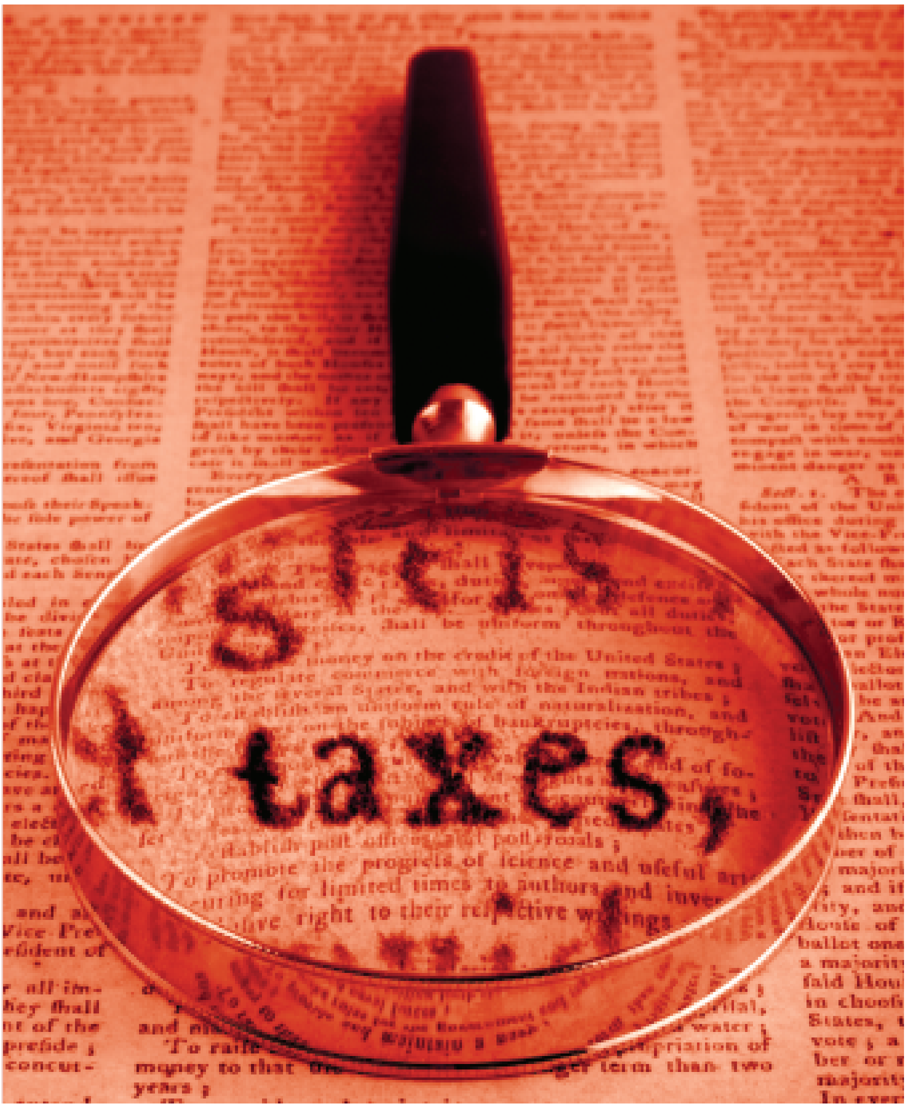
Budget fine-tunes taxation rules

ALTHOUGH ALISTAIR DARLING'S THIRD BUDGET SPEECH LACKED ANY HEADLINE-GRABBING TAX ANNOUNCEMENTS, IT DID CONTAIN A NUMBER OF CHANGES THAT TREASURERS NEED TO BE AWARE OF, AS **NEIL EDWARDS** EXPLAINS.

In the past HMRC generally accepted that if a company undertook a capital reduction and credited this to reserves, then any of those reserves subsequently distributed as a dividend would be treated for UK tax purposes just like any other dividend – that is, as income. But following the introduction of the dividend exemption regime with effect from 1 July 2009, it became apparent that HMRC considered such dividends to be capital in nature and so would not qualify for the dividend exemption. The resulting uncertainty caused by this apparent change in practice has had a significant impact on commercial transactions, with some having been put on hold until the matter is resolved.

However, in his Budget speech last month, Darling confirmed that new legislation would be introduced "as soon as possible in the next parliament" to ensure that company distributions could still benefit from the dividend exemption even though they are capital in nature. The legislation will be retrospective and there will also be an option for companies to elect for the retrospective application to be disapplied.



DEBT CAP The UK debt cap regime came into effect for accounting periods beginning on or after 1 January 2010. The rules, which seek to deny tax relief in the UK for interest expense in excess of the worldwide group's total external interest cost, formed part of the foreign profits package of measures, which also included the introduction of a dividend exemption.

HMRC has been consulting with business about anomalies in the existing rules. The resulting changes to the debt cap rules contained in the Budget include:

- results of securitisation companies will be excluded from various calculations required by the debt cap rules;
- assets and liabilities that have the economic effect of loans will be taken into account when calculating the gateway test even where the balances do not have the legal form of loans; and
- it will be made clear that limited liability partnerships cannot be the ultimate parent for the debt cap purposes.

There remain other problems with the application of current legislation. In particular, groups that have raised fixed-rate debt in the UK and entered into floating interest rate swaps may find that fair value movements recorded against the debt where hedge accounting is applied can give rise to unintended anomalies and potential tax cost. Further consultation is continuing with a view to correcting this by regulations later in the year.

Other issues that remain include the potential tax cost to groups of ignoring group companies with small amounts of net interest income from the calculations, the interaction with the late interest rules which can defer deductions for tax purposes, the treatment of transitional adjustments on adoption of new accounting standards (for example, conversion of subsidiaries to IFRS or the impact of the reform of IAS 39), and details of arrangements that will be excluded from the targeted anti-avoidance rule.

ACCOUNTING CHANGES Legislation is to be introduced to enable HMRC to make retrospective changes to tax legislation which could be affected by accounting changes, in particular the ongoing revisions to IAS 39. The proposals let HMRC introduce changes by statutory instrument to mitigate the impact that accounting changes may have. HMRC continues to consult with business on the nature of any changes that will be required as and when the detail of the accounting changes is known.

CONTROLLED FOREIGN COMPANIES The UK government issued a discussion document on 26 January 2010 on reform of the UK's rules for controlled foreign companies. The document includes proposals for the UK tax treatment of financing and treasury activities carried on in overseas group companies. Legislation enacting any reform could be introduced as early as the Finance Bill 2011.

OVER AND UNDER HEDGING As flagged in the Pre-Budget Report, legislation came into force on 1 April to make over and under hedging tax-inefficient. Over and under hedging is a technique that has been used by groups to reduce borrowing costs or increase investment returns by over or under hedging foreign exchange exposures before tax but in a way which obtains an effective post-tax hedge.

Although such arrangements are not motivated by tax avoidance, they pass onto the taxman, through tax relief, foreign exchange risks that would otherwise be borne by businesses.

From 1 April 2010 such hedging techniques have tax deductions restricted for any losses arising on the hedging instrument. Any losses arising on the hedging instrument will be available only to carry forward and set against any gains arising on the same structure in future years. Since the tax relief has been effectively denied, such structures no longer provide an effective post-tax hedge.

THIS TIGHTENING OF THE RULES WILL INEVITABLY MAKE LIFE MORE DIFFICULT FOR COMPANIES THAT ARE SEEKING TO RESTRUCTURE THEIR EXTERNAL BORROWINGS.

GROUP MISMATCH ARRANGEMENTS The term "group mismatch schemes" is used to refer to intra-group transactions which are economically neutral to the group but generate a net tax loss for it. An example is certain types of intra-group loan which gives rise to tax-deductible interest expense for the borrower with no taxable interest income for the lender.

To date, HMRC's response to such schemes has typically been to introduce targeted anti-avoidance rules. However, this approach adds to the complexity of the tax law and so increases companies' tax compliance costs.

The discussion document proposes the introduction of principles-based rules whose main principle would be that intra-group transactions should be taxed symmetrically; and that there should only be a departure from that principle where the main purpose of the arrangements was not the reduction of UK tax. The document puts forward several mechanisms for achieving the underlying principle, and invites comments.

HMRC has been encouraged by the introduction of two other sets of principles-based rules in 2009 (for disguised interest and for transfers of income schemes). It says that there have been no further disclosures of schemes which those rules were designed to block. However, it also acknowledges that the consultation process is likely to be time-consuming to ensure that the principle is correctly articulated and does not conflict with other rules.

At the earliest, the new principles-based approach would be introduced in the Finance Bill 2011.

The rules would cover transactions involving loans, quasi-loans, derivatives and manufactured payments, as group mismatch schemes have typically used these kind of instruments and mechanisms. The discussion document concentrates on transactions between UK companies, but states that HMRC would like to explore the possible extension of the principle to cross-border transactions.

In addition, the introduction of principles-based rules should enable the repeal of certain targeted anti-avoidance rules. If the principles are extended to cross-border transactions, it may also be possible to repeal the existing tax arbitrage rules.

DEBT BUY-INS If a company buys in its own debt liability at a discount to par value, then the company would normally book a credit to its profit and loss account and would be taxed on that credit.

Up until 2005, corporate groups could avoid this charge by arranging for the asset end of the loan to be bought in by a company within the group other than the borrower. Anti-avoidance legislation was then introduced to deem a taxable credit to arise in the borrower equal to the difference between the amount paid to buy in the debt and the amount shown as due under the loan in the borrower's accounts at the time of the buy-in. However, many companies took advantage of a let-out provision, intended to help in genuine company rescue situations, which avoided the tax charge by establishing newly incorporated companies to repurchase the debt.

HMRC announced in October last year that it wishes to tighten the law to ensure that only those buy-ins undertaken as part of a genuine corporate rescue will benefit from the buyback profits not being subject to tax. Hence the Finance Bill 2010 will ensure that a taxable credit will arise in the borrower unless the buy-in falls within certain narrowly defined exceptions covering corporate rescue situations (including debt for equity swaps) and debt for debt exchanges.

This tightening of the rules will inevitably make life more difficult for companies that are seeking to restructure their external borrowings, particularly as it can be difficult to ensure that the precise arrangement of any debt restructuring falls within one of the three exceptions in order to avoid a tax charge.

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