UK Government Budget Continues to Target Tax Avoidance

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The Budget handed down on March 22, 2006 confirms that, following the introduction of the tax disclosure rules in the Finance Act 2004, the Government is continuing to introduce specific anti-avoidance legislation to address tax avoidance schemes which have been disclosed. The disclosure rules themselves are also to be amended, to extend their scope. This memorandum describes these and certain other new measures of interest.

Tax Shelter Disclosure Rules

Two main changes will be made to the tax shelter disclosure regime that was introduced in the Finance Act 2004,[1] so far as it relates to corporation tax, income tax and capital gains tax.

First, the general scope of the regime will be extended. Under existing rules, only tax shelters which involve certain types of employment arrangements or financial products are required to be disclosed. Under the new rules, there will be no such limitation.

Second, a commonly used, but often difficult to apply, exemption from disclosure (often known as the "filters") will be abolished. The exemption currently applies where: (i) a promoter of a scheme would not be able to obtain a premium fee for it, (ii) a promoter would not reasonably want to keep the scheme confidential from other promoters and (iii) if the scheme involves a financial product to which a promoter is a party, the terms of that financial product are not off-market. Instead of filtering disclosures in this way, the rules will in future apply if a scheme has one of a number of different "hallmarks". The hallmarks will fall into three categories:

1. generic hallmarks targeted at new and innovative schemes, which will be based on the premium fee, confidentiality and off-market terms filters mentioned above;

[1] Described in our alert memo "U.K. Tax Shelter Reporting Rules Introduced" dated August 10, 2004.

2. a hallmark targeted at mass marketed products; and

3. hallmarks targeted at areas that HMRC consider to be of particular concern, which will include schemes intended to create tax losses to offset income or capital gains tax and certain leasing schemes.

It will still be the case, however, that no disclosure will be required if obtaining a tax advantage is not one of the main benefits expected to arise from a scheme.

Some other changes will also be made to the rules as they apply to schemes devised for use in-house. Small or medium sized enterprises will be exempted from disclosing such schemes and the general time limit for disclosure will be reduced to 30 days.

The above changes will apply to schemes that are made available or implemented on or after July 1, 2006. It is not yet clear, however, whether schemes that were made available or implemented for the first time before that date, and are then made available or implemented in substantially the same form after that date, will be grandfathered.

Group Relief Rules

Following the decision of the ECJ in December 2005 in the Marks & Spencer case that certain aspects of the UK's group relief rules were in breach of EU law, the Government has given further details of how the rules will be changed to become EU compliant.[2] As anticipated the proposed changes extend the availability of group relief to the minimum extent necessary to achieve EU compliance.

UK resident members of a group of companies will be entitled to utilize the losses of members of the group resident in an EEA state (or losses incurred by a non-resident member of the group in a permanent establishment in the EEA) only if all possibilities of relief have been exhausted and future relief is unavailable in any other country. The quantum of any such losses must be recalculated under UK principles and the announcement emphasizes that the onus will be on the UK company to establish the availability of the loss in the UK. It is likely that in many cases the foreign subsidiary's business will need to be wound up before the loss becomes completely unrelievable overseas and thus available in the UK. There will also be rules determining the priority of entitlement to utilize the loss where there is a third country company in the chain between the UK company and the loss-making company.

[2] See our alert memo "Marks & Spencer: UK Government Cut Their Losses" date February 21, 2006.

The changes will take effect from April 1, 2006. As mentioned in our earlier alert memo, anti-avoidance provisions will take effect from February 20, 2006 to prevent artificial attempts to make losses unrelievable.

Introduction of REITs

Following the publication of draft rules on REITs in December 2005, further details have now been released.[3]

No further changes to the draft legislation have been released, although the guidance notes to that draft legislation have been updated. Details of the charge on conversion into a REIT have been announced. It will consist of a 2% "entry charge" levied on the market value of investment properties held by a company upon its joining the REIT regime. A few other changes to the regime will also be made, including a cut in the required distribution rate from 95% to 90% and a change to the financing cost: profit ratio.

As previously announced, the regime will take effect from January 1, 2007.

Revenue Responses to Tax Shelter Reporting

As in 2005, a number of specific anti-avoidance measures will be introduced to counteract tax advantages derived from schemes of which HMRC has become aware as a result of tax shelter reporting. These include new rules that are intended to prevent the following:

1. the use of cash-collateralized stock loans with no provision for manufactured payments in order to avoid tax on interest;

2. the purchase and sale of rights to distributions on shares by financial traders in order to create tax losses;

3. the use of mandatorily convertible securities to avoid tax;

4. the use of intra-group arrangements to avoid tax on income arising to the group or to create a loss when the group as a whole suffers no economic loss. These include certain schemes -

    a. that take advantage of the group continuity rules relating to loan relationships and derivative contracts,

[3] See our alert memo "UK Government Publishes Draft Rules on REITs" dated December 20, 2005.

b. that exploit accounting rules that result in profits on loan relationships being de-recognized in certain circumstances,

c. that result in an investor in a loan relationship receiving a less than commercial (taxable) lending return where a connected party receives the value of the return in an non-taxable form, or

d. that use currency hedges to obtain tax relief where there is a loss on the hedge but no tax charge where there is a profit;

5. the use of alternative guaranteed exit arrangements in order to fall outside the "redeemable shares" requirement of the new rules introduced in the Finance (No 2) Act 2005 that treat certain shares as debt;

6. the contrived creation of corporate capital losses, the buying of capital gains and losses, the conversion of income streams into capital gains and the creation of capital gains matched by income deductions where the gains are franked by capital losses;

7. the avoidance or deferral of income tax and/or NICs by the use of employment related securities options. Where a tax avoidance purpose is present, the option itself will be treated as a security, which unlike options generally may be taxable on acquisition. Employment related options that do not give a right to acquire securities will also be taxed in the same way as securities rather than options. As previously threatened, the changes will take effect from December 2, 2004, which will raise interesting questions in respect of employees who have already acquired such rights.

With the exception of items 6 and 7 above, no draft legislation has yet been published in connection with these new rules. Until that happens, which should be when the Finance Bill is released in the next few weeks, it remains to be seen whether the provisions will turn out to apply more broadly than in the targeted circumstances identified in the announcements.

Notable also in this context is an announcement from HMRC that they are examining the scope for adopting a common approach to avoidance schemes that are based on the same theme (such as the grouping theme targeted in item 4 above). This may be a forewarning of further more generalized sets of anti-avoidance rules to be introduced in the future.

Stamp Duty: EU Compliance

Under current rules an exemption from stamp duty is available for certain company reconstructions. The requirements that must be satisfied to obtain the relief are very strict. In 2005 HMRC changed its practice with respect to the relief, in order to make the rules compliant with EU law, by waiving the requirement that the acquiring company is registered in the UK if it is in an EEA state. The requirement relating to the place of registration of the acquiring company is now to be abolished, rendering this concession obsolete and enabling non-EU acquiring companies to benefit from the relief. In addition the extremely strict requirement that there is no overall change in the ownership of the company is being slightly relaxed to make the relief more practical in its application.

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