2015 SUMMER BUDGET ANNOUNCED IN U.K.[1]

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Investment Managers
Non-Dom Taxation
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The first Conservative budget for nearly two decades set out plans to cut welfare spending; commit to not raising income tax, National Insurance, or V.A.T. for the lifetime of this parliament; boost the minimum wage; and move the U.K. from a lower wage, higher tax, higher welfare economy to a higher wage, lower tax, lower welfare country. Large corporations appear to be winners, while individuals who have benefitted from the special treatment for non-domiciled individuals and hedge fund members benefitting from carried interests are the losers. The crackdown on tax avoidance continues to be a dominant theme.

CORPORATION TAX – REDUCTION IN RATE

The main corporation tax rate for April 1, 2016 is set at 20% for all profits other than ring-fenced profits from oil activities. The rate for all non-ring-fenced profits will reduce to 19% from April 1, 2017 and will further reduce to 18%, with effect from April 1, 2020.

NON-DOMICILED INDIVIDUALS – PERMANENT NON-DOM STATUS TO END

Individuals who are resident and domiciled in the U.K. are taxed on their worldwide income and gains. Individuals who are resident but not domiciled in the U.K. ("non-doms") may claim the benefits of remittance basis taxation so that they are taxed only when foreign income and gains are remitted to the U.K. Long-term non-doms are able to claim the remittance basis but are usually required to pay a remittance basis charge ("R.B.C.") of between £30,000 to £90,000 per annum for the privilege of retaining that status. The charge increases with the length of time non-dom status is maintained.

U.K. domiciled individuals are subject to inheritance tax ("I.H.T.") on worldwide assets. In contrast, non-doms are usually subject to I.H.T. only in relation to U.K. property, modified by certain anti-avoidance rules. For example, non-doms who are long-term residents are deemed to be U.K. domiciled for I.H.T. purposes after being resident in the U.K. for 17 of the most recent 20 tax years. As a result, they are liable to I.H.T. on worldwide assets. These long-term non-doms can lose their deemed domicile status only by being non-U.K.-resident for four tax years.

Some U.K.-domiciled individuals may acquire non-dom status by leaving the U.K. to settle in a foreign country on a permanent basis. Often, if they return to the U.K.

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their U.K. domicile status reverts on their return, but in a small minority of cases, they may assert that they retain their non-dom status for some time.

Some non-doms settle offshore trusts. Provided the trust does not have any U.K.-source income and the individual does not remit the trust income to the U.K., the trust income may not be subject to tax in the U.K. Further, "excluded property trusts" may not be subject to I.H.T.

From April 2017, an individual who has been resident in the U.K. for 15 of the most recent 20 years will be taxed on worldwide income and gains. There will be no special grandfathering rules for those already in the U.K. The government will consult on whether split years will count toward the 15 years. They will also consult on the need to retain a *de minimis* exemption beyond 15 years where total unremitted foreign income and gains amount to less than £2,000.

In addition, an individual who has been resident in the U.K. for 15 out of the last 20 years will be subject to I.H.T. on worldwide assets. Individuals born in the U.K. to U.K.-domiciled parents will no longer be able to claim non-dom status if they leave the U.K. but then return and take up residency.

Special new rules will apply to offshore trusts. Non-doms who have set up offshore trusts and are deemed domiciled under the 15-year rule will not be taxed on the trust income and gains that are retained in the trust, and such excluded property trusts will have the same I.H.T. treatment as at present, subject to I.H.T. changes regarding the taxation of residential property, discussed below. Such individuals will be taxed on any benefits received from trusts on a worldwide basis from April 2017. Further details will be available during consultation.

Non-doms need to review their tax arrangements. Some long-term residents may wish to leave the U.K. before the new rules take effect and advice should be sought in this regard. Those that wish to remain and those coming to the U.K. will need advice on the new tax reality.

NON-DOMS – I.H.T. ON RESIDENTIAL PROPERTY CHANGES

As mentioned above, individuals who are domiciled (or deemed to be domiciled) in the U.K. are subject to I.H.T. on worldwide assets. In contrast, non-doms are subject to I.H.T. only on assets situated in the U.K. Foreign assets are excluded from the scope of I.H.T.

Where U.K. residential property is held directly by a non-dom individual, it is subject to I.H.T. at 40%, as reduced by applicable relief measures. If the non-dom individual holds shares in an offshore company that holds the U.K. property ("enveloping"), there is no I.H.T. charged upon death because the non-dom holds non-U.K. property – the shares in the offshore company. Similarly, offshore trusts are subject to I.H.T. on holdings of U.K. property but may avoid such charges by enveloping the property within an offshore company.

With effect from April 6, 2017 the government intends to amend the I.H.T. rules so that non-doms and offshore trusts owning U.K. residential property through an offshore company, partnership, or other opaque vehicle will pay I.H.T. on the value of

that property. This will be achieved by changing the status of the shares of offshore companies or similar structures to the extent that they derive their value directly or indirectly from U.K. residential property. The foreign shares will no longer be treated as excluded property

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Where the company holds a number of assets, only the value of the residential property should be subject to tax. A deduction should be available for borrowings taken out to purchase the U.K. property, and the spousal exemption and other forms of relief may also apply.

The rules will only apply to U.K. residential property and not to U.K. commercial property or other U.K. assets. A special exemption will apply to widely-held vehicles that hold U.K. residential property.

The government will consult on the implementation of the proposals and further details will be provided in the consultation.

This is the latest line of attack on the holding of U.K. residential property through offshore corporate structures. The rules follow the introduction of the Annual Tax on Enveloped Dwellings ("A.T.E.D.") in April 2013 and the non-resident capital gains tax ("C.G.T.") in April 2015. Like the A.T.E.D. rules, the intention of these new rules is to encourage the de-enveloping of U.K. property.

In this respect, the A.T.E.D. rules were largely unsuccessful. Many retained corporate holdings of U.K. property because of the I.H.T. benefits and the tax costs associated with de-enveloping. It is intended that the new rules will remove such I.H.T. advantages. The government has also indicated that it will consider the costs associated with de-enveloping during the course of the consultation. As a result, it is expected that many corporate structures will de-envelope U.K. residential property in the coming months.

ANNUAL INVESTMENT ALLOWANCE PERMANENTLY INCREASED AT A REDUCED LEVEL

Since January 2013, an annual investment allowance ("A.I.A.") has been available to provide businesses with a 100% deduction for qualifying capital expenditures. When the legislation was introduced, the allowance was set at £25,000. However, there have since been a number of temporary changes to this limit, including the temporary increase to £500,000 that is currently in place for qualifying expenditures incurred in the period from April 2014 to December 31, 2015.

From January 1, 2016, the A.I.A. will be increased on a permanent basis from £25,000 to £200,000. Transitional rules will apply for any chargeable periods that straddle January 1, 2016.

Businesses looking to invest in a significant quantity of qualifying plants and machinery may wish to accelerate spending so that it falls with the higher threshold of £500,000 applicable up to December 31, 2015. Care will need to be taken with respect to expenditures incurred within the chargeable period straddling the change in allowances in order to maximize A.I.A. availability.

AMORTIZATION OF GOODWILL

Currently, when a company acquires goodwill or customer-related intangibles from an unrelated party, it can claim a corporation tax deduction for amortization recognized in its profit and loss account. Alternatively, the company can elect for a fixed deduction of 4% a year. If, on disposal, the company makes a loss, this usually forms part of the company's trading profit or loss for the year.

Legislation will be introduced to withdraw relief for all goodwill and customer-related intangibles acquired on or after July 8, 2015, except where the acquisition is pursuant to an unconditional obligation entered into before that date. If a loss arises on the disposal of assets falling into these new rules, it will be treated as a non-trade expense. This means that if the cost cannot be set off against other profits in the year of disposal, it will not be available to offset trading profits in subsequent years. A corporation tax deduction will continue to be available for amortization on other types of intangible assets.

Goodwill acquired before July 8, 2015 will continue to be treated under the old rules; so, a corporation tax deduction will continue to be available for amortization, and any loss on disposal will be treated as part of the company's trading profit or loss for the year of the disposal. The purpose of this new provision is to remove the tax relief available when a business acquisition is structured as an asset purchase so that goodwill can be recognized. This will bring the rules for business asset purchases into line with those for companies who purchase only the shares of the target company.

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These provisions almost return companies to the position they held prior to the introduction of the intangible rules in 2002, except that indexation is not available when goodwill is disposed of at a profit. As a result, companies may have three types of goodwill on their balance sheets: pre-2002 goodwill that is dealt with under capital gains tax principles; goodwill acquired before July 8, 2015 with respect to which amortization can be deducted for corporation tax purposes; and new goodwill, which is dealt with under the intangible rules but for which amortization is not deductible for corporation tax purposes.

CORPORATION TAX – CONSORTIUM RELIEF AND LINK COMPANIES

A claim and surrender of group relief can currently be made between a company with a share in a consortium (a "member of the consortium") and the consortium company (the "company owned by a consortium").

Relief is extended to companies in the same group as a member of the consortium that is defined as a "link company" but only where the link company is located in the U.K. or (subject to meeting certain requirements) in either an E.U. Member State or in Iceland, Liechtenstein, or Norway.

In a measure first announced in Autumn Statement 2014, legislation will be introduced to remove the requirements relating to the location of the link company. This revision will have effect for consortium claims to group relief for accounting periods on or after December 10, 2014. Removing the location condition from the legislation will make the operation of the relief simpler and therefore more attractive to those looking to invest by entering into a consortium.

CARRIED INTEREST – CHANGES TO C.G.T. BASE COST CALCULATION

Employees of fund managers and private equity companies often participate in structures (typically partnerships) that allow them to benefit from some of the growth in the value of the assets they manage. The return that participants in these structures receive, generally known as a "carried interest," is taxable under the C.G.T. rules.

The treatment of the participants in a carried interest arrangement is the same as for any other member of a partnership and follows the scheme set out in Statement of Practice D12 ("S.P. D12"). In part, that statement applies when a partnership asset is revalued. Each partner is credited in his/her current or capital account with a sum equal to his/her fractional share of the increase in value. An upward revaluation of taxable assets is not itself an occasion to impose tax. The combined effect of S.P. D12 and various planning techniques can mean that book transactions undertaken by the partnership can boost an individual's base cost of the carried interest for C.G.T. purposes, so that it is higher than the actual amounts invested by that person. This has the effect that the individual will pay less C.G.T. than they would otherwise.

The proposed changes take effect immediately and are narrowly targeted at persons who provide investment management services for a collective investment scheme. The effects of the rule change will be that any amounts received from a carried interest partnership structure will be treated as being proceeds subject to C.G.T. and participants' base costs will be limited to the amounts that they actually paid to acquire interests in the carried interest vehicle.

At this stage, the impact of these changes is difficult to gauge; for participants in carried interest partnerships, the change is likely to increase the amount of tax that they will pay on profits; for the industry as a whole, the changes may result in a move to adopt alternatives to the partnership structures currently used for carried interest vehicles.

CONSULTATION ON TAXATION OF PAYMENTS TO INVESTMENT MANAGERS

The budget announces that the government will initiate a consultation process on taxation of performance linked rewards paid to asset managers.

Investment managers are typically rewarded in a number of ways, two of the most significant being:

- The opportunity to effectively invest in the assets that they are managing on behalf of their client or employer investment funds (*i.e.*, carried interest), the returns on which are treated as capital; and
- Performance based fees, which are treated as a reward for services and taxed as trading income.

The consultation is a response to the actions taken by some investment managers to attempt to reclassify their trading activities as investment activity. This would lead

to the performance based fees being classified as capital rather than income and being taxable under the C.G.T. rules rather than the income tax rules.

The consultation follows on from the introduction of legislation on disguised management fees in Finance Act 2015 and proposes to set out tests in legislation to clarify which performance fees are capital and which are taxable under the income tax rules.

The consultation document outlines alternative potential statutory regimes that could be adopted and seeks respondents' views on the relative merits of the two proposals. One approach would list particular activities that are, in the government's view, clearly investment activity such that a performance linked interest in a fund vehicle performing such activities may be charged to tax as chargeable gains provided certain conditions are met. The alternative would focus on the length of time for which the underlying investments are held.

It is not anticipated that the treatment of performance related rewards which have historically been subject to capital gains tax will change as a result of this consultation.

AMENDMENTS TO TAX-ADVANTAGED VENTURE CAPITAL SCHEMES

Tax-advantaged venture capital schemes are subject to E.U. state aid rules, which were changed last year.[2] As a result of the changes, a number of amendments needed to be made to the existing provisions governing investments in Enterprise Investment Schemes ("E.I.S."), Seed Enterprise Investment Schemes ("S.E.I.S."), and Venture Capital Trust Schemes ("V.C.T.") that are eligible for tax reliefs (referred to collectively as "risk finance investments" or "R.F.I.'s"). The amendments were subject to consultation, and draft legislation was published on March 24, 2015. The consultation closed on May 15, 2015.

A number of changes to the E.I.S., S.E.I.S., and V.C.T. rules have now been proposed. Unless stated otherwise, the measures take effect from the date of Royal Assent.

- If an individual subscribes for additional shares in a company, the new shares will not be eligible for E.I.S. relief, unless the individual has either made an R.F.I. in the company before Royal Assent or the individual's prior shares in the company (excluding founders' shares) were qualified as an R.F.I.
- A new requirement will be introduced for the money to be used for the growth and development of the company (or subsidiary company).
- The rule prohibiting the use of money for the acquisition of shares will be extended to all investments made by V.C.T.'s on or after Royal Assent.
- A new rule will be introduced to prevent companies from using E.I.S. and V.C.T. investments to acquire a business.

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[2] See the article authored by Beate Erwin on this point that appears in this edition, here.

- Companies must raise their first investment under R.F.I. within seven years of making their first commercial sale or ten years if the company is a knowledge-intensive company (as defined in Summer Finance Bill 2015). However, no age limit will apply to companies raising an investment where the amount of the investment is at least 50% of the company's annual turnover, averaged over the previous five years.
- In addition to the existing £5 million cap on annual investments, a new cap will be introduced on the total amount of investments a company may raise under an R.F.I., *i.e.*, £12 million in general and £20 million for knowledge-intensive companies. Any R.F.I.'s used by a business previously owned by another company will count towards the total funding limit.
- Knowledge-intensive companies are permitted to have up to 500 employees for raising capital by R.F.I.'s.
- Companies will no longer need to use at least 70% of S.E.I.S. funds before raising funds under E.I.S. or V.C.T. (with effect from April 6, 2015).
- E.I.S. relief of investors in companies that redeem the shares of S.E.I.S. investors will no longer be reduced, so long as the S.E.I.S. relief on the redeemed shares is repaid (with effect from April 6, 2014).
- Farming outside the U.K. will not be an eligible activity for E.I.S., S.E.I.S., V.C.T., and Enterprise Management Incentives.

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C.F.C. LOSS RESTRICTION

The U.K. controlled foreign company ("C.F.C.") regime targets profits that have been diverted from the U.K. Under current rules, a C.F.C. charge is computed by reference to the profits of the C.F.C. during an accounting period. A claim can be made to offset certain expenses and losses to reduce the amount of tax payable.

Where profits arise within a C.F.C. accounting period starting on or after July 8, 2015, relief for these expenses and losses will no longer be available. This specifically includes:

- Losses and surplus expenses arising in the current year or brought forward from previous years; and
- Losses and surplus expenses arising in other group companies.

For accounting periods that straddle July 8, 2015, the relief will be restricted on a just and reasonable basis.

This change, which will affect large U.K. companies with overseas subsidiaries in low-tax jurisdictions, is part of the measures to counter perceived tax avoidance (particularly by multinational groups) and maintain the competitiveness of the U.K. corporation tax regime.

TRANSFERS OF STOCK AND INTANGIBLES BETWEEN CONNECTED PARTIES

There are special rules that apply to the transfer of shares of stock for corporation tax and income tax purposes, and to transfers of intangible assets for corporation tax purposes. These provisions typically provide that transfers are treated as taking place at market value ("fair market value rules"). However, where the transfer pricing legislation contained in Chapter 1 of Part 4 of Taxation (International and Other Provisions) Act 2010 ("T.I.O.P.A.") applies, it supersedes the fair market value rules. Under the transfer pricing rules, it is possible to obtain a tax advantage by fixing a transfer pricing price that is lower than the market value of the stock transferred.

Legislation will be introduced to revise the interaction between the fair market value rules and Part 4 of T.I.O.P.A. so that a further adjustment can be made under the market value rules in the Corporation Tax Act ("C.T.A.") or the Income Tax (Trading and Other Income) Act ("I.T.T.O.I.A."). The measure will have effect for transfers of trading stock or intangible fixed assets made on or after July 8, 2015.

These amendments will ensure that disposals made outside the normal course of business are brought into account for tax purposes at full fair market value. This amendment will stop corporate groups from using a transfer pricing rule to manipulate the value of assets in intragroup transfers.

H.M.R.C. TO INVEST £800 MILLION TO RAISE £7.5 BILLION FOR TREASURY

The Chancellor of the Exchequer announced in March that H.M.R.C. was expected to raise £5 billion from investigating tax avoidance and evasion. The budget announces that £800 million is budgeted to recover £7.5 billion in tax, showing that H.M.R.C. intends to dedicate compliance resources to investigate U.K. residents that have participated in tax avoidance schemes or evaded taxes.

H.M.R.C. was criticized by the Public Accounts Committee earlier this year for not prosecuting more people in relation to the HSBC Swiss data provided by the French government, and it is not surprising that criminal investigations are set to triple. To enhance the powers available to H.M.R.C. to identify tax evasion, H.M.R.C. wants the authority to formally obtain data from online intermediaries and payment providers on U.K.-resident businesses to ensure that their tax affairs are in order.

H.M.R.C. is continually looking at ways to obtain additional information from suppliers and intermediaries that could be used to target tax evasion and the hidden economy. This raises questions about how the information is retained and the safeguards in place to ensure that it is used only for the purpose for which it was obtained.

There will also be an increased focus on businesses and individuals who participate in tax avoidance schemes, with the threat of serial avoiders being named and shamed, as well as subjected to surcharges on the most recent tax returns.

TACKLING OFFSHORE EVASION

The U.K. has already entered into agreements to automatically exchange information with the U.S. under the F.A.T.C.A. legislation and with the U.K. Crown Dependencies under automatic exchange of information agreements. The U.K. will also receive information from the British Overseas Territories on U.K. residents holding assets in those territories.

The O.E.C.D. has also introduced a Common Reporting Standard for the automatic exchange of information between member states, which is scheduled to start in 2017.

From early 2016, following consultation with professional and representative bodies, H.M.R.C. wishes to introduce legislation that will require financial institutions, tax advisers, and other professionals ("relevant persons") to notify their clients that information will be automatically exchanged. The legislation will also require a disclosure of the type and detail of the information to be exchanged, and the criminal and civil penalties that apply in relation to tax evasion.

H.M.R.C. realizes that it is essential that U.K. residents are made aware that most countries will automatically exchange information from 2017 on and that it will be very difficult to hide income and/or gains overseas. This initiative may well be connected to the proposed strict liability offence in relation to non-disclosure of overseas assets.

H.M.R.C. believes that there are still significant overseas assets that have not been disclosed. The purpose of this initiative is to "shake the tree" and ensure that U.K. intermediaries and professionals notify clients of the risks involved in not ensuring their tax affairs are in order. This is almost certainly linked to the statement that H.M.R.C. intends to triple the number of criminal investigations for tax evasion.