the ECJ was announced on 13 December 2005, a week after the PBR. Both sides had good reason to be pleased with the outcome: M&S was able to claim group relief for the losses of its German and French subsidiaries and HMRC officials (and other Member States, too) were no doubt pleased that the Court limited the availability of cross-border group relief to situations where the losses could not be relieved in the country of origin, so there would not be a cross-border free-for-all on EU corporate losses.

The relief will apply to UK groups with non-UK subsidiaries that have incurred foreign tax losses that cannot be relieved elsewhere. The subsidiaries must be either resident in the European Economic Area (EEA) or have incurred the relevant losses in a permanent establishment in the EEA. The foreign tax loss will need to be recomputed under UK tax principles, although it remains to be seen how this will work in practice. Also it is not clear what comprises an unrelievable loss and, because the onus will be on the taxpayer to self-assess in the company tax return form that the loss meets the conditions for relief; this will result in some uncertainty. Nevertheless the relief is to be welcomed, even if it is only likely to be available in a limited number of circumstances. Additional comfort can be drawn from the fact that, as the Government considers that the cost to the Exchequer of this relief is low, it no longer needs to consider the option of abolishing group relief altogether, as had been feared.

It is intended that the relief will be effective from 1 April 2006, though this commencement date should not preclude pre-1 April 2006 claims, as the ECJ judgment effectively held that the current group relief rules are contrary to EU law to the extent they did not provide group relief for losses arising in the EEA in the circumstances referred to.
There will also be an anti-abuse provision to deny loss relief where arrangements have been made, where the main purpose or one of the main purposes is to obtain UK group relief, and which result in losses becoming unrelievable outside the UK that would otherwise be relievable, or which result in unrelievable losses arising which would not have arisen but for the availability of the UK relief. This rule will apply to arrangements made on or after 20 February 2006.

The disclosure regime

The Chancellor announced the extension to this regime in the PBR, stating that the extended DoTAS regulations were intended to apply from April 2006. Since then, there have been two rounds of quite hurried consultation with HMRC on the new system and I suspect that both HMRC and the rest of the tax community are relieved that the start date has been pushed back to 1 July 2006, so that we have sufficient time to develop a sensible, workable scheme with proper, detailed guidance.

The detail we have so far indicates that the new regime will operate as a series of 'hallmarks', rather like the system for VAT, instead of the filter system that we have now. If a scheme falls into any of the hallmarks, it will be disclosable. So there will be no overriding escape clauses, such as for schemes that do not need to be kept confidential and do not command premium fees.

The hallmarks are to be arranged into three categories.

- The first group has three hallmarks focusing on arrangements regarded as new and innovative. These are derived from the existing 'filters' of confidentiality, premium fee and off-market terms.
- One hallmark will focus on mass-marketed tax products.
- The final group focuses on areas regarded as a particular risk by HMRC, such as schemes intended to create tax losses to offset income or capital gains tax and certain leasing schemes.

The range of taxes covered by disclosure is also to be extended to cover all of income tax, corporation tax and capital gains tax. Finally, businesses will have to disclose 'in-house' schemes within 30 days of implementation, instead of with their corporation tax returns, as at present. A de minimis provision will, however, be added so that neither individuals nor businesses that are SMEs will have to disclose in-house schemes.

Where hallmarks are to be based on existing filters, we hope that their operation will follow the established understanding rather than introducing further new concepts to consider. For new hallmarks, we recommend that the scope be carefully considered to prevent excessive disclosure obligations for ordinary arrangements.

Ernst & Young will continue to take an active part in the consultation process as the hallmarks are developed.

What's Not So New

We have more detail about the new reliefs that were announced in the PBR, particularly REITs and the R&D tax scheme. However, we also have more detail about a number of anti-avoidance measures too.

Real estate investment trusts (REITs)

As anticipated, the Chancellor provided further details on the implementation of a UK real estate investment trust (UK-REIT) regime for property companies. The most important is that companies converting into a UK-REIT will suffer a conversion charge of 2% of the market value of the assets transferred to the REIT tax-exempt business. The REIT may elect to spread the charge over four years, in which case the conversion charge increases to 2.19%. This has been one of the areas of most concern within the sector — how much would it cost to get in? So this relatively low cost of entry is very welcome.

A number of other changes were announced, too, relaxing some of the proposed conditions, including the following.

- The interest cover test has been reduced from 2.5:1 to 1.25:1 and is now based on profits before tax rather than profits after tax.
A UK-REIT will be required to distribute only 90% of the profits from its tax-exempt business, on or before its corporation tax filing date. Previously, the requirement was 95% within six months of the year end.

A UK-REIT may now issue non-participating, fixed-rate preference shares and debt instruments that are convertible to ordinary share capital, provided that they are on commercial terms.

Research and development (R&D) tax relief schemes

Following the themes discussed in the December 2005 consultation paper, changes to the R&D tax relief were announced, including the following.

- Additional R&D support to companies with up to 500 employees (from the current 250 limit), through R&D tax credits. Details will be announced later and will be subject to State Aid discussions with the European Commission.

- Extending the definition of qualifying expenditure under the R&D tax relief schemes and the vaccine research relief scheme to include payments made to clinical trial volunteers, effective from 1 April 2006 for large companies. For SMEs commencement will be subject to State Aid discussions with the European Commission.

- Alignment of the process and time limits for enhanced deductions claims with those for the cash back claims under the SME scheme. All companies will now be required to make, amend or withdraw their claims under the R&D tax relief schemes and the vaccine research relief scheme by the first anniversary of the filing date of the tax return.

While these changes are welcome, we are disappointed that more changes, particularly for software claims by SMEs, were not included. It is also a pity that for smaller companies, the changes are in the gift of the European Commission and not the UK Government.

Leased plant and machinery

The broad principles of this reform, including the definition of a 'long funding lease' to which the new regime applies, were set out in the PBR and further details were given in the Budget press releases. The new regime will, in broad terms, tax the lessor and the lessee under a 'long funding lease' as if the lease were a loan, with the entitlement to capital allowances for the lessee and the financing charge in the lease taxable for the lessor and deductible for the lessee. The start date will be 1 April 2006 and further draft legislation and a Technical Note will be published 'before the end of March'.

Corporate capital losses

Following representations after the PBR, revised legislation has been issued for the capital loss TAARs (targeted anti-avoidance rules), along with extended guidance notes. The changes are relatively minor and the structure of the new rules remains as announced last December. However, it is noticeable that text has been added to the guidance notes to confirm that it is HMRC’s view that transactions carried out to crystallise losses in respect of genuine commercial diminutions in value will be disqualified for capital loss purposes by the new rules, unless the transactions concerned have independent commercial substance.

Sale of lessors

Little has changed since the PBR announcements. The draft legislation will be amended to take account of developments in the reform of the taxation of 'long funding leases'; and to the extent that these changes are beneficial they will have effect from 5 December 2005. These retrospective changes exclude leases of real property and many internal reorganisations from the new rules and permit certain consequential losses to be surrendered as group relief, as well as preventing double taxation. Other changes, tightening up the new rules, will be effective from 22 March 2006. Further draft legislation is to be published 'before the end of March'.

Other anti-avoidance measures

As widely anticipated, measures were announced to close down perceived 'avoidance schemes' using complex 'intra-group...
arrangements’. Various specific provisions, which appear to have arisen as a result of the disclosure regime, address different areas of perceived abuse. However, there is also recognition that a broader approach may be required in the longer term to stem the rise of similar transactions in the future. Of these seven targeted anti-avoidance measures, one was announced in the PBR in relation to stock loans and another was announced on 20 January in respect of certain arrangements relating to the sale of rights to distributions on shares. The remaining measures seek to tackle abuses arising in part from previous targeted anti-avoidance measures and new challenges presented by the move to IFRS.

It is hard to determine the precise scope or targets of some of these measures and we await publication of the Finance Bill with interest.

**Stamp duty and stamp duty land tax**

There were some welcome relaxations to the conditions for relief from stamp duty on group reconstructions. For such reliefs the acquiring company will no longer need to be registered in the EEA. Additionally, the requirement for the shareholdings in the acquiring company to mirror the shareholdings in the target company is relaxed and will be regarded as met, provided that the proportions of shares are as nearly as is practical the same.

There were also a number of announcements relating to SDLT.

- From 22 March 2006 ‘seeding relief’ for contributions of property into unit trusts will be withdrawn, presumably on the premise of countering perceived abuse, although the funds for which it was intended to provide liquidity will be hit hard.

- Reliefs relating to alternative (commonly referred to as Islamic) financing arrangements will be extended to all persons (and not just individuals).

- SDLT provisions relating to certain lease and partnership transactions will be simplified and regulations will deem certain arrangements not to amount to ‘chargeable consideration’ for the purposes of SDLT. Particularly welcome will be the simplification of the taxation of trading partnerships with large land holdings, and the removal of a potential double charge to tax on certain partnership transactions.

**Other Budget Announcements**

- As announced in the PBR, the 0% starting rate and the 19% non-corporate distribution rate are both abolished, leaving just the small companies rate of 19% and the full 30% rate, taking us back to where we were before FA 2002.

- First-year allowances for small enterprises investing in plant and machinery are being increased to 50% from 40%.

- Expenditure on British films by a ‘film production company’ (essentially a company which films, produces and delivers films) will be deductible as revenue, with a cap of 80% of total qualifying expenditure, rising to 100% for films costing £20 million or less. To qualify for these new reliefs expenditure on activities which take place in the UK must be at least 25% of total production expenditure on the film.

- Measures have been introduced to exempt the London Organising Committee of the Olympic Games Ltd from corporation tax and to provide the power to ensure that International Olympic Committee revenues and the income of non-UK-resident athletes/workers in the UK temporarily for the Games will not be chargeable to corporation tax, income tax or CGT.

- The CFC rules will be extended to UK companies which became non-resident in the UK for tax purposes before 1 April 2002, so that those companies may be treated as CFCs from 22 March 2006.

- The Budget announcement contained further proposals to tackle perceived manipulation of the rules for determining the value of oil revenue to be brought into account for corporation tax, supplementary charge and petroleum revenue tax purposes. The new rules will apply in each of these areas from 1 July 2006.

- A new relief has been introduced for trading activities carried on by charities, where only part of the trade is carried on for charitable purposes.
A new relief has been announced for income arising on service charges and sinking funds held in trust by Registered Social Landlords, local authorities and certain other bodies.

What Wasn't Mentioned

Filing dates

A consultation was announced in early December regarding the possibility that filing dates for company accounts and tax returns might be aligned and both brought forward to seven or nine months after the end of the accounting period. Representations were made in mid-February and we await the results with interest and no little concern. However, nothing was said in the Budget speech or press releases.

Taxation of intangible fixed assets

As discussed in my post-PBR article (The Tax Journal, Issue 817, 12 December 2005) certain loopholes in the regime for intangible fixed assets were closed down with effect from 5 December 2005. No further information was given with the Budget material and we assume that the changes announced will form part of the Finance Bill.

Conclusions

Overall, this was not an exciting Budget. There were no major new announcements, as almost everything had been trailed over the previous few months. It was a 'steady as she goes' Budget, with some revenue-raisers that will not hit the voters too directly (such as the oil and gas changes and the anti-avoidance provisions) and a few minor give-aways, such as for the Olympics.

On the anti-avoidance front, a few loopholes were closed and the DoTAS rules are to be extended to catch a wider range of 'abusive' tax schemes. What is of rather more concern is that some of the changes, particularly in the capital loss regime, seem to catch pieces of 'toolkit' planning that were generally considered to be acceptable best practice, even by inspectors. Now these are being labelled as 'tax avoidance', as HMRC moves the goal posts once again.

Perhaps most worrying, we are starting to see the beginnings of a reaction from industry to the new anti-avoidance environment. As the UK tax regime becomes more and more unpredictable, and further complex rules are introduced to close the 'tax gap', we are seeing groups questioning whether they should remain in the UK. The Chancellor needs to make sure that he doesn't pluck the goose so hard that its hissing stops it laying golden eggs!

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