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TAX BRIEFING

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In this briefing we attempt to provide some insight into a number of the fiscal measures announced by the Chancellor in Monday's Budget Speech. Readers who are interested in a summary of the new measures announced on Monday may wish to review the executive summary provided by the Treasury, which can be found here.

Given the uncertain nature of the Brexit negotiations, and the ever-present possibility of an early election, perhaps the Chancellor lacked a stable foundation, in the form of a solid economic and political forecast, on which to base significant reforms to the tax code. Indeed, as the Chancellor set out early in his Budget speech, if the "economic or fiscal outlook changes materially in-year" (for which, read a 'no deal Brexit'), a new Budget would be forthcoming in the shape of upgrading the Spring Statement 2019 to a "full fiscal event". We may therefore find that some of the measures set out in this Budget are of a rather temporary nature, and that the anticipated ability of the UK to provide fiscal legislation which is less constrained by EU rules will not be visible until after Brexit.

Further detail on many of the measures will be available on 7 November 2018, when Finance Bill 2019 will be published, along with a number of other documents (including consultations and tax information and impact notices) mentioned in the Budget.

Nonetheless, the Budget brings with it some important fiscal statements. We have chosen to cover a few of the ones we see as more important for businesses in the following pages.

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Tax homepage

1. Digital Services Tax

The international debate around the development of modern tools for the taxation of the digital economy is still on going, at the level of the OECD, EU Commission, UN and a number of other international or multinational organisations. But it seems the UK government feels the pace of progress is too slow, and is proposing its own solution to the challenge of taxing significant digital economy players. A consultation document on the design of the tax is expected in the coming weeks, and draft legislation will be published in the Finance Bill 2019/20.

This is perhaps reminiscent of the position adopted by the UK in 2014: in the midst of the OECD discussion of the BEPS project the UK chose to introduce its own new form of tax to tackle base erosion, in the form of the wide reaching diverted profit tax ("DPT"). Then, as now, the reaction to the UK "go it alone" is mixed; the proposals are on the one hand headline grabbing, against the backdrop of the continuing fair share of tax debate and the sense that multinationals are able to reduce their tax burden to levels significantly below those paid by domestic or more local businesses. On the other hand, the tax is perceived in some parts of the world as politically motivated. US lawmakers and officials have already referred to the tax as a 'dangerous precedent', unilateral in nature and directed at American companies as part of the emerging global trade war. It is interesting that the UK is positioning itself in this manner at a time when Brexit is still casting significant uncertainty over the global trading position of the UK.

The subsequent paragraphs provide some further details of the proposals for the DST.

Background

The problem of taxing companies in the digital economy has arisen due to the changing nature of how and where companies do business, occasioned by the digitalisation of business practices. Many new business models in this sector have generated huge profits from consumers in jurisdictions in which they do not have a physical presence, which means that such profits are largely not taxed in the jurisdiction where the revenue representing them is earned or the consumers who allow those profits to be generated are based.

As well as the concerns raised by tax authorities, political and media pressure has arisen, with the feeling that large multinational businesses within the digital economy are failing to pay their 'fair share' of tax in the countries where, or by reference to which, their profits are generated.

The UK has expressed its preference for tackling this issue on an international basis, but given slow progress in achieving this goal, it has this week announced the new UK DST, forecast to raise £1.5bn over four years.

The government's stated aim for the tax is that digital businesses should pay tax in the UK that reflects the value they derive from UK users. The tax is intended to be narrowly targeted and will be disapplied if and when satisfactory multilateral reform of the international corporate tax framework is achieved.

The DST applies a 2% tax on the revenues of search engines, social media platforms and online marketplaces – business models which the government considers derive significant value from the participation of their users without requiring physical presence in the UK. The tax applies to the revenues of these in-scope business models whenever they are linked to UK users, which means that the location of the user is significant and not the location of the business. The government gives a number of examples:

- if a social media platform generates revenues from targeting adverts at UK users, the government will apply a 2% tax to those revenues;
- if a marketplace generates commission by facilitating a transaction between UK users, the government will apply a 2% tax to those revenues; and
- if a search engine generates revenues from displaying advertising against the result of key search terms inputted by UK users, the government will apply a 2% tax to those revenues.

Other proposed features of the tax include:

- a double threshold: businesses with revenue of less than £500m will be outside the scope of DST, and the first £25m of relevant UK revenues are also not taxable. Small businesses will therefore not be in scope;
- a safe harbour: the government will be consulting on the design of a safe harbour which is intended to ensure the DST is proportionate, and does not bite on loss making or very low margin operations; and
- a review clause: the DST will be subject to formal review in 2025. In addition, the government will disapply the DST if an appropriate international solution is in place prior to 2025.

The DST will be an allowable expense for UK Corporate Tax purposes under ordinary principles. However, given the DST will not be within the scope of the UK's double tax treaties, it is not clear to what extent it may be creditable against other direct tax liabilities of the same taxpayer.

2. Off payroll working in the private sector (IR35)

The tax rules distinguish in a number of important manners between employees, on the one hand, and self-employed workers, on the other hand. The latter are generally exposed to lower national insurance charges, and are not subject to payroll deductions. This has encouraged individuals and businesses to opt for self-employment status. In response, where workers are in economic and commercial terms operating as employees – usually through the introduction of an intermediary like a personal services company (PSC) - tax rules commonly known as IR35 apply to re-characterise the relationship as one of employment for tax purposes.

Broadly speaking, however, the IR35 rules require payroll deductions to be operated by the intermediary, as opposed to the end user. This was subject to revision in relation to public sector employers, where from 2017 onwards public sector end users were required to operate payroll deductions such that PSCs and similar intermediaries became themselves subject to payroll deductions. The new legislation proposed in the budget will extend a similar treatment to the private sector, and will therefore have the effect of levelling the playing field.

The changes, which will apply only to "large and medium-sized businesses", will mean that the responsibility for undertaking employment status assessments and operating PAYE and paying NICs will move from the PSC to the private sector end-user.

Based on concerns expressed by respondents to the government's consultation, the reforms will not be implemented until April 2020, rather than April 2019 as was originally proposed, giving organisations more time to prepare for the potentially burdensome administration involved in the changes.

Prior to implementation, a further consultation on the detailed operation of the rules will be published, with draft legislation expected in Finance Bill 2019/20 in Summer 2019. During this time, HMRC will also continue to work with stakeholders to improve the 'Check Employment Status for Tax' (CEST) online tool, which was criticised by many respondents to the consultation, and to improve its detailed employment status guidance.

Many businesses are currently heavily dependent on the use of individuals working through PSC arrangements, particularly in sectors such as IT, engineering and construction. Such businesses will need to consider how to introduce processes to check the status of their contract workers, leading to a review of existing and future engagements in order to determine any potential exposure under the new rules. Businesses will need to consider carefully whether a conservative approach to including contractors within the IR35 regime may lead to a loss of talent, while a bullish approach could result in the unwitting inclusion of unlawful tax schemes within employment supply chains, leading to potential liability under legislation such as the Criminal Finances Act 2017, in addition to payroll and NIC obligations.

3. Reform of the corporate intangible fixed assets regime

Following a consultation earlier this year, the corporate intangibles regime is to be reformed by introducing:

- a partial reinstatement of tax relief for acquired goodwill on the acquisition of businesses with eligible intellectual property, with effect from April 2019; and
- a change to the degrouping rules in respect of post-2002 intangible fixed assets, so that they are more closely aligned with the equivalent chargeable gains rules. A degrouping charge will not arise where degrouping is the result of a share disposal that qualifies for the Substantial Shareholding Exemption, with effect for degroupings taking place on or after 7 November 2018.

This latter reform is significant as it will align the degrouping rules in the intangible fixed assets regime with those in the capital gains tax regime, which is to be welcomed. This alignment also removes the need for the often complex exercise in M&A deals of having to determine whether IP is pre- or post-2002.

4. Corporate capital loss restriction

The use of carried forward capital losses will be restricted to 50% of capital gains from 1 April 2020. The measure will include an allowance that allows companies unrestricted use of up to £5m capital or income losses each year.

This measure aligns the treatment of carried forward capital losses with trading losses, changes to which were introduced from 1 April 2017.

5. Hybrid capital instruments

New rules are to be introduced for the taxation of hybrid capital instruments to ensure that they are taxed as loan relationships in line with their economic substance. Hybrid capital instruments for these purposes are instruments which allow the debtor to defer or cancel interest payments but do not carry other "significant equity features", such as provision for altering the debt amount, although provision (otherwise than at the creditor's option) for conversion into ordinary shares of the debtor or its quoted patent, or a reduction in the debt if the debtor is experiencing solvency or liquidity problems; or in order to meet a regulatory or other legal requirement will not prevent the debt from qualifying for the regime. Significantly, it is also necessary for the debtor to make an irrevocable election into the regime within 6 months of the debt issue.

The changes, which are prompted by the new Bank of England rules on setting a minimum requirement for own funds and eligible liabilities ("MREL"), replace the rules contained in the Taxation of Regulatory Capital Securities Regulations 2013 (the "RCS Regulations") but, in contrast those regulations (which applied only to banks and insurers), will apply to hybrid capital issued by borrowers in any sector (financial or non-financial). Falling within the regime should generally mean that interest on such hybrid capital instruments is deductible by the issuer. Also such instruments will be stamp duty, and stamp duty reserve tax, exempt, will be a "normal commercial loan" (so will not de-group a debtor from its parent) and will not (in certain circumstances) give rise to a taxable credit on release of the debt. However, unlike securities falling within the RCS Regulations, there will be no specific exemption from withholding tax for qualifying hybrid capital instruments, so it will be necessary to rely instead of other, more generally applicable, exemptions such as the quoted Eurobond exemption for listed debt. The withholding tax exemption will be maintained however for regulatory capital securities issued before 2019 until the end of 2023.

Also of note is that new rules are to be introduced to eliminate tax mismatches where a company has issued debt externally (for example to satisfy MREL requirements) and uses the funds wholly or mainly to lend to a fellow group company. These rules will allow the external loan relationship to be taxed on an amortised cost basis in the same way as the intra-group lending.

Most of the measures will have effect for accounting periods beginning on or after 1 January 2019, with the provisions relating to stamp taxes and the transitional provisions relating to withholding tax taking effect from Royal Assent to Finance Bill 2019/20.

6. Stamp duty on shares

A targeted market value rule is introduced with immediate effect for listed securities transferred to connected companies. Where the rule applies, the transfer will be chargeable based on the higher of the amount or value of the consideration (if any) for the transfer and the market value of the securities. Particularly given the nature of stamp duty – a voluntary tax on documents – this is a significant deviation from previous law, likely in an attempt to modernise stamp duty which currently does not contain any market value deeming provisions – and which is strictly still a voluntary tax.

In the same context, the government has also announced that it will consult on aligning the stamp duty and stamp duty reserve tax consideration rules and introducing a general connected party market value rule, which it says will "simplify stamp taxes on shares and prevent contrived arrangements being used to avoid tax". The consultation will be published on 7 November 2018.

7. Stamp duty land tax for non-residents

As announced by the Prime Minister at the Conservative Party conference, a consultation will be launched in January 2019 on the government's proposal for an SDLT surcharge of 1% for non-residents acquiring residential property in England and Northern Ireland (SDLT having been replaced in Scotland and Wales by Land and Buildings Transaction Tax and Welsh Land Transaction Tax respectively). No timeframe is given for the introduction of the surcharge but it is possible that the measure would be open to challenge on the grounds of discrimination if introduced before the UK leaves the EU.

8. Entrepreneurs Relief

Entrepreneurs Relief applies a reduced 10% capital gains tax rate on certain disposals by an individual selling shares in their 'personal company'. The relief is to be changed such that it will only apply where an individual shareholder holds a 5% interest in both the distributable profits and the net assets of the company, in addition to the existing 5% voting and share ownership tests. The government has described this aspect of the rules, as originally drafted, as a "loophole" which was being "abused". The change applies to disposals on or after 29 October 2018.

In addition, the qualifying period for shareholdings to qualify for the relief has been extended from 12 months to two years, with effect from 6 April 2019 (except where a business ceased before 29 October 2018, in which case the existing 12 month rule will continue to apply).

The first change above may be another example of HMRC closing long-standing planning practice (as mentioned in the introduction), possibly as a result of disclosures made regarding Entrepreneurs Relief (in particular where shares are issued with voting rights and nominal share capital out of kilter with their economic entitlements) under the financial products hallmark of the DOTAS regime.

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