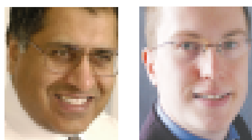
Safety first



MOHAMMED AMIN AND **NEIL EDWARDS** CONSIDER THE IMPLICATIONS OF THE BUDGET FOR CORPORATE TREASURERS.

Executive summary

- Alistair Darling's first Budget contained a number of announcements that are relevant to treasurers. This article considers the key ones.

DISGUISED INTEREST The government announced a consultation in December 2007 on a principles-based approach to financial products anti-avoidance legislation. It proposed back then to replace existing closely articulated anti-avoidance legislation with a simpler principles-based approach to ensure that companies would not be able to design schemes with a return that was economically equivalent to interest but was not taxed as interest. Such arrangements have been devised from time to time, allowing companies to receive the equivalent of interest in a low-tax or untaxed form, and have previously been targeted by specific anti-avoidance provisions.

It was originally announced that the principles-based approach proposals could come into effect as early as 1 April 2008. While companies did not necessarily object to the approach itself, there was concern that the proposals involved a fundamental change and would be brought in without proper time for consultation. They were also drafted in a manner creating considerable uncertainty for taxpayers undertaking normal commercial transactions which ought not to fall within these new rules. As a result, the government announced that implementation would be put back until Finance Bill 2009 and be subject to further consultation.

Meanwhile, a number of specific changes to existing anti-avoidance measures were announced. In particular:

Distributions Normally, distributions are non-deductible to the payer and non-taxable to the recipient company. In future, amounts treated as distributions (for example, interest on bonus debentures) will be taxable under the loan relationship rules where part of a scheme is to avoid tax.

Overseas tax credits Where tax on interest is reduced or eliminated by credits for overseas tax in circumstances where no such tax is ever borne by that company (for example, because the loan is sold cum interest), the entitlement to the credit is to be removed. This measure will also penalise any companies which invest in overseas securities and sell the securities with rights to accrued interest.

Share yield as debt Several amendments are to be made to the legislation which seeks to tax certain shares that give an interest-like return as debt. In particular, the amendments will prevent companies creating artificial deductions and ensure that returns cannot be taken outside of the rules by the introduction of volatility into the share value, or by using partnership interests rather than shares.

Convertible loans Specific provisions govern the taxation of

WHERE TAX ON INTEREST IS REDUCED OR ELIMINATED BY CREDITS FOR OVERSEAS TAX IN CIRCUMSTANCES WHERE NO SUCH TAX IS EVER BORNE BY THAT COMPANY, THE ENTITLEMENT TO THE CREDIT IS TO BE REMOVED.

convertible loans. A mismatch can arise between the treatment under UK GAAP in the lender and in the borrower due to the requirement for the borrower to bifurcate the liability (that is, account for the debt and equity components of the note separately). As a result, the finance cost recognised (and deductible) for the borrower can be higher than the finance income recognised (and taxable) by the lender. Where such an arrangement arises between connected parties, the lender is to be taxed on the excess debits such that the tax position becomes symmetrical.

Derivatives Derivatives over shares are in some cases excluded from the derivatives contracts regime and instead taxed as capital items. This exclusion is now subject to the proviso that they are not designed to produce a return equivalent to a commercial rate of interest.

CONTROLLED FOREIGN COMPANIES Also announced were amendments to the controlled foreign company (CFC) rules, designed to close down arrangements to keep companies outside the provisions. The changes involve:

Economic rights Extending the definition of a controlled company from looking solely at voting rights over the company to include companies where the greater part of the income, proceeds from a

disposal or assets on a winding up would accrue to a UK company. This change should prevent companies avoiding the CFC rules by holding the majority of the economic rights but not the majority of the voting rights in a foreign company. For example, they could arrange for the voting rights to be held by a foreign parent of the UK company or by a trust.

Trusts and partnerships Preventing the use of trusts and partnerships to take profits outside the chargeable profits of a foreign company, or to avoid the profits being taken into account as part of the gross income of a company for the holding company's exemption.

LEASING ANTI-AVOIDANCE Draft anti-avoidance legislation published in October and December 2007 seeking to counter certain arrangements involving the grant of a lease of plant or machinery for a premium, chains of leases and finance leasebacks was confirmed, but subject to some amendments intended to avoid unintentionally catching certain innocent transactions.

Concerns had been raised that the proposed rules to stop companies creating additional capital allowances by structuring certain finance leases with upfront premiums could apply to a wide range of property leases which include fixed plant and machinery. The original legislation will now be amended so as to narrow its scope.

In addition, the government announced that it has become aware of circumstances where the sale of lessors legislation may be adversely affecting commercially driven transactions. The issue is to be considered and an announcement made as soon as possible.

CAPITAL GAINS TAX The Chancellor confirmed his proposed capital gains tax reform would go ahead as previously announced in the Pre-Budget Report such that an individual's capital gains will be taxed at 18%. The taper relief rules are to be abolished, so there will no longer be any distinction between business and non-business assets. Nor will the rate of tax be dependent on the period of ownership of the asset. These reforms will result in significant winners and losers. On the one hand, tax payable on gains on personal savings and investments will typically be reduced, but on the other owner-managed businesses, private equity investors and employees will be disadvantaged.

This change also affects the relative tax burden on certain collective investment arrangements. For example, gains on unit trusts and open-ended investment companies (OEICs) held directly will be subject to 18% tax, whereas the effective tax burden remains 40% if such investments are held by a higher rate taxpayer via a single premium insurance bond.

The Chancellor confirmed the introduction of the lifetime entrepreneurs relief announced in January. Effectively, the 10% lower taper relief rate will be available for the first £1m of gains made on certain disposals of trading businesses or shares in an individual's personal trading company.

ISLAMIC FINANCE Further changes were announced to promote the City of London as a centre for global Islamic finance, continuing the process of changes to the UK tax system to ensure it is compatible with shariah-compliant financing arrangements. These include extending the stamp duty and stamp duty reserve tax exemptions for loan capital to alternative finance investment bonds (sukuk) and, subject to consultation, to provide relief from stamp duty land tax (SDLT) for property transactions to enable the issue of alternative finance investment bonds.

THE CHANCELLOR CONFIRMED HIS PROPOSED CAPITAL GAINS TAX REFORM WOULD GO AHEAD AS PREVIOUSLY ANNOUNCED IN THE PRE-BUDGET REPORT SUCH THAT AN INDIVIDUAL'S CAPITAL GAINS WILL BE TAXED AT 18%.

WHAT WASN'T INCLUDED The Budget made no mention of the taxation of foreign profits. A discussion document was published last spring, and consultation has been ongoing, with the expectation of a consultation document around the time of this Budget.

These provisions are likely to result in significant changes to the corporation tax rules:

- The taxation of foreign dividend receipts will be revised, probably resulting in an exemption for many foreign dividends received by UK companies;
- The replacement of the existing controlled foreign company regime with a controlled company (CC) regime to address concerns that the existing regime is not compliant with EU legislation. The anticipated CC regime would seek to ensure that passive income of UK and foreign companies was taxed at the UK tax rate;
- A possible restriction on UK companies' ability to deduct interest costs against their UK taxable profits. The original proposals included a cap based on a group's worldwide total interest cost;
- Revisions to anti-avoidance provisions regarding the "unallowable purpose" rule in the loan relationships and derivative contracts legislation, and replacement of the treasury consent regime with a reporting requirement;
- The much anticipated consultation document is now expected by summer 2008. Companies will be keen to understand what impact the proposals will have on the international competitiveness of the UK tax regime and what compliance burden the new rules could impose; and
- No announcements were made regarding accounting in foreign currency. Representations had been made to HMRC that many groups faced significant tax volatility on foreign exchange movements due to developments in the accounting rules governing functional currency, which may make it impossible for many companies which under UK GAAP presently account in foreign currency to continue doing so. It would appear that any relief to allow companies to avoid this volatility is some way off.

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