Corporate tax update

First quarter 2016

Welcome to the latest edition of our Corporate Tax Update, written by members of RPC's tax team and published quarterly. In this edition we highlight some of the key tax developments of interest to UK corporates from the first quarter of 2016. This update includes consideration of some of the major announcements and measures comprised in the 2016 Budget and the revised draft Finance Bill 2016 legislation, published in March.

2016 Budget

A number of tax measures were announced by the Chancellor in the 16 March 2016 Budget that are likely to be of interest to corporates. Also on Budget day, a *Business Tax Road Map* was published which sets out the government's business tax plans for the remainder of the current Parliament (together with an indicative timetable). The *Road Map* also reaffirms the government's commitment to the implementation of the OECD's Base Erosion and Profit Shifting (BEPS) project. more›

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VAT recovery for holding companies – Upper Tribunal decision

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VAT groups: HMRC consultation announced following *Skandia* and *Larentia + Minerva* decisions

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Other developments

First-tier Tribunal holds that "worthless" deferred shares are "ordinary share capital" for entrepreneurs' relief purposes

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European Commission publishes anti-avoidance package

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Changes taking effect in 2016/7, or otherwise to be legislated for by Finance Bill 2016, include:

Further reduction in the rate of corporation tax
From April 2020, the main rate of corporation tax will be reduced to 17%. This marks a further reduction (of 1%) in the staged decrease in the main rate of 20%, which will fall to 19% from April 2017 and had been due to fall to 18% from 2020.

Reduction in CGT rates
From 6 April 2016, the rates of capital gains tax have been reduced to 10% (from 18%) for basic rate taxpayers and 20% (from 28%) for all other taxpayers. These changes, however, do not apply to gains arising on sales of taxable residential properties, nor to carried interest to the extent subject to CGT (where the 18% and 28% rates of CGT will continue to apply).

Entrepreneurs' relief – long term investors
For shares bought on or after 17 March 2016, and subject to a (separate) lifetime limit of £10m, a 10% rate of CGT will apply to gains arising on sale of ordinary shares subscribed for in a non-listed trading company provided the shares are held for at least 3 years beginning on 6 April 2016.

Taxation of carried interest
From 6 April 2016, new rules determine when so-called "carried interest" is taxed as income, and when it is taxed as capital gain. See here for previous commentary on this change. Under the new rules, capital gains treatment will depend on how long the underlying investments are (on average) held by the scheme in question. In a change from the previous draft FB 2016 legislation, it has now been confirmed that full CGT treatment will be available if the average holding period is 40 months or more (and not four years as previously provided in the draft legislation) and income tax treatment will apply in full where the average holding period is less than 3 years, with a tapering in between these periods.

Hybrid mismatches – extension to permanent establishments
As commented on previously (see here) new rules will, from 1 January 2017, tackle "aggressive tax planning" by use of complex cross-border investment by multinational groups. The UK legislation is being introduced in response to the OECD's recommendations as part of the BEPS project (Action 2). It was announced on Budget day that the rules will also now address so-called "mismatch" arrangements involving permanent establishments. This would include, for example, the situation where a permanent establishment's profits are taxed neither in the "host" jurisdiction nor in the "home" jurisdiction.

Overseas property developers
From 16 March 2016, non-UK residents who realise profits from either (i) trading in UK land, or (ii) developing UK land with a view to selling it, will be subject to UK tax on such profits. This will be the case regardless of where any such trade is carried on, and regardless as to whether such person has a UK permanent establishment or not.

Changes to SDLT rates for commercial property transactions
From 17 March 2016, the SDLT regime applicable to non-residential property is being overhauled. A "slice" system will now apply, to mirror changes to the residential property SDLT rates applicable from December 2014.

For non-rent consideration, a maximum SDLT rate of 5% now applies, to the extent the non-rent consideration for the property exceeds £250,000. For rent consideration, a maximum SDLT rate of 2% now applies to that proportion of the NPV over £5m.

Employee shareholders – £100k lifetime limit
From 17 March 2016, a £100,000 lifetime limit of exempt gains under the employee shareholder regime will apply. The limit will only apply to shares acquired under an employee shareholder agreement entered into after 16 March 2016.

Royalties and withholding tax
The circumstances in which royalty payments are subject to withholding tax are to be widened:

- from 17 March 2016, withholding tax will apply to royalty payments paid to connected parties and that are part of arrangements designed to exploit a double tax agreement that the UK is party to
- from the date of Royal Assent of FB 2016, the definition of intellectual property will be extended to ensure that a wider range of royalty payments are subject to withholding
- also from the date of Royal Assent of FB 2016, royalty payments connected to a UK permanent establishment will be deemed to have a UK "source", so that withholding will be required.

Close company loans
From April 2016, loans by "close" companies to participators will be subject to tax at a rate of 32.5% (an increase from 25%). The applicable rate of tax on such loans will, as a result, match the dividend upper rate (also as amended from April 2016).

Changes announced at Budget 2016, but to be legislated for at a later date include:

Corporation tax losses
From April 2017, and subject to the results of a consultation, companies with "large" profits will be subject to restrictions so that only 50% of profits over £5m will be able to be offset against carried forward losses. On the plus side, and again from April 2017, all companies will be given greater flexibility as to how they can use any carried forward losses (see below).

Confirmation of new "fixed ratio" rule to limit interest tax deductions
Following the publication of the OECD's recommendations on interest expense deductibility, as part of the BEPS project, the Government has confirmed it will introduce rules to limit interest deductions by companies (see below). Following further consultation on the detailed design of the new rules, legislation will be introduced in Finance Bill 2017, to take effect from 1 April 2017.

Corporation tax for "very large" companies – instalment payment dates
It was announced that the introduction of revised corporation tax instalment payment dates, for companies with annual taxable profits of at least £20m, will be delayed to apply from April 2019 (and not April 2017 as originally intended – see previous update here).

Substantial shareholding exemption – review
The Government will consult on a possible reform of the substantial shareholding exemption (though no further details are given).

Termination payments
From April 2018, termination payments that exceed £30,000 and therefore are subject to income tax on such excess will also be subject to employer national insurance contributions.

Salary sacrifice
The Government is to consider restricting the range of employee benefits that, when provided via "salary sacrifice" schemes, deliver income tax and national insurance benefits. However, it has been confirmed that there is no desire to prevent pension savings, childcare and health-related benefits from benefiting from such treatment.

Business Tax Road Map

Building on the perceived success of the 2010 Corporate Tax Road Map published by the last coalition government, and with the stated goal of giving UK businesses greater certainty when it comes to tax, the Government has published a "Business Tax Road Map" setting out plans for major business taxes to 2020 and beyond.

Two particular plans, highlighted above, are worthy of further analysis.

Corporate interest tax deductions
In response to the OECD's recommendation under Action 4 of the BEPS project, the Government has confirmed that from 1 April 2017 a new restriction as to the ability to deduct corporate interest expenses will be introduced to the UK's tax legislation.

Under the planned *Fixed Ratio Rule*, corporation tax deductions for net interest expense will be limited to 30% of a group's UK EBITDA. It is the Government's view that 30% is sufficient to cover the commercial interest costs arising from UK economic activity for "most businesses".

A de minimis group threshold of £2m (net interest expense) will apply before the new rules apply. This will, according to the Government, mean that 95% of groups will be excluded from the new rules.

The current "debt cap" rules will be abolished, as the new rules will include provisions that ensure that a group's net UK interest tax deductions cannot exceed the group's global net third party expense.

Corporation tax loss relief
The Government plans to bring the UK's corporation tax loss rules "into line with international best practice".

First the good news. From 1 April 2017, current rules that (i) prevent carried forward tax losses from being utilised by other group companies, and (ii) require carried forward losses only to be used against corresponding profits, will be removed. In a move benefiting more than 70,000 companies (according to the Government) from 2017 companies will be able to use carried forward losses against profits from other income streams and/or against profits of other group companies.

At the same time, from 1 April 2017 there will be a restriction on the amount of taxable profits that can be offset by carried forward losses. From that date only 50% of profits can be offset through losses carried forward. This will, however, only apply to profits over £5m, which (according to the Government) means that 99% of business will not be affected.

In a further move against banks, from 1 April 2016 only 25% of bank profits can be offset through pre-April 2015 carried forward losses (previously 50%).

Back to contents>

Corporation tax – general

Supreme Court confirms VAT repayments (and interest) are subject to corporation tax

On 17 February 2016, the Supreme Court in *Shop Direct Group v HMRC*[1] held that VAT repayments (including statutory interest) are subject to corporation tax. The decision upholds those of the Tribunals and Court of Appeal.

It is well established that VAT repayments are subject to corporation tax (see here for a recent decision on this very issue). However this particular decision confirms, conclusively, that this is the case even where there have been transfers of trade, changes to VAT groups and other business changes between the date of VAT overpayment and the date of the VAT refund.

In this particular case the appellant received a large VAT repayment of nearly £125m. This mostly related to VAT overpaid by trading companies in the appellant's VAT group and by the time of receipt the various trades had been permanently discontinued. The Supreme Court held that the relevant legislation (which charges to tax any amounts received which arise from a discontinued trade) contained no requirement that, in order for a corporation tax charge to arise, the receipt must be by the original trader. Rather, the legislation was concerned with the original source of the repayment (being the discontinued trade).

The decision can be viewed here:

Back to contents>

1. [2016] UKSC 7.

VAT

Insurance claim settlement services not exempt

On 17 March 2016, the ECJ (in *Minister Finansów v Aspiro SA, formerly BRE Ubezpieczeniasp. z o.o.*[2]) ruled that claim settlement and other services provided by a Polish company in the name and on behalf of an insurance company did not benefit from the VAT exemption for insurance-related services.

This is the latest in a series of decisions that highlight the narrow scope of the VAT "insurance" exemption. See here and here for our commentary on two recent UK decisions that also illustrate the limitations of the exemption.

In this case the company, under a contract with the insurer, carried out a comprehensive range of services in connection with the settlement of claims. These services included the receipt and registration of claims, investigating the claim, taking steps to establish liability and amount of damage suffered, settling claims, conducting proceedings for third party recovery and considering appeals and complaints in respect of settlements.

The company argued that its services were indispensable to the insurer and were entirely related to the insurer's business. Therefore the services should be exempt as "insurance services" within the scope of the exemption in the EU VAT Directive[3].

The Court had little difficulty in finding that the company did not make supplies of "insurance transactions". Although the company had a contractual relationship with the insurer, it had no such relationship with the insured person.

The Court then considered whether the company provided "insurance related" services. The VAT exemption, which must be interpreted strictly, states that only insurance related services *performed by insurance brokers and agents* can fall within the exemption. The Court held that the services provided could not fall to be treated as such because the company's activities did not involve the bringing together of insurer and insured.

The UK currently does exempt the provision of claims handling services, but this decision may lead to a change in legislation.

The decision can be found here.

Back to contents>

VAT recovery for holding companies – Upper Tribunal decision

On 4 February 2016, the Upper Tribunal (in *Norseman Gold plc v HMRC*[4]) upheld the First-tier Tribunal decision that a holding company providing management services to subsidiaries, for an unspecified and undocumented charge, could not recover input tax.

HMRC argued that the holding company did not carry on an economic activity for VAT purposes during the periods for which the company sought to recover input VAT, as the company did not make supplies for *consideration*. Although the judge at the First-tier had accepted that the management services supplied by the company to its subsidiaries were capable of being taxable

2. Case C-50/15.
3. Article 135(1)(a) 2006/112/EC.
4. [2016] UKUT 0069 (TCC).

supplies, there was insufficient evidence that the parties intended any consideration to be paid for those supplies.

The Upper Tribunal held that it was not sufficient (to establish the direct and immediate link required for VAT recovery) for the holding company to have a vague intention to charge its subsidiaries for the management services at some unspecified time, and in an unspecified amount.

This decision serves as another reminder (following the *BAA* case) for holding companies to give early consideration to input VAT recovery.

The decision can be viewed here.

Back to contents>

VAT groups: HMRC consultation announced following *Skandia* and *Larentia + Minerva* decisions

On 14 January 2016, HMRC announced the launch of a consultation on the UK's VAT grouping rules, in light of the ECJ decisions in *Skandia*[5] and *Larentia + Minerva*[6]. See here and here for our earlier commentary on these decisions.

The 12-week consultation, to be launched in spring 2016, follows meetings with business representative bodies during January and February 2016. Proposals for changes to the UK VAT grouping rules will emerge following publication of the consultation responses, in summer/ autumn 2016.

Those changes are likely to include:

- allowing non-corporate bodies to join UK VAT groups
- replacing the "control" test currently required for bodies to be sufficiently linked for VAT group purposes.

The announcement can be viewed here.

Back to contents>

5. Case C-7/13.
6. *Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG v Finanzamt Nordenham* (C 108/14) and *Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* (C 109/14).

Employment taxes

Deutsche Bank and *UBS* schemes – Supreme Court finds in HMRC's favour

On 9 March 2016, the Supreme Court[7] overturned the Court of Appeal decisions in the cases involving similar restricted securities schemes separately operated by *Deutsche Bank* and *UBS*.

Deutsche Bank and *UBS* both operated similar incentive arrangements that purported to avoid income tax and national insurance. Although the details of each scheme differed, the key to the success of each was that the respective employees received shares that were "restricted securities" under ITEPA 2003. If this was the case, and provided the shares could be shown to be at risk of forfeiture and issued by a company that was not "associated" with the respective employer company, the award of shares would not be subject to tax and national insurance.

The Supreme Court held that it was capable of applying a purposive interpretation to the relevant ITEPA rules and that, in doing so, the shares were not "restricted securities". This was the case even though the ITEPA rules in question were prescriptive. Instead, the employees received awards of shares which should have been taxed under the general earnings provisions in ITEPA.

In particular, in each case the scheme provisions that would forfeit the employee's shares were held to have no genuine business or commercial purpose (other than tax avoidance). Applying a purposive interpretation of the ITEPA definition of "restricted securities", the forfeiture provision should therefore be disregarded with the effect that the shares were not "restricted" at all.

This decision is likely to give HMRC greater confidence in attacking other tax mitigating arrangements it views as seeking to exploit the ITEPA rules governing employment-related securities.

The decision can be viewed here.

Back to contents>

Upper Tribunal rules payment for injury to feelings taxable as a termination payment

On 14 January 2016, the Upper Tribunal (in *Moorthy v HMRC*[8]) held that a payment for injury to feelings, made in connection with the termination of employment and as part of a compromise agreement, was taxable under section 401 of ITEPA 2003.

In this case the employee alleged unfair dismissal and age discrimination (in connection with his redundancy process) against his previous employer. Under a compromise agreement he received £200,000 by way of compensation for loss of employment. HMRC sought to tax this amount (save for the £30,000 statutory threshold).

The Tribunal disagreed with the Employment Appeal Tribunal's view[9] as to how "injury" should be construed for the purposes of the exemption from a section 401 tax charge provided by section 406 of ITEPA. The Tribunal preferred the narrower meaning of "injury", so that only termination payments for medical conditions fall within the scope of section 406.

7. *UBS AG v HMRC* and *DB Group Services (UK) Limited v HMRC* [2016] UKSC 13.
8. [2010] UKUT 13 (TCC).
9. In *Timothy James Consulting Ltd v Wilton* UKEAT/0082/14.

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The Tribunal's decision confirms that care should be taken in apportioning any discrimination payments between those that relate to discrimination connected to the termination (always taxable under section 401 ITEPA) and those that relate to discrimination prior to termination (not taxable).

It remains to be seen whether this decision is appealed.

To view the decision, click here.

Back to contents>

Other developments

First-tier Tribunal holds that "worthless" deferred shares are "ordinary share capital" for entrepreneurs' relief purposes

On 1 March 2016, the First-tier Tribunal in *Castledine v HMRC*[10] held that a director who held only 4.99% of a company's ordinary share capital, taking into account deferred shares, did not qualify for capital gains tax entrepreneurs' relief.

The deferred shares in question had no voting rights and no dividend entitlement. They also carried no realistic expectation (on the particular facts in issue) of a right to distribution on winding up of the company. However, the Tribunal held that due to the wide definition of "*ordinary share capital*" for the purposes of the entrepreneurs' relief legislation – namely all of the issued share capital, however described, other than capital carrying a fixed rate dividend right – the deferred shares had to be taken into account in calculating the taxpayer's holding. The Tribunal also noted that the legislation requires the taxpayer to hold "at least" 5% of the ordinary share capital, affording no discretion for "almost" 5% ordinary shareholders.

The Tribunal was not willing to entertain the taxpayer's argument that a purposive approach should be applied to the definition to exclude such "worthless" shares. Rather, the Tribunal agreed with HMRC that the intention behind the requirement for relief was to provide for a simple, unambiguous threshold (of exactly 5% of ordinary share capital) that must be reached before entrepreneurs' relief will be available.

The decision can be viewed here.

Back to contents>

10. [2016] UKFTT 145 (TC).

International

European Commission publishes anti-avoidance package

On 28 January 2016, and in response to the OECD's Base Erosion and Profit Shifting (BEPS) project, the European Commission published a package of anti-avoidance measures as part of its ongoing plans to ultimately introduce a common consolidated corporate tax base (CCCTB).

The package comprises:

- a draft anti-avoidance Directive, with a minimum set of measures to be implemented into member states' domestic laws
- a draft Directive for country-by-country reporting
- a recommended "principal purpose" test for inclusion in double tax treaties.

The proposed anti-avoidance Directive is the most interesting (and controversial) element here. Although the OECD has confirmed it is compliant with the BEPS project recommendations, there are a number of key differences, for example:

- on interest deductibility: the draft Directive proposes automatic deductibility for finance costs "matched" by finance receipts (with a fixed ratio rule only applicable to the excess; it also proposes a €1m de minimis (compared to £1m as proposed by the UK's consultation; increased to £2m as announced at Budget 2016)
- "hybrid mismatches": the EC's proposals are quite different to those put forward by the OECD and would be likely to result in a different regime applying to an intra-EU arrangement as opposed to a non-EU arrangement
- exit charges: the BEPS project did not specifically address exit charges. The EC's proposals go further than current UK legislation by, for example, imposing an exit charge on asset transfers between a member state head office and a permanent establishment elsewhere in the EU.

Given the controversies and complications attached to the CCCTB project, not to mention the forthcoming EU referendum in the UK, it seems unlikely that this package will find its way into UK domestic law.

The measures can be viewed here.

Back to contents>

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