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BUDGET 2016 – INTERNATIONAL TAX ISSUES

In a nutshell

The 2016 budget included several measures that will impact international businesses. All the changes, some expected and some new, require equal and careful consideration as more information is published.

We have identified six key changes to international tax in the 2016 budget:

1. Companies who pay UK corporation tax will benefit from a further reduction in corporation tax to 17% from April 2020, while the acceleration of corporation tax payments for larger companies will be delayed until April 2019.
2. From April 2017, additional flexibility will be built into the group relief rules for carried forward losses and loss streaming, a change which will also benefit UK corporation tax payers; but this will be less advantageous for companies paying high levels of UK corporation tax because they will suffer a 50% restriction on the usage of brought forward losses against current year profits above £5m.
3. In response to the proposals outlined in the final report of the OECD's Base Erosion and Profit Shifting (BEPS) project, new rules will be introduced from April 2017 restricting UK companies' interest relief to 30%.
4. Consultations are planned to consider reforming the Substantial Shareholding Exemption.
5. New rules will be introduced to withhold tax on royalty payments.
6. There will be additional powers to tackle VAT fraud.

This briefing explains the changes listed above, examines some of the potential implications for international businesses and recommends actions that may need to be taken in response.

1. Corporation tax rates and payment dates

The corporation tax rate - currently 20% (and will drop to 19% from 1 April 2017) - will fall to 17% by April 2020, benefiting all companies who pay UK corporation tax. This drop, intended to add further stimulus to overseas investment, will give the UK the lowest tax rate in the G20.

Companies with taxable profits of over £20 million were granted further breathing space when the Government announced its decision to delay the bringing forward of corporation tax payment dates. This measure, announced previously, will now be deferred until 1 April 2019 to give these businesses more time to prepare.

2. Corporation tax loss relief

From 1 April 2017, there will be more flexibility in how brought forward tax losses can be utilised by companies who pay corporation tax. Under current rules, corporation tax losses carried forward from prior years can only be used by the company that incurred the loss; and for certain types of loss, the offset is restricted to certain types of profit. For example, trading losses can only be offset against trading profits.

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The new rules will allow companies to offset brought forward losses against profits from other income streams, as well as from other companies within the group. This welcome change should reduce the level of loss that becomes trapped in companies unable to offset it under current rules.

The picture is not so rosy for larger companies because they will be vulnerable to the change in the amount of carried forward loss that can be offset against eligible taxable profits. Currently there is no restriction for these firms. However, from 1 April 2017, the amount of profit that can be offset against losses carried forward will be capped at 50% of the amount of profits in excess of £5 million. Where the company is in a group, the £5 million profit threshold will apply to the group.

3. Interest deductibility

In response to proposals outlined in the final report of the OECD's BEPS project, released last year, new rules will limit the corporate tax deductibility of interest expenditure that large multi-nationals can claim from 1 April 2017. These rules will be applied after a consultation expected this summer. Previously, interest deductions were based on an arms-length principle, taking into account the fundamentals of each business - an approach that yielded, in many cases, deductions of well over 30%. The new rules work differently and will have a significant impact on the amount of interest a group can take.

A fixed ratio rule will limit corporate tax deductions for net interest expense to 30% of a group’s UK earnings before interest, taxes, depreciation and amortization (EBITDA). There will also be a group ratio rule for groups with high external gearing for genuine commercial purposes, replacing the current worldwide debt cap regime. In order to ensure large businesses comply with this new rule, there will be a *de minimis* group threshold of £2 million net UK interest expenses.

4. Substantial Shareholding Exemption (SSE)

The SSE was introduced 14 years ago to prevent tax from acting as a barrier to commercially desirable business sales or group restructuring. A consultation planned in 2016 will examine the possible reform of the SSE for corporate capital gains. The current rules provide relief from UK corporation tax for capital gains on share disposals by corporate entities where certain conditions are met.

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5. Royalty withholding

The regime for calculating the deduction of tax at source will now include all international royalty payments arising in the UK within the charge to income tax, unless those taxing rights have been given up under a double taxation agreement or the EU Interest and Royalties Directive.

UK withholding tax will apply to a wider definition of royalty payments. There will be a domestic anti-treaty abuse provision to prevent royalty payments being paid to tax havens without the deduction of tax via the use of conduit companies. Withholding tax will apply to payments that are attributable to a UK permanent establishment, even if the payment of the royalty is not made from the UK.

The new rules will apply to royalty payments made under tax avoidance arrangements from 17 March 2016 but the change to the source rules for royalty payments connected with permanent establishments in the UK and the expansion of the definition of royalties will affect payments made on or after the date of Royal Assent of the 2016 Finance Bill.

6. VAT Fraud

Before the spring is over, the government plans to consult on a new penalty for participating in VAT fraud. In order to tackle online fraud in goods, it is proposed that HMRC will be given stronger powers to direct the appointment of a VAT representative and greater flexibility to improve security. HMRC will also be able to hold an online marketplace jointly and severally liable for the unpaid VAT of an overseas business that sells goods in the UK via its website.

7. Conclusion and Recommendations

In response to the changes to international tax described above, we recommend the following actions:

- **CORPORATION TAX RATES AND PAYMENT DATES**: Although cash flow will be improved by the reduction in corporate tax rates, larger companies will need to plan ahead to ensure they are prepared for the acceleration of tax payments in 2019. The changes will also affect accounting for deferred tax assets and liabilities. Companies should review these positions in their accounts to ensure they are reflected at the appropriate blended rates. Disclosure of the associated impact may, in certain instances, be required in financial statements.

- **CORPORATION TAX LOSS RELIEF:** Companies may need to review decisions on when to claim tax allowances on capital expenditure. The changes will also have tax accounting implications in relation to the value of associated deferred tax assets. The way businesses are structured should be reviewed to take account of these implications.

- **INTEREST DEDUCTIBILITY**: The new rules will encourage groups to try and ensure that debt is allocated amongst group members in line with where EBITDA is generated. Given the likely practical challenges of this, all UK companies and groups with net interest expenses above the £2 million threshold should review their finance arrangements and ensure they understand how the new rules will impact their particular circumstances, following the summer consultation.

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- **SUBSTANTIAL SHAREHOLDING EXEMPTION:** Changes to the SSE regime could affect all UK corporate entities with substantial shareholdings in investments and/or subsidiaries. Companies should bear this in mind when thinking about future disposals or restructuring, and keep up to date on the developments in this area.

- **ROYALTY WITHOLDING**: The proposed new rules are expected to apply mainly to companies. Groups who think they might be affected by these changes should review their royalty arrangements in order to understand the impact.

- **VAT FRAUD:** Following consultation, legislation expected in 2017 is likely to continue the government's tough stance on VAT fraud. There will no doubt be an opportunity for businesses to voice their opinion during the consultation and so those wishing to do so should keep up to date on the progress of this proposal.

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