Tax and the City briefing for January

January 2017

Year of change

2017 will be another year of change for big business. The anti-hybrids rules commenced on 1 January (with the benefit of lengthy draft guidance, which is still the subject of consultation until 10 March). Additional layers of compliance complexity pile on from 1 April, when the worldwide debt cap is replaced with the new corporate interest restriction rules (alongside a modified debt cap) and the changes to the carried-forward loss regime (see below) commence. 'Early in 2017', we are promised draft legislation for consultation on changes to the taxation of partnerships. Changes to the VAT grouping rules are under consideration, with the consultation closing on 27 February. A double Budget year, 2017 will see the last Spring Budget on 8 March followed later in the year by an Autumn Budget - two opportunities to announce further tax tinkering.

April brings more welcome changes: improvements to the substantial shareholding exemption (SSE) for disposals made on or after 1 April 2017 (see below); and the rate of corporation tax decreasing to 19%. The OTS is due to report on stamp duty on paper share transactions in the summer, so it is hoped there may be some welcome simplification (if not abolition) of at least this part of the stamp duty regime on the agenda later this year.

BEPS Action 4: updated OECD report

The draft legislation for the UK's corporate interest restriction does not contain any special rules for banking and insurance groups. By way of contrast, regulatory capital of banks and insurers is given special treatment under the UK's anti-hybrids rules. It will be interesting to see if HMRC/HMT reconsider their position in the light of the updated OECD report on Action 4, published on 22 December 2016 (see www.bit.ly/2hM6X8p), which suggests that it might be appropriate to exempt banks and insurers from the corporate interest restriction.

Tax rulings

The non-confidential version of the Commission's decision that Apple received illegal State aid was published on 19 December. Apple and Ireland have appealed against the decision and the appeal hearing is eagerly awaited. In the meantime, the decision confirms that the Commission remains determined to challenge tax rulings where it considers there is embedded State aid.

Some comfort used to be had from the notion that that the selectivity condition kept most tax rulings on 'the right side of the line'. However, the CJEU's recent judgment in the joined cases of *World Duty Free Group SA (formerly Autogrill España SA)* (Case C-20/15 P) and *Banco Santander* (Case C-21 15 P) takes a broad view of selectivity, showing that a tax system can be selective even if it is open to all business sectors.

State aid aside, multinationals with the benefit of tax rulings should also brace themselves for more international disputes about where tax should be paid (and hope that cross-border dispute resolution is quick to improve). This is because, from 1 January 2017, Council Directive (EU) 2015/2376 obliges member states to exchange information automatically on all new cross-border tax rulings

that they issue. By 1 January 2018, member states will also have to provide the same information for all cross-border rulings issued since the beginning of 2012.

Loss carry forward

Significant changes to the carry-forward loss regime will be included in Finance Bill 2017. Part of the draft legislation was published on 5 December and more is promised (most notably, anti-avoidance provisions) by the end of January. The good news is that carried-forward losses incurred on or after 1 April 2017 will be available to be carried forward and set off against other income streams and against profits from other companies within a group.

The bad news is that larger companies will be subject to a new rule that will restrict to 50% the amount of taxable profit that can be offset by carried-forward losses. As this restriction will only apply to taxable profits in excess of £5m (calculated on a group basis), the government expects that 99% of companies will be unaffected by the restrictions. Unlike the first change, the restriction will apply to historic losses carried forward, not just those incurred on or after 1 April 2017.

So companies will have to get used to operating two loss carry-forward regimes: one for pre-April 2017 losses; and another for post-April 2017 losses. The position for banks is, as usual, more complex. Banks have been subject to a restriction on the carry forward of losses (the 'bank loss restriction') since April 2015. From that time onwards, only 50% of their profits could be reduced by pre-April 2015 carried-forward relevant reliefs (trading losses, non-trading loan relationship debits and management expenses). The amount of profit that banks can offset with pre-April 2015 losses was then cut to 25% from 1 April 2016; and from 1 April 2017, banks will also have to operate the new carry-forward loss restriction to losses which fall outside the scope of the existing bank loss restriction. The government will amend the bank surcharge legislation to ensure that the bank surcharge continues to apply to the taxable profit of banking companies before the effect of losses surrendered from nonbanking companies within the group.

The insurance industry has also expressed concern that the loss restriction could reduce the balance sheet value of their carried-forward losses, which would reduce credit available for calculating their Solvency II requirement. However, the government has not been sympathetic and considers the balance sheet reduction 'an acceptable consequential impact' of the new rules.

Points to note about the loss restriction from the response to the consultation document published on 5 December are:

- The definition of group follows the group relief definition (rather than the IFRS 10 definition which was initially considered). However, additional criteria (to be provided in draft legislation by the end of January) will ensure that companies cannot easily break the group relationship to receive their own £5m allowance.

- There is no surrender of pre-acquisition carried-forward losses by target to an acquiring group for five years. The existing loss-buying rules will also apply but the time limit for considering whether a loss-buying condition (e.g. a major change in the conduct or nature of a trade or investment business) is met will be extended to five years.

- When a company disposes of all its assets that have a possibility of producing income, it can no longer surrender its carried-forward losses to other companies within the group. (This is more favourable than the initial proposal, which would have expired all of a company's losses when it went into liquidation.)

- As post April 2017 losses can be used more flexibly than pre-April 2017 losses, the loss refreshing rules will be amended to prevent pre-April 2017 losses being refreshed as post April 2017 losses.

Substantial shareholding exemption

Against the above backdrop of detailed technical legislation, the outcome of the consultation on the reform of the SSE provides something akin to light relief. While the government has (unsurprisingly) rejected a move to a full participation exemption, the conditions for the application of the main exemption are to be simplified, and a new subsidiary exemption will be introduced.

For disposals made on or after 1 April 2017, the government proposes to:

- remove the investing company trading condition – what will matter is that the company or group being sold satisfies the trading condition, not the status of the shareholder group;
- extend the period over which the substantial shareholding requirement can be satisfied from 12 months within two years prior to the disposal to 12 months within six years prior to the disposal – this will make it easier for staggered disposals to benefit from the exemption; and
- remove the post-disposal investee (target) trading condition.

The new subsidiary exemption has some striking features, as it does remove the need to satisfy any trading tests for certain 'qualifying institutional investors' (QIIs). The key features of this new exemption are:

- neither the investing nor the investee company need to satisfy trading tests;
- it is available to QIIs, which will include pension schemes, life assurance businesses, sovereign wealth funds, charities and investment trusts;
- a substantial shareholding can be smaller than 10% if the cost of its acquisition was at least £50m; and
- ownership by the QII can be direct or indirect, but cannot be traced through a company listed on a recognised stock exchange.

There will also be a proportionate exemption system where a QII holds jointly with other investors.

The rationale for this new exemption is stated to be based on aligning the tax treatment of investors who are exempt/immune from tax on gains on investments they make directly, but are currently subject to tax on gains made on investments held through UK resident companies.

There will inevitably be disappointment that other proposals have been rejected, including the suggested removal of the focus on ordinary share capital and the lowering of the 10% threshold. It is unfortunate that the opportunity has not been taken to address more of the issues that are widely felt on M&A transactions, notably:

- the inability to apportion the activities of joint ventures to the parent company when assessing the trading condition; and
- earn-out arrangements, where any future payment is not within the SSE as it is treated as consideration for the disposal of the right to such payment, and not for the disposal of the shares (or an interest in them).

What to look out for

- The Upper Tribunal hearing in *Travel Document Services and Ladbroke Group v HMRC*

(concerning a loan relationships avoidance scheme) is scheduled for 26–27 January.

- Further draft legislation on the corporate interest restriction and loss carry-forward changes, respectively, is promised by end of January.

- The Court of Appeal hearing in *HMRC v The Chancellor, Masters and Scholars of the University of Cambridge* (concerning whether investment management fees are VAT recoverable) is scheduled for 31 January or 1 February.

- The consultation period on draft Finance Bill 2017 legislation ends on 1 February.

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