



MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS CONSIDERS WHAT THE BUDGET MEANS FOR TREASURERS.

Gordon Brown's feel-good Budget

On 22 March, Gordon Brown gave his 10th Budget. However, I assume that, unlike his 19th century predecessor Nicholas Vansittart, to whom he compared himself, the current Chancellor of the Exchequer does not expect his next job to be Chancellor of the Duchy of Lancaster. There seemed to be something in the Budget for everybody, and the Chancellor of the Exchequer looked like he was feeling very good about life.

SECURITISATION COMPANIES A special regime was applied to securitisation companies for periods of account starting on or after 1 January 2005. For a temporary one-year period, they are taxed as if they had prepared accounts under the 'old' UK generally accepted accounting principles (UK GAAP) as they applied to periods of account ending on 31 December 2004. The temporary regime is extended by 12 months to 31 December 2007, while HM Revenue & Customs (HMRC) devises a permanent regime for taxing securitisation companies.

The legislation in the Finance Act 2005 section 84 that implemented this temporary scheme included, within the definition of securitisation company, many companies issuing listed debt that one would not think of as a securitisation company. A simple example is any listed company that has more than £50m of listed bonds in issue.

These companies are accounting under International Financial Reporting Standards (IFRS) and have organised their tax affairs accordingly. Being forced to prepare their tax return under old UK GAAP could have resulted in serious adverse tax consequences, quite apart from extra compliance costs. The definition of securitisation company given in the Finance Act 2005 section 84 is narrowed, with retrospective effect, so that it excludes everything except real securitisation companies.

However, as the change is retrospective, companies that don't like it can elect out of it and retain the application of old UK GAAP for tax purposes for the two-year transitional period.

Many companies that have the right to elect may choose not to bother to minimise compliance effort. However, it is worth estimating your figures on both bases. Depending on the facts, electing for old UK GAAP to apply may save your company a material amount of tax.

ISLAMIC FINANCE As I mentioned in my article last year (*The Treasurer*, December 2005, page 34), Islamic finance is something that treasurers should bear in mind. The Budget contained further

changes to help the tax system better accommodate Islamic financing techniques.

One change in particular should help retain and develop London's leading role in international Islamic finance, by making the position of foreign investors in London more certain. One form of Islamic deposit account involves the financial institution acting as the agent for the depositor when investing the funds. The depositor, as the financial institution's principal, is paid a fixed prior share of the profits from the investment, while the financial institution which acts as agent is remunerated by keeping the rest of the profits, and may also charge the depositor/principal a fee.

Under basic tax law, when foreign principals have UK agents, the UK agent can cause the foreign principal to have a UK taxable presence (called a 'permanent establishment'). This makes the foreign principal's profits subject to UK tax. Since foreigners are generally not taxed on UK source bank interest, it would be inappropriate to tax them on the Islamic finance equivalent. Accordingly, the law will be changed so that a UK financial institution acting as an agent for these Islamic finance arrangements (called 'alternative finance arrangements' in tax law) will not cause the foreign principal to have a UK taxable presence.

LEASED PLANT AND MACHINERY As stated in the Pre-Budget Report in December, the government is proceeding to legislate a revision to the tax treatment of 'long funding leases'. Essentially, these are finance leases of more than seven years and some shorter leases, including some leases accounted for as operating leases. Capital allowances will be given to the lessee and not the lessor as is the case at present.

Since most lessors and lessees at present take the availability of capital allowances into account when agreeing leasing rates, it is likely that the change will push up leasing quotes, and make long UK-UK finance leases significantly less attractive for UK lessees. There may be some merit in UK customers leasing from an overseas lessor, depending on the final text of the legislation, although HMRC is keen to prevent any international arbitrage between different countries' leasing rules.

UK REAL ESTATE INVESTMENT TRUSTS UK REITs have been discussed for several years and have finally almost arrived. From 1 January 2007 existing property companies can elect to become

UK REITs and new ones can be formed. UK REITs that meet the qualifying definitions will be exempt from tax on their property rental income and their property gains. However, 90% of the tax-exempt profits (excluding capital gains) must be distributed as dividends, and the dividends will be paid net of 22% basic rate income tax. The government hopes that this will revitalise the listed property sector as it has done in the US and several other countries.

Throughout the development of the proposals, the government has been concerned about UK REITs being excessively geared with the resulting interest costs reducing the amounts available to pay as taxable dividends, and also about the loss of tax revenue if owners of shareholdings greater than 10% can receive their dividends free of UK tax by relying upon a double tax treaty.

Previously, the government had proposed simply prohibiting excessive gearing or shareholdings exceeding 10% with the penalty being disqualification from REIT tax treatment. The final rules address these issues in a less draconian way.

- The gearing limit is that the tax-exempt rental profits, before capital allowances or interest costs, must be at least 125% of the interest costs. To the extent that the interest costs exceed this limit, there is a corporate tax charge on the excess interest.
- Where a UK REIT pays a dividend to any person owning 10% or more of the company (a substantial shareholder), a tax charge will be levied on the company on its profits in proportion to the share attributable to the substantial shareholder. However, the UK REIT will be protected from this tax charge if it takes reasonable steps to prevent the situation arising – for example, by having a provision in its memorandum and articles precluding shareholders being entitled to dividends if they own 10% or more of the shares.

On balance, these restrictions are likely to prove acceptable to many existing listed property companies, and it is likely that a number will convert to UK REIT status. Although conversion also involves a toll charge of 2% of the market value of the investment properties owned at conversion date, this appears less onerous than some of the alternative forms of conversion charge that had been discussed, such as payment of part or all of any unrealised capital gains.

If UK REITS become a significant stock market sector, then they may be attractive to pension funds, charities and overseas investors in a way that normal property companies (with their corporate tax on rents and property gains) have not been.

EXTENSION OF GROUP RELIEF A decision by the European Court of Justice in December 2005 established that the existing rules for group relief are now not compliant with the UK's obligations under the EU treaties, so legislation will revise the group relief rules.

The changes will have no impact on group relief claims between UK companies or UK permanent establishments. They will apply where a UK parent company has a subsidiary (direct or indirect) resident in the European Economic Area (EEA – the countries of the

Executive summary

- The Budget makes Britain less business-friendly at a time when other EU countries are moving in the opposite direction.
- Real securitisation companies should check their tax position under UK GAAP and under international financial reporting standards.
- The Budget gave a further boost to Islamic financing techniques.
- Leasing legislation is to face an expected shake-up, with lease costs looking set to rise.
- UK Real Estate Investment Trusts are set to arrive from 1 January 2007 in an attempt to boost the listed property sector.

European Union plus Iceland, Liechtenstein and Norway) or has a permanent establishment in the EEA. Group relief will be available in the UK.

However, the foreign loss will only be relieviable in the following circumstances:

- Once it has been recomputed under UK tax principles;
- Where relief has not been obtained overseas;
- Where all possibilities of foreign relief have been exhausted; and
- Where future relief is unavailable in the country where the losses were incurred, or in any other country.

All the compliance obligations are placed on the UK claimant company, presumably to minimise the risk of a successful challenge that the new UK rules are discriminatory under the EU treaties.

By now, treasurers should have got the message that the UK government is not happy about having to allow such group relief.

STAMP DUTY LAND TAX: WITHDRAWAL OF UNIT TRUST

SEEDING RELIEF Stamp duty land tax at 4% is a major cost when valuable properties are sold. When stamp duty was enacted, relief was given for initially seeding a unit trust with property. The presumed objective was to facilitate the creation of unit trusts as property collective investment schemes. Property owners could use existing property to create a unit trust, prior to external investors buying the initial units or contributing cash for the issue of additional units.

It was quickly realised that this seeding relief could be used to sell a property without paying any stamp duty. The owner created a unit trust by transferring the property to seed it, free of the stamp duty. The units could then be sold to a purchaser free of stamp duty. The new owner could then extract the property from the unit trust, also stamp duty-free, or leave the property in the unit trust to facilitate a future sale free of stamp duty.

Seeding relief was abolished from 2pm on Budget day. However, this has no impact on the ability to sell existing property-owning unit trusts free of stamp duty. Many property owners will have already transferred all their large properties to unit trusts, even if no sale is imminent, to facilitate future sales free of stamp duty. From a corporate treasurer's perspective, if you want to use a relief in future, don't delay in case it is withdrawn.

A PLACE TO DO BUSINESS? The government is keen to promote the UK as a place to do business. However, several of the changes discussed here, as well as others too detailed for this article, have increased the corporate tax burden and made the UK a less certain tax system in which to operate. Meanwhile, other EU countries are changing their tax regimes to make them more business-friendly.

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