Tax and the City Briefing for January

January 2018

Budget and Finance Bill 2018

With the government turning to technology companies, rather than banks, as the target for new revenue-raising measures, the banks appear to have got off lightly for once. Some welcome developments for the City are set out below.

Bank levy re-scope

It was confirmed that the rescope planned from 2021 (which will limit the application of the bank levy to UK balance sheets for UK-based and foreign banks alike) will be legislated for in Finance Bill 2018 and that some technical changes will be made to the bank levy calculation prior to that. From 1 January 2019, the largest retail banks will be required to separate core retail banking from investment banking under ring-fencing requirements. In recognition of this, for chargeable periods ending on or after 1 January 2018, Finance Bill 2018 will ensure that ring-fenced entities will not be liable for bank levy amounts arising in respect of any non-ring-fenced entity within the group (so long as the ring-fenced entity is not the responsible member for the group). To simplify administration of the bank levy, with effect from Royal Assent of Finance Act 2018, instead of the current requirement that groups annually nominate a "responsible member" to meet their bank levy obligations, there will be an option to renew automatically an entity's responsible member status.

1.5% season ticket charge

The government confirmed that the stamp duty and SDRT charge on issues of shares to (and transfers integral to capital raising to) clearance services and depositary receipt issuers will not be reintroduced after Brexit.

Postponement of gain on branch assets on incorporation

Legislation is included in Finance Bill 2018 to ensure that a corporate reconstruction involving an exchange of shares in an overseas company that previously received the trade and assets of a branch of a UK company does not end the postponement of a tax liability under TCGA 1992, section 140 because of the priority of the substantial shareholding exemption over the usual treatment of share exchanges. This change will remove a tax barrier that has particularly impacted on financial sector businesses that have traditionally operated through a network of foreign branches, and which need to restructure, for example to meet changing regulatory requirements in the territories where they conduct their business.

Corporate interest restriction

The City continues to get to grips with the complexity of the corporate interest restriction enacted in November in Finance (No. 2) Act 2017 but having effect from 1 April 2017. For multinationals to which the restriction applies, the global differences in implementation of the corporate interest restriction is an added headache. These differences result from the flexibility permitted by the OECD's BEPS project in the approach to deal with risks posed by the banking and insurance sectors (including the possibility, which the UK government did not take up, of exempting banks and insurers).

For groups with a US presence there is now the US interest restriction to contend with which is more restrictive than the OECD's recommendation. As part of the most significant reform of the US tax code in 30 years, the US has introduced a limitation on interest deductibility. For the first five years, this effectively caps the deductibility of net business interest of a US company at 30% of its share of group earnings (computed by adding back net interest expense, taxes, depreciation, and amortisation) ("EBITDA") as reflected in the group's consolidated financial statements and then, for taxable years from 1 January 2022 the restriction will be to 30% of group EBIT (so without adding back depreciation and amortisation).

The Autumn Budget announced that technical amendments to the UK's rules to ensure they work as intended will be made in Finance Bill 2018 and more in Finance Bill 2019 with some of these changes to be treated as having effect on and after 1 April 2017. It is obviously good that corrections are being made to the rules (rather than the rules having unintended consequences) but it is further evidence that the UK's corporate interest restriction is over-engineered and too hurriedly brought in and the differing commencement dates add to the complexity of the application of the rules.

Penalties for enablers of defeated tax avoidance – final HMRC guidance

A significant amount of time and resources have already been spent throughout the City and beyond carrying out risk assessments, training staff and generally getting ready for the enablers regime which, with effect from 16 November 2017, imposes penalties on enablers of defeated abusive tax arrangements.

Section 5.8 of HMRC's final guidance, published on 22 December, deals with the interaction with the Code of Practice on Taxation for Banks (the "Code") and has been rewritten since the 20 October draft. Overall, the changes are helpful to banks as section 5.8 of the guidance has been extended to explain when a bank may be considered an "enabling participant" in a customer's abusive tax arrangements, as well as when a bank may be a "financial enabler". In both cases, at the time it provided the financial product or entered into the arrangement, the guidance states the bank must know or be reasonably expected to have known, at least one of the purposes of the customer for obtaining the product or other banking service was to participate in abusive tax arrangements. (The draft guidance had required the bank to know, or reasonably be expected to know, that the customer's *main* purpose for obtaining the product was to participate in abusive tax arrangements).

The final guidance confirms that HMRC will not usually argue that a bank could reasonably be expected to know that it was facilitating abusive tax arrangements if, in complying with its existing commercial, regulatory, tax and Code requirements, it did not need to, and did not, perform any tax analysis of the transaction (paragraph 5.8.10). There is no expectation on the bank to insert additional checks or ask further questions to establish whether the purposes for which a relevant product or service is being obtained include its use in abusive tax arrangements, provided that they do have in place and follow adequate processes, taking the necessary care and attention that is required in the performance of its duties.

Final guidance on hybrid and other mismatches

The final guidance was added to HMRC's International Manual on 4 December (at the time of writing it is contained as a separate PDF at INTM850000 pending migration into the manual itself). This guidance takes into account the comments received on the March 2017 draft guidance. The examples have been improved and some re-written into a more consistent style; summaries have been added to the start of most of the examples in chapters 3 and 4; and examples that had been withdrawn in March 2017 have now been rewritten and reinstated. To help people

navigate the choppy seas of the 400+ pages of guidance, a chapter overview is now included in the form of diagrams providing illustrative and simplified examples of the main types of hybrid and other mismatch structures to which the rules in each of the main chapters of the legislation apply (INTM550100).

The interaction of the hybrids rules in TIOPA, Part 6A with other areas of the legislation, such as the distribution exemption, transfer pricing, group mismatch legislation and unallowable purpose for loan relationships, is now made clear in INTM550080. The hybrids rules do not contain a priority rule but, in general, the guidance explains that the hybrids rules will need to be considered whenever a mismatch within the scope of Part 6A arises, unless the application of other rules removes the mismatch entirely. Having said that, HMRC would expect to apply the hybrids mismatch legislation in priority to the corporate interest restriction rules and in priority to the distribution exemption. In the context of transfer pricing, HMRC explain the same result is achieved whether you do a transfer pricing adjustment first, followed by application of Part 6A to any remaining mismatch, or apply Part 6A first and then apply transfer pricing to any non-arm's length amounts remaining after the Part 6A adjustment for the mismatch.

The section on regulatory capital securities has been amended to make it clear that regulatory capital securities are not restricted to banking/insurance business (INTM551060). There is now specific mention of other financial institutions, such as investment firms, which issue regulatory instruments. As in the earlier version, the guidance then explains that excluding anything that is a regulatory capital security, for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209), from the definition of 'financial instrument' ensures that such regulatory instruments are not caught inadvertently by the hybrid mismatch rules. The reason for exemption is that these financial instruments may be treated differently under different countries' tax systems and, as a result, can give rise to hybrid mismatch outcomes. Without the exemption, these instruments could be caught by the hybrid rules even though they are issued to satisfy mandatory regulatory requirements. This would disadvantage regulated financial institutions that operate cross-border.

INTM597030 has been re-written to reflect clearance applications should be submitted directly to the Base Protection Policy Team at the email address: Teamhybrids.mailbox@hmrc.gsi.gov.uk (and copied to the customer relationship manager if there is one).

Although the guidance is described by HMRC as "final", further revisions are expected. Finance Bill 2018, Schedule 7 contains 8 pages of amendments to clarify the hybrids rules, some applying from 1 January 2017 and others from 1 January 2018. As with the corporate interest restriction, it is good that these points are picked up and acted on, but it is a shame that we are in this position because the UK pushed ahead with the hybrids rules so quickly and brought in rules going beyond the OECD's recommendations.

Insurance linked securities

The regulations to introduce a new regime for the taxation of insurance linked securities (ILS) came into force on 15 December 2017. In order to attract ILS activity to the UK and develop the UK's position as a global hub for specialist insurance and reinsurance, a new regulatory framework for ILS and a new tax regime have been introduced. The tax regulations make the tax treatment of insurance special purpose vehicles consistent with that of other investment vehicles, and investors are taxed as if they had invested in the underlying assets directly.

What to look out for:

- The deadline for comments on the draft regulations updating the rules on taxing securitisation companies (disapplying withholding from annual payments by securitisation companies) is 15 January.
- The Court of Appeal is scheduled to hear the appeal in the VAT avoidance case of HMRC v Newey (t/a Ocean Finance) on 30 January.
- The consultation on the third tranche of HMRC's guidance on the corporation tax loss reform (commencement provisions and worked examples) closes on 9 February.
- UK Finance's guidance on the failure to prevent the criminal facilitation of tax evasion is expected to be published shortly as it has now been approved by HM Treasury. There will be a link to this guidance from the HMRC part of the Gov.uk website in due course.

This article was first published in the 19 January 2018 edition of Tax Journal.

Michael Lane
T +44 (0)20 7090 5358
E michael.lane@slaughterandmay.com

Zoe Andrews
T +44 (0)20 7090 5017
E zoe.andrews@slaughterandmay.com