Executive summary

On 8 March 2017, the UK Chancellor, Philip Hammond presented his Budget proposals to build the “foundations of a stronger, fairer, more global Britain.” Mr. Hammond reviewed the strengths of the UK economy noting the robust growth and record employment. He stressed, though, that there was no room for complacency and highlighted the need to keep Britain at the cutting edge of the global economy. The Chancellor also noted that while the deficit is down, debt is still “too high” and productivity remains “stubbornly low.”

As part of a planned move to one annual fiscal event, to be held in the autumn, there will be another Budget before the end of 2017. The Chancellor therefore left himself many options for future changes. Among the future issues, that has already attracted coverage with this Budget, is the future financing of Social Care, with a Green Paper due later this year. Another issue to have made headlines is the Chancellor’s moves to address perceived unfairness in the different tax treatment between employees and those self-employed or providing services through a service company.

From a business tax perspective, the new restriction on corporation tax deductibility of interest will be effective from 1 April 2017, with relaxation of the public infrastructure exemption and a number of other changes. The new rules on utilization of corporation tax losses and measures reforming the substantial shareholding exemption regime will also come into force from 1 April.
Publication of the 2017 Finance Bill on 20 March and a number of consultations and calls for evidence will provide more details on the Budget proposals.

Detailed discussion

Corporation tax rates

The Government confirmed that the corporation tax rate changes will be implemented as scheduled, being 19% from 1 April 2017 and 17% from 1 April 2020 (making it the lowest rate in the G20).

In the Spring Budget the Government also announced that it will amend the Northern Ireland Corporation Tax (NICT) regime to give all small and medium sized enterprises (SMEs) trading in Northern Ireland the potential to benefit from the regime once it commences (which is scheduled to be April 2018). It will also make changes to NICT to prevent against perceived abuse and ensure it is ready for commencement.

Corporate interest restrictions revisions

The Government is introducing a new restriction on the tax deductibility of corporate interest expense from 1 April 2017. This was originally announced in Budget 2016, with draft legislation being published in December 2016 and January 2017 for consultation.

The new rules will restrict each group's net corporation tax deductions for interest and other financial payments to 30% of earnings before interest, tax, depreciation and amortization (EBITDA) that is taxable in the UK, subject to a modified debt cap based upon the worldwide group's net interest expense. An optional group ratio rule, based on the net-interest to EBITDA ratio for the worldwide group, may permit a greater amount to be deducted in some cases, again subject to a modified debt cap. All groups will be able to deduct up to £2mn of net interest expense per annum under the regime.

As a result of the introduction of the new rules, the existing worldwide debt cap legislation, which restricts interest expense based on gross worldwide interest expense, will be repealed.

Following consultation, the Government has announced some changes to address unintended consequences, including the following:

> A correction to the rules which would have prevented domestic groups in particular from being able to fully carry forward disallowed interest for use in a future period due to the interaction of the modified debt cap and carry forward rules.

> The extension of the definition of related party debt to include third party debt covered by guarantees from related parties for the purposes of the group ratio rule will no longer apply where the guarantees are provided by other group members. Guarantees granted before 31 March 2017 and certain performance-related guarantees will also be excluded.

> Amending the public benefit infrastructure exemption to allow this to be easier to apply in practice, including removing the need to compare the level of debt of qualifying group companies with non-qualifying group companies. Transitional rules will also apply in the first year to allow businesses time to restructure to qualify for the exemption, if necessary.

> The definition of interest will include income and expenses from dealing in financial instruments as part of a banking trade.

> Rules for insurers regarding the calculation of interest on an amortized cost basis will provide a practical alternative to fair value accounting.

While the underlying principles behind the corporate interest restriction rules are straightforward, the draft legislation to achieve the policy goals is complex and contained a number of areas that introduced unintended consequences or resulted in potentially significant administrative burdens to taxpayers.

The amendments announced as part of the Budget cover some, but not all, of the key areas that have been raised with the Government as part of the consultation and are expected to be welcomed by businesses. However, the complexity of the draft rules will mean that companies will need to carefully look at the rules as applied to their facts to ensure that they do not give rise to unexpected results, and to take action where appropriate.
Withholding tax on interest

The Government has announced the introduction of a new withholding tax exemption to cover interest paid on debt traded on a multilateral trading facility. A consultation will be launched on 20 March 2017.

Alongside this, the Government is also aiming to extend the administrative simplification offered by the existing Double Taxation Treaty Passport (DTTP) scheme to encourage foreign investment and make it easier for UK businesses to raise finance.

UK businesses are required to withhold income tax on payments of annual interest to non-UK lenders at 20% unless a specific exemption applies or a claim is made under a double tax treaty to reduce the rate. An exemption for debt listed on certain recognized stock exchanges is already included in the legislation and the Budget proposals will introduce a similar exemption for debt traded on multilateral trading facilities, which are alternatives to stock exchanges, bringing together parties buying and selling financial instruments. This new exemption also follows on from the introduction of an exemption for qualifying private placement debt in 2016.

The existing DTTP scheme is designed to simplify the administrative procedures for obtaining consent to apply treaty rates of withholding tax to the payment of interest. A consultation was launched to review the existing scheme in May 2016. Following that review, the scheme will be available to all types of overseas lenders and UK borrowers from 6 April 2017 and not just corporate lenders and borrowers as currently allowed.

Further simplification of the administrative burden to apply a reduced rate of withholding tax will be welcomed, as will the introduction of an additional exemption. However, it remains to be seen how far the proposals will go and it is hoped that these are not scoped too narrowly, leaving the UK at a disadvantage compared to other jurisdictions. Businesses will need to monitor any changes to the administrative procedures to ensure that they are meeting all their withholding tax obligations.

Patent box

The new patent box regime was introduced in Finance Act 2016 and took effect (subject to transitional provisions) on 1 July 2016, but no provisions were included dealing with scenarios where research and development (R&D) is undertaken under cost sharing arrangements.

Rules have now been developed, with effect from 1 April 2017, intended to ensure that companies undertaking R&D under cost sharing arrangements are neither advantaged nor disadvantaged from a tax perspective. Following consultation, the final provisions will be revised to narrow the definition of a cost sharing arrangement and to better align the treatment of payments into, and payments received from, a cost sharing arrangement.

R&D administrative changes

Following the recent review of R&D tax incentives, the Government has announced that it will make administrative changes to the R&D Expenditure Credit and will take action to improve awareness of R&D tax credits among SMEs.

The Budget announcement is the result of an informal consultation carried out by HM Treasury over the past few months with industry regarding the effectiveness of the UK R&D regime. This review has concluded that the UK regime is effective and internationally competitive, but that administrative changes would further improve the current regime.

Through the release of the Industrial Strategy Green Paper and the informal consultation, the Government has demonstrated its continued support for innovation in the UK and its importance to the economy. It is welcome that the Government is prepared to engage directly with R&D claimants, and listen and respond to their concerns around the current regime. While there was no detail of the potential changes released, it is expected that these will be available soon.

Amendments to the anti-hybrid rules

The Government has confirmed its intention to introduce changes to the anti-hybrid rules to prevent deductions for amortization being treated as relevant deductions for certain cases within the anti-hybrid rules. It will also remove the requirement to make a formal claim to apply the permitted time period rules in respect of financial instruments.

The anti-hybrid rules were introduced in Finance Act 2016 and came into force with effect from 1 January 2017. The Government had announced these proposed amendments at Autumn Statement 2016 and a technical note was published in December. The Budget announcements confirm the proposals are unchanged from those set out in the technical note and will have effect from the commencement of the anti-hybrid rules.
The changes are important as the Organisation for Economic Co-operation and Development had made it clear that amortization should not be included within the rules and to include them could be counterproductive to the policy intent. The claim to apply the permitted time period rules would also be impractical.

Although the legislation will have effect from the commencement of the anti-hybrid rules, it is not yet enacted and groups will need to consider the impact this might have on their financial reporting requirements.

**Loss relief reform**

As previously announced, Finance Bill 2017 will include legislation to reform the rules on the utilization of carried forward tax losses for corporation tax purposes. The rules broadly restrict the offset of brought forward losses to 50% of profits arising on or after 1 April 2017, and enable carried forward losses incurred on or after 1 April 2017 to be offset against profits of any description (or group relieved). There were no new policy announcements in this respect in the Budget, other than a confirmation that the draft legislation published on 26 January 2017 will be revised to include provisions for oil and gas companies and oil contractors.

The legislation that will be published as part of the Finance Bill on 20 March will need to be considered carefully to determine what other changes there may be from the January draft. With the reforms coming into effect in April, businesses will have little time to prepare for their impact.

**Plant and machinery lease accounting**

Following the finalization of International Financial Reporting Standard (IFRS) 16, HM Revenue & Customs (HMRC) published a discussion document in August 2016 setting out certain options to reform lease taxation. As part of the Budget documentation, HMRC announced that it intends to retain the existing regime governing lease transactions (which means the lessor under a non-long funding lease would continue to claim capital allowances), but would like to consult in summer 2017 on the legislative changes required to achieve this. This is likely to focus more on the lessee’s position given that it is lessee accounting that is primarily affected by the introduction of IFRS 16.

The announcement that there will be no fundamental change to the existing position is positive and appears to be a sensible response to the accounting changes.

**Amendment to legislation to tax profits from trading in and developing UK land**

The Government has announced changes to the Profits from Trading in and Developing Land legislation, introduced as part of Finance Act 2016. Finance Act 2016 brought developers of UK land into the scope of UK corporation tax and income tax on profits arising from the dealing in or trading of land, regardless of the developer’s tax residence. The legislation was effective in respect of profits arising from disposals on or after 5 July 2016, apart from profits arising from contracts entered into before 5 July 2016.

The Government has now announced that it will remove the exclusion in respect of contracts being entered into before 5 July 2016, because it has become aware that contracts can concern property disposals anticipated to complete months or years after the contract date. Accordingly, any profits from the dealing in or developing of UK land recognized in accounts corresponding with Generally Accepted Accounting Practice on or after 8 March 2017 will now be subject to UK tax.

The removal of the original grandfathering provisions is somewhat surprising and can be punitive given that it is fairly common market practice for exchange and completion to be set months (or years) apart, particularly on large scale developments. As a result of these amendments, there may be a substantive number of developers who have exchanged contracts in good faith on the basis of the law that was current at that time.

**Removal of capital loss election following appropriations of capital items into trading stock**

The appropriation of a capital asset to trading stock is deemed for tax purposes to be a sale and reacquisition at market value of the asset, which may then generate either a capital gain or an allowable loss. The trading stock then takes that market value as its deemed cost. However, it has been possible for a taxpayer to elect to reduce the chargeable gain or allowable loss arising upon this deemed disposal by rolling over the gain or loss into the deemed cost of the trading stock. The effect of this was that the gain or loss effectively becomes part of the trading profit or loss on the sale of the stock.

The Government has announced that, from 8 March 2017, this longstanding election will only be permitted where such an appropriation would generate a capital gain, and not a capital loss. Accordingly, it will no longer be possible to
convert an allowable loss into a more flexible trading loss, so that such a loss will only be available for set-off against capital gains.

This legislative change is the removal of a long-standing relieving provision which permitted taxpayers a measure of flexibility in obtaining tax relief for a loss. Removal of this provision will therefore have a detrimental impact on businesses which have suffered genuine economic loss in respect of assets held for the purposes of their business.

Late-life oil and gas assets
HM Treasury will publish a discussion paper on tax issues associated with the transfer of late-life oil and gas assets, and will establish an advisory panel of industry experts to consider options for change.

Tax relief for decommissioning expenditure is given at the end of field life, and is likely to result in refunds of tax previously paid during the productive life of the field. However, where fields are transferred late in their lives to new investors, those new investors may not generate sufficient profit during the remaining years of the field to enable effective relief for decommissioning expenditure. A properly functioning market in oil and gas assets is critical to the industry’s ability to maximize economic recovery from the North Sea, but the mechanism for giving decommissioning tax relief presents a potential barrier to entry for those who want to invest in the future of the basin. HM Treasury, with the support of the industry, proposes to consider options for change that would address this problem.

HM Treasury’s announcement that a panel is to be set up to consider specific aspects of the decommissioning tax relief mechanism will be welcomed. While this announcement is a clear indication that HM Treasury understands the potential significance of this issue, much hard work lies ahead to prove the case for change and identify a satisfactory solution that does not increase the Exchequer’s exposure to decommissioning.

Business rates
The Chancellor has announced £435mn of further support for businesses facing significant increases in bills from the business rates revaluation which takes effect in England from April 2017.

The effects of the 2017 business rates revaluation in England have given rise to some significant concerns from businesses. The Chancellor has recognized that the revaluation has given rise to hardship in some cases and accordingly provided three measures to address some of the concerns on transition.

The Chancellor also noted that there is scope to reform the revaluation process, making it smoother and more frequent to avoid the dramatic increases that the present system can deliver. The Government will set out its preferred approach for delivering more frequent revaluations at Autumn Budget 2017 and will consult ahead of the next revaluation in 2022.

The measures are only meant to soften the impact of business rate rises, not to provide rate cuts. They do not address the interaction of business rates with the digital economy, although the Chancellor did concede in his speech that “in the medium term … we have to find a better way of taxing the digital part of the economy… that part that does not use bricks and mortar.”

HMRC large business review
HMRC will consult on its risk profiling process for large businesses and how it can promote increased compliance. Separately, HMRC has recently started to engage with large businesses to understand how well the Customer Relationship Manager (CRM) model is currently working, and what changes could be made for it to work better for taxpayers and HMRC alike. The consultation on risk reviews will be released before the Parliamentary Summer recess.

It is welcome that the Government is engaging with large businesses to determine how the effectiveness of its relationship can be improved without imposing an undue compliance burden on business.

Other announcements
Other announcements in this Spring Budget include the following:

- Finance Bill 2017 will include legislation bringing the proposed reform of the substantial shareholding exemption. Budget 2017 announced that there would be amendments (as yet, unspecified) to the proposals “to provide clarity and certainty.”
A consultation document will be published on 20 March on the case for bringing non-UK resident companies currently chargeable to income tax on their UK taxable income (and to nonresident capital gains tax on certain gains) within the scope of corporation tax.

Following an earlier consultation on certain administrative matters relating to partnerships, the Government will legislate in Finance Bill 2017/18 (the next Finance Bill after Finance Bill 2017) with a response document likely to be issued later this year.

There will be consequential amendments to the legislation to simplify the Petroleum Revenue Tax regime. This legislation has retrospective effect from 23 November 2016.

The Government also confirmed that it will seek State aid approval for the continued provision of tax reliefs for the production of high-end television, animation and video games beyond 2018. Broadly, the relevant provisions provide an additional tax deduction or a payable tax credit in relation to qualifying expenditure, provided that certain conditions are satisfied.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United Kingdom), London
- Claire Hooper +44 20 7951 2486 chooper@uk.ey.com
- Chris Sanger +44 20 7951 0150 csanger@uk.ey.com

Ernst & Young LLP, UK Tax Desk, New York
- James A. Taylor +1 212 773 5256 james.taylor1@ey.com
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2017 EYGM Limited.
All Rights Reserved.

EYG no. 01122-171Gbl
1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com