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Client Alert Commentary

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2019 — A Year of Change for UK Corporate Tax?

The UK government broadens the scope of tax on non-resident persons and contemplates changes to stamp duty, taxing the digital economy, and Brexit-related changes.

In recent years the pace of change in the corporate tax world seems to have been accelerating year on year — and 2019 looks to be no exception to this trend.

This *Client Alert* provides a brief overview of some of the most significant changes expected in 2019. In particular, measures will take effect to broaden the scope within which UK non-residents will be subject to UK tax — notably, with respect to the direct and indirect disposal of UK property through, for example, property-rich companies. This change means that non-resident companies that previously may not have needed to consider their UK tax position on account of having no UK presence, may now need to do so.

The UK government has made various amendments to the legislation governing the availability of Entrepreneurs' Relief (ER). The government implemented these measures to ensure that the relief operates as intended and that only persons with a real economic interest benefit from the relief. Many individuals holding interests with the expectation that they will benefit from ER may lose their entitlement.

As we expect and in line with previous years, the UK government continues to expand the ambit of anti-avoidance and diverted profits tax rules. We also expect to see further discussion around the introduction of a digital services tax in the UK and a number of EU Member States and a continuation of the debate regarding the global long-term solution to taxing the digital economy.

Hanging over all of these changes is the spectre of Brexit, the outcome of which, at the time of writing, remains uncertain.

Property

Taxing gains made by non-UK residents on UK property

Background

Historically, gains realised by non-residents in respect of UK property have generally not been subject to UK tax. Therefore, investing in UK property has been an attractive proposition to non-UK residents. The UK's approach to the taxation of UK property differs from the approach of many developed countries and the UK government has sought to erode this position over recent years.

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Measures coming into effect

From 6 April 2019, non-UK residents will be within the scope of UK tax on chargeable gains realised on the disposal of all UK property. The UK government has broadened the scope of tax on chargeable gains realised in respect of UK property to level the playing field between UK residents and non-UK residents and align the chargeable gains tax treatment of residential and commercial property.

The new rules will tax chargeable gains realised by non-UK residents on both:

- Disposals of interests in UK land
- Disposals of a substantial interest (broadly, at least 25%) in UK property rich entities (*i.e.,* assets that derive at least 75% of their value from UK land)

Those who are exempt from tax on chargeable gains for reasons other than being non-resident (such as overseas pension schemes) will continue to be exempt and, following lobbying from the property industry, the new regime provides for a specific trading exemption.

Business Taxation

Amendments to Entrepreneurs' Relief

Background

ER operates so as to apply a rate of capital gains tax of 10% to qualifying gains up to a lifetime limit (currently £10 million). It applies on a disposal of shares or securities of an individual's "personal company" if certain conditions are met throughout a qualifying period. Over the past 10 years, the test for a "personal company" has required a person to hold at least 5% of the company's ordinary share capital, which allowed the individual to exercise at least 5% of the voting rights. There was no requirement for the economic rights of the shareholder to match their shareholding or voting power.

Measures coming into effect

The Finance Bill 2019 introduces various amendments to the legislation governing the availability of ER. These changes:

1) tighten the test for a company to constitute a "personal company" for ER purposes, with effect from 29 October 2018;

2) extend the ER holding period from one year to two years, with effect from 6 April 2019; and

3) allow shareholders whose holdings are diluted below the 5% threshold to elect to bank their ER in respect of their qualifying period of shareholding, with effect from 6 April 2019.

The changes outlined at (1) above mean that many management teams, who previously expected their holding to benefit from ER, will lose their entitlement to benefit from the relief.

The government introduced the changes to the "personal company" definition for ER purposes and the extension of the ER holding period to ensure the ER requirements are more characteristic of genuine entrepreneurial activity and the relevant individual has a material stake in the company.

From 29 October 2018, for a company to constitute a "personal company" in relation to an individual the individual must also meet one of the following conditions:

a) By virtue of their holding in the ordinary shares, be beneficially entitled to at least 5% of the profits available for distribution to equity holders and at least 5% of the company's assets available for distribution to equity holders on a winding up

b) In the event of a disposal of the whole of the ordinary share capital of the company, be beneficially entitled to at least 5% of the proceeds

This additional test is intended to ensure that individuals benefiting from ER have a genuine economic and material stake in the business and constitute true entrepreneurs. The government introduced limb (b) in December 2018 as an alternative test to limb (a). This was in response to the widespread criticism of the initial draft legislation, which only provided for additional limb (a) and operated to deny relief in a number of common situations.

The aim of the changes highlighted at (3) above is to remove the disincentive to accept external investment if such investment would reduce some or all of the existing shareholdings below the 5% threshold.

Reintroduction of tax relief for the cost of goodwill

Background

In 2015 the UK government removed tax relief for amortisation of purchased goodwill. The government believed that removing the relief aligned the UK regime with other major economies, reduced distortion, and levelled the playing field for M&A, on the basis that such relief was available on asset acquisitions, but not share acquisitions.

In 2018 the government consulted on revising the taxation of the intangible fixed asset regime and sought views on whether scope existed to make targeted, value for money reforms, and improve competitiveness. Following the consultation, the government decided to partially reintroduce tax relief for the amortisation of goodwill in a bid to improve the attractiveness of the UK as a place to do business.

Measures coming into effect

Tax relief will be available to companies for goodwill acquired on or after 1 April 2019. Relief will be given at a fixed rate of 6.5% on up to six times the value of any qualifying intellectual property assets in the business being acquired. Qualifying assets will include: patents, registered designs, copyright and design rights, and plant breeders' rights. Relief will not be available in certain circumstances and provision has been made to deny relief for internally-generated assets.

Anti-Avoidance Measures

Taxing income from intangible assets received overseas in low tax jurisdictions

Background

Large multinational groups have sometimes been perceived as having an unfair competitive advantage by holding their intangible property, which generates significant income through UK sales, in low tax offshore jurisdictions.

Measures coming into effect

From 6 April 2019, UK income tax will be imposed on certain non-UK residents in respect of income received in a low (or no) tax jurisdiction from intangible property that is referable to sales of goods or services in the UK. The measure will apply regardless of whether there is a UK taxable presence and will apply to income receivable from both related and unrelated parties. A £10 million de minimis UK sales threshold will apply and in the event of non-payment by the non-UK resident entity, joint and several provisions will enable collection of the debt from connected parties. By introducing this measure, the UK government hopes to level the playing field for businesses operating in the UK.

International Tax

Updates to tax treaties by MLI

Background

The OECD base erosion and profit shifting (BEPS) multilateral instrument (MLI) was designed to counter perceived tax avoidance by amending a number of double tax treaties (DTAs) at once, rather than requiring numerous instruments to amend individual treaties. The MLI does this by sitting alongside DTAs and modifying them for the purposes of implementing various BEPS measures (by, for instance, adding a general anti-avoidance provision to a DTA). Broadly, each jurisdiction may elect which measures of the MLI apply to its tax treaties (and both jurisdictions party to the DTA must make the relevant election in order for such measure to affect the relevant DTA). Therefore, once the MLI is in effect and a DTA is to be relied upon, the MLI will have to be considered alongside the text of the DTA.

Impact and commencement

The MLI came into force in the UK on 1 October 2018. However, the changes to the UK's DTAs did not have effect immediately, but instead come into effect for the following taxes on the following dates:

1) Withholding taxes: 1 January 2019

2) Corporation tax: 1 April 2019

3) Income tax: 6 April 2019

However, the MLI only comes into effect on these dates if it has also come into effect in the other jurisdiction party to the DTA. When relying on a UK (or any other) DTA, it will be crucial to ensure:

- Whether the MLI applies to that particular DTA as at the relevant date it is being relied upon

- If the MLI does apply, the effect it has on the DTA and in turn the proposed transaction

This will, of course, include financings where DTAs are being relied upon to mitigate any applicable withholding tax.

The introduction of a "principal purpose test" is one of the most notable changes the MLI has made to many treaties. Under this test, if one of the principal purposes of transactions or arrangements is to obtain DTA benefits such benefits may be denied. As a result tax authorities will be looking at transaction structures more closely and looking at substance in holding company jurisdictions.

Looking Ahead

Taxation of the digital economy

Further progress is expected in 2019 in developing a global consensus on the taxation of the digital economy. Governments have had to re-evaluate the effectiveness of the current tax framework in the context of the digital economy, as it does not adequately reflect the way digital businesses create value.

Many jurisdictions tax income: (a) of a person tax resident in the jurisdiction, or (b) of a non-resident whose income is sourced within the jurisdiction. Typically, subject to certain exceptions, the ability to tax income sourced in a jurisdiction has been limited to taxing business profits attributable to a permanent establishment through which a non-resident carries on business, or imposing withholding tax on certain types of payment. The current tax rules have been developed in the context of value being created by the physical presence of people and property. Many governments believe that the digital economy requires a new regime specifically to resolve the disconnect between where income is generated and where the taxes are paid in respect of such income.

The UK government believes that while the best solution to taxing the digital economy is global reform, an interim solution is needed, pending agreement on a long-term solution within the OECD, G20, and EU. The UK government is currently consulting on introducing a 2% digital services tax from 1 April 2020. The tax would apply to revenues generated by three in-scope businesses: social media platforms, online marketplaces, and search engines. The tax would apply to such businesses with a global revenue of at least £500 million, after application of a £25 million allowance, applied on a group-wide basis. The EU Commission has also proposed an interim solution in the form of a 3% digital services tax. A number of other EU Member States have introduced, or announced their intention to introduce, their own legislation for a digital services tax, including France, Italy, Spain, and Austria.

The OECD has established a Task Force on the Digital Economy, with a view to a consensus-based solution in 2020. On 29 January it issued a policy note on addressing the tax challenges of the digitalisation of the economy following the inclusive framework on BEPS meeting on 23-24 January. The policy note sets out a strategy for future discussions and provides that international discussions are to focus on two central pillars under which the inclusive framework (a group of 27 OECD member and non-member countries) will explore proposals for updating the global tax framework in the context of the digital economy. The first pillar will focus on taxing rights and "nexus" (*i.e.*, how to determine the connection a business has with a particular jurisdiction), and the second pillar will focus on resolving outstanding BEPS problems. The proposals involve looking at (1) allocating taxing rights to market or user jurisdictions, (2) a new nexus based on significant economic presence, and (3) developing an income inclusion rule, a tax on base-eroding payments, and a coordination rule to give jurisdictions the right to "tax back" profits that are derived from jurisdictions that apply low or no taxation. A consultation document is to be issued which describes the two pillars in more detail and a public consultation is to be held in March 2019 as part of the meeting of the Task Force on the Digital Economy.

Stamp duty and SDRT consultation

Background

In general, stamp duty or stamp duty reserve tax (SDRT) is charged on a transfer of shares in a UK company at 0.5% of the consideration for such transfer. With effect from 29 October 2018, the UK government introduced a new "market value rule" for SDRT on the transfer of listed shares between connected companies whereby the consideration is calculated by reference to the higher of:

a) The consideration for the transfer

b) The market value of the shares transferred

If listed shares are transferred to a depositary receipt issue or clearance service the new rules impose a charge simply on the market value of the shares transferred. This new market value rule only applies to listed securities which, as such securities are usually traded on exchange with no written instrument being executed, should only impact SDRT (as opposed to stamp duty).

Market value rule extension

On 7 November 2018, HM Revenue and Customs (HMRC) published a consultation paper that asks taxpayers for their views on extending the market value rule described above to transfers of non-listed securities:

a) Between connected companies

b) To persons which are not companies (*e.g.*, individuals) and which are connected to the transferor (for instance, a transfer of UK shares by a company to an individual connected with that company)

The proposed extension of the market value rule potentially places a significant administrative and cost burden on taxpayers. While share valuations are already required in certain circumstances for stamp duty purposes (such as if the consideration for a transfer of UK shares is an issue of new shares in the purchaser), such valuations inevitably involve the additional cost of a valuation expert and can be somewhat subjective. In contrast, the daily published share price can simply be used for listed shares.

In addition, the extension of the market value rule may significantly impact corporate reorganisations if shares are often contributed to other group companies for nil consideration. While in many circumstances stamp duty group relief may be available to mitigate the stamp duty charge, applying for the relief can be a time consuming process, adding to the cost of commercially motivated reorganisations. In some circumstances, stamp duty group relief may not be available because one of the tests in the somewhat formulaic conditions is not met (such as a non-UK entity not being considered a "body corporate" for UK tax purposes). In these cases, the cost of the reorganisation will be increased by the charge to stamp duty and the valuation.

Other issues and what to watch for

The consultation document also suggests technical changes to the way stamp duty and SDRT are calculated for transactions that have an element of contingent consideration and suggests an alignment of the definition of consideration for stamp duty and SDRT purposes.

Responses to the consultation were due by 30 January 2019. While the details of the technical changes will no doubt be important, the potential extension of the market value rule is likely to have the biggest impact for tax payers — yet it seems unclear that such an extension will be of significant benefit to HMRC. Many of the responses to the consultation will likely make this point and how HMRC reacts will be interesting to see.

Brexit

While the UK is due to leave the EU on 29 March 2019, at the time of writing it remains unclear whether there will be a transition period before Brexit takes place, a "no deal" Brexit, or possibly no Brexit at all — or even, with the very real possibility of Brexit being delayed, when there will be any clarity on the issue. As such, making accurate predictions on the effect of Brexit on the UK tax code is impossible.

However, it is worth noting that even under a no deal Brexit, at least in the short term, the UK tax code is unlikely to alter dramatically. Given the political climate, a UK government is unlikely to repeal any of the anti-avoidance measures implemented as part of the OECD's BEPS projects — indeed the UK has often been at the forefront of implementing legislation on perceived tax avoidance. Therefore, however Brexit plays out, a complete overhaul of the UK tax system seems unlikely (at least in the short term).

Taxpayers and their counsel should consider the effect of Brexit on international tax rules applying to UK companies. As it stands, in the event of a no deal Brexit, UK companies will cease to be within the EU for the purposes of EU legislation with immediate effect. In addition, even if an agreement is entered into between the EU and UK which provides for a transitional arrangement, non-EU countries may treat the UK as a non-EU member state with immediate effect. This, for example, could impact group companies seeking to rely on provisions within certain tax treaties that avail benefits to companies within the EU — for example, the EU derivative benefits test in relevant DTAs with the US.

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