TRAVERS SMITH

International Tax Update

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The UK is now settling into life under its first formal coalition government since the Second World War, between the Conservative and Liberal Democrat parties. The May general election also delivered only the second change in government in the UK since 1979. With these political changes, and the public finances suffering from the effects of the financial crisis, UK tax policy is in a state of flux. Some of the key points of interest to our international friends are summarised below.

"The most fundamental and far-reaching reform of our corporate tax regime in generations" – but what, and when?

In delivering his emergency Budget on June 22, Chancellor George Osborne certainly did not undersell the corporation tax reforms which are in the pipeline. To start with, we are promised rate cuts of 1% per year for four years from 2011, bringing the headline rate down to 24%. In keeping with the Government's declared philosophy of "less breaks, lower rates", this is being paid for in part by a trimming of the depreciation allowances available on purchases of plant and machinery, where the main 20% rate is being cut to 18%.

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However, a rate cut – even quite a large one – and a minor adjustment to depreciation relief certainly do not add up to anything most people would regard as a fundamental and far-reaching reform. More is promised in the autumn (originally it had been expected as part of the June Budget), and it seems that the areas to be watching will be:

- moving to a more territorial-based, rather than entity-based, tax system. This approach is likely to be seen most clearly in the completion of the review of the taxation of foreign branches and in the conclusion of the long-running consultation on the controlled foreign companies regime;
- a review of relief for corporate interest payments. Even with the introduction of the very complex and much criticised "world wide debt cap" from January this year, the UK's regime is still generous by international standards. Any changes are however unlikely to come soon given the difficult policy issues which would need to be resolved;
- whether the system will be materially simplified (an Office of Tax Simplification has been created, but there is more than a degree of scepticism as to what it might achieve); and
- whether the mooted General Anti-Avoidance Rule will come into being. This was a key plank of Liberal Democrat tax policy for which the Conservatives have historically shown no enthusiasm. The proposal is currently out for consultation, but we would be surprised if any more came of it than the last time it was on the agenda in the late 1990s.

Taxing the banks

A new levy on banks was announced in the June Budget. This is intended to be effective from January 2011 and, whilst the Chancellor indicated that France and Germany had agreed to introduce similar measures, the UK appears to be prepared to introduce this measure alone if necessary. At this stage the levy is expected to take the form of an annual payment of a small percentage – after a phasing in period, 0.07% - of banks' total liabilities (excluding a limited number of specific categories of liability).

The details of the measure remain subject to consultation over the summer, but the basic shape of the levy seems to have been decided. It clearly has much in common with the measures suggested by the IMF in their report to the G20, although the government has made it clear that the levy will be used for general expenditure rather than being put aside to form a reserve fund to deal with the costs of future crises. The intention is to raise around £2.5bn per annum, although some press coverage has reported the IMF as believing that given the size of the UK banking sector the target figure should be more in the region of £6bn.

The territorial scope of the new bank levy is particularly interesting, especially given the new government's stated aspirations in relation to corporation tax. It will apply by reference to the consolidated worldwide liabilities of any UK headed bank group – so, in other words, not territorially at all, cutting across the eventual aim of the upcoming corporation tax reforms – as well as to the liabilities of UK branches and subsidiaries of overseas bank groups.

Since the tax is entirely new in form, it will not be covered by any of the UK's existing tax treaties. There is therefore an obvious scope for double taxation if, as the UK hopes, other countries introduce similar taxes. This is acknowledged by the government in its July 13 consultation document on the bank levy, but at the time of writing it can say no more than that "the Government is considering the impacts and need for mechanisms to alleviate double taxation and will urgently take forward discussions with other countries that plan to introduce bank balance sheet levies".

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Separately, the government is still hoping to introduce a "Financial Activities Tax" on the profits and wages of banks, but appears to believe that to go it alone with this measure would place the UK at an unacceptable competitive disadvantage and so it is seeking international agreement on the measure. A financial transactions tax, or Tobin tax, of the type previously advocated by Gordon Brown, appears to be off the table at least for the time being.

Quite apart from the double taxation issue, which has the potential to be very time consuming to settle if other countries do follow the UK's lead, there are an enormous number of points of detail which need to be resolved, in particular around identifying liabilities which attract the tax. The January 2011 date for introduction feels a little optimistic, and given the legislative timetable there is also a clear danger that this tax will follow the unhappy example of last year's one-off "bank payroll tax" on bonuses, and come into force prior to the enaction of the legislation creating it.

Headline rate changes

The UK is increasing its VAT rate from 17.5% to 20% with effect from 4 January 2011. This is the key revenue raising measure from the emergency Budget. The new rate is almost exactly the EU average, although the VAT base in the UK – i.e. the range of goods and services subject to VAT at the standard rate – remains narrower than in many other countries.

The rate of capital gains tax paid by individuals earning more than £37,400 (including the gain) has been increased to 28% from 18% for disposals after Budget day. "Entrepreneur's relief", available (broadly) to holders of 5% or more of the shares in a trading company for which they work, and reducing the tax rate on a qualifying gain to 10%, has been greatly extended so it is now available on the first £5m of lifetime gains, increased from £2m.

The new 50% top rate of income tax on incomes over £150,000 announced by the previous government came into force on 6 April. Again as previously announced, the various rates of National Insurance (NI) will all be increased by 1% from 6 April 2011.

"Treaty Passports": a new, streamlined treaty procedure for interest payments

Independently of the Budget, the government has announced that a new procedure for claiming treaty relief from UK withholding tax on interest will be available for those wishing to take advantage of it from September. This will replace the existing Provisional Treaty Relief ("PTR") system for single lenders. A new "Syndicated Loan Scheme" is reasonably imminent which will improve the existing PTR system for syndicated loans. The new rules will apply to corporate lenders only.

The new system will allow for overseas corporates to apply for a "Double Tax Treaty Passport". On getting one, the lender will be issued with a passport number by HMRC which will be put on a publicly available database. A borrower from that lender will then be able to treat the relevant treaty as applying from day one of the loan, even where the borrower and lender are connected. There will be no need to make a formal treaty application (unlike under PTR), although the borrower must notify HMRC promptly that it is relying on its lender's passport. Even under the new scheme, HMRC will issue a direction permitting gross payment but they expect this process to be rapid (and it will be of limited significance since the procedure will permit gross payment pending receipt of the direction).

If the treaty passport scheme is applied with a light touch, it will be a giant step forward from the old PTR system.

Passport holders will be required to operate with "utmost good faith", and with a "genuine and full self assessment that all conditions for relief are truly met with any loan chosen to be passported". They must also declare that they will not use their passport in cases where there is any question that they might not beneficially own the interest (ie in a situation to which the Indofoods case might apply).

At the time of writing, HMRC is also promising (or threatening) various enforcement and audit procedures to make sure that lenders are not abusing the scheme. Slightly worryingly, HMRC also reserves the right not to apply the scheme to a particular loan or borrower. It is not clear at this stage why it might do this, or whether the non-withholding borrower will be considered in breach of its obligations in such a case (as is the case with PTR where a direction permitting gross payment is not eventually issued).

Whilst this system offers the possibility of being extremely helpful, its true value will depend on the fine tuning which will take place over the next few months. If HMRC's audit activity proves to be onerous, or if the exposures to a withdrawal of relief (and consequent imposition of interest and penalties) are felt too great, the scheme will not prove popular with either lenders or borrowers. On the other hand, if it is applied with a light touch, it will be a great step forward from the old PTR system.

Employee incentives: a reminder of what's on offer

In the UK there is a group of employee share incentive plans that, provided specific rules are followed, give participants favourable tax treatment. These are known collectively as "approved plans" and, broadly, fall into two categories; those that must be offered to all eligible employees (All-Employee) and those where the Board of Directors can select its participants (Discretionary Plans).

There are currently two approved All-Employee plans available to companies. Under the Save-As-You-Earn or "SAYE" plan, employees are granted an option to buy shares in the company (paid for by salary deductions of £5 to £250 per month) at a discount of up to 20%. The terms of the plan are that participants can only exercise their options using the proceeds of a tax approved savings contract that lasts three or five years. The normal charge to income tax and National Insurance ("NI") does not then arise on exercise of the option (though any gain on the sale of the shares will fall within the CGT regime in the usual way).

The Share Incentive Plan or "SIP" is an All Employee share ownership plan under which participants can be given a variety of awards such as free shares worth up to £3,000 per tax year, the opportunity to buy partnership shares worth up to £1,500 per tax year and the offer of matching shares on the basis of up to two free shares for every partnership share purchased. The shares are held in a special form of trust set up for the SIP and, provided they are left in the trust for at least five years, can be taken from the trust free of income tax and NI. Any growth in the shares' value whilst held in the trust also escapes capital gains tax.

The approved Discretionary Plans are the Company Share Option Plan (CSOP) and Enterprise Management Incentives (EMI). These are both share option plans that offer exemptions from income tax and NI on exercise provided certain conditions are met. There are, however, limits on the value of shares that a participant can hold under such options. EMI is a more flexible plan than CSOP because options can be granted with a discounted exercise price and there is no minimum holding period. The eligibility criteria for EMI are also less stringent which makes them attractive to private companies. Historically, some overseas companies have struggled to meet the EMI condition that requires its trade to be carried on wholly or mainly in the UK. The rules for EMI will soon be changed so that a company with a permanent establishment in the UK will be able to grant awards (provided the other eligibility criteria are also met). Under both CSOP and EMI it is common for companies to make the exercise of options dependent upon the company meeting financial performance targets.

Approved plans remain attractive in spite of the recent increase in the rates of capital gains tax. A 28% capital gains tax charge is clearly preferable to paying income tax and NI at a combined rate of 42% or even 52% (including the April 2011 NI increase), and for companies there is the advantage that they can escape employers' NICs (which, from April 2011, will be charged at 13.8%). It is also possible for individuals to reduce their capital gains tax exposure by timing their disposals to take advantage of their annual capital gains tax free allowance (currently £10,100) and using other exemptions and reliefs.

It is quite often possible to structure an existing plan operated by a non-UK company as a UK approved plan, thereby benefitting from the tax advantages set out above. This is usually done by creating a UK sub-plan to the main plan which is amended to satisfy the relevant statutory criterion and approved by the UK Revenue authorities.

How to find out more

If you have any questions or would like to know more about how these issues may be relevant to you, please contact Simon Yates, Mahesh Varia or your usual contact in the Travers Smith Tax Department.

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