UK takes steps to implement EU Anti-Tax Avoidance Directive

Executive summary

As part of the draft Finance Bill clauses published by the United Kingdom (UK) Government on 6 July 2018,¹ a number of changes have been proposed to ensure that the provisions of the European Union (EU) Anti-Tax Avoidance Directive (ATAD) are transposed into UK tax law as required. Although the UK is scheduled to leave the EU on 29 March 2019 and the Withdrawal Agreement has not yet been finalized, it is expected that the UK will need to comply with the ATAD requirements at least throughout any transition period agreed. Consequently, the UK is proposing to implement any changes that would be required to be brought in by the ATAD by 1 January 2019 (when the UK will still be within the EU) or 1 January 2020 (which is expected to be within the transition period). Requirements that must be implemented by a later date are still under review.

The ATAD sets out a requirement for Member States to adopt certain anti-avoidance provisions to facilitate the creation of a “level playing field” across the EU. The UK Government has assessed the ATAD requirements against the existing tax legislation and has concluded that changes are required in the following areas:

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Controlled foreign company rules, which need to be applied with effect from 1 January 2019

Exit taxation rules (in particular, the deferral mechanisms applicable in certain circumstances), which need to be applied from 1 January 2020

Certain anti-hybrid rules, which need to be applied from 1 January 2020 (other “reverse hybrid” changes are required by 1 January 2022 and are still under review)

The consultation on the draft legislation will run until 31 August 2018 and measures are intended to be included in what will become Finance Act 2019.

Detailed discussion

Background

The ATAD is intended to provide a coherent and coordinated legislative implementation across the EU of some anti-avoidance provisions, many of which are outputs from the G20/OECD’s Base Erosion and Profit Shifting (BEPS) project. Political agreement on the original version of the ATAD was initially reached in June 2016 and laid out minimum standards in respect of five areas:

- Corporate interest restriction rules
- A General Anti-Abuse Rule
- Controlled foreign company rules
- Anti-hybrid rules
- Exit taxation rules

The measures generally needed to be applied in national law with effect from 1 January 2019, although the exit taxation changes are not required until 1 January 2020.

The original anti-hybrid provisions within the ATAD were confined to cross-border hybrid mismatches between EU Member States in order to facilitate reaching political agreement, but changes to expand the scope of the anti-hybrid rules to include those with third countries were adopted by the Council of the EU in May 2017 (these changes were known as ATAD 2). As a result of these changes, the anti-hybrid requirements contained within the revised ATAD, incorporating ATAD 2, were not required to be applied in national law until 1 January 2020, with a further deferral to 1 January 2022 for the new requirements relating to “reverse hybrids” (i.e., where the investors regard the person as a separate entity and the territory of establishment regards it as opaque for tax purposes).

Changes required to UK tax legislation

Unlike some Member States, the UK has already implemented rules covering all five areas required by the ATAD and the Government noted when both the original ATAD and ATAD 2 were agreed that these were aligned with the principles of UK law. However, it was envisaged that some changes would be required in order to fully align domestic law.

Following a review of the relevant UK legislation against the requirements of the ATAD, the Government is proposing to make changes in three of the five areas in order to implement the minimum standards and these are discussed further below.

Controlled foreign companies

The UK already has a comprehensive set of controlled foreign company (CFC) rules and the Government considers that these already meet or exceed most of the ATAD’s requirements. It has, however, identified two specific subsets of changes that it considers will be required to ensure the CFC rules are ATAD-compliant. Such changes will need to apply with effect from 1 January 2019. No draft legislation has been published in respect of the CFC rules, although the Government has published a policy note setting out the proposed changes.

Definition of control

It is proposed that the UK definition of a CFC will be amended to take into account a broader range of interests when assessing “control,” including those held by non-UK related parties. This would mean that a non-UK company could be regarded as a UK CFC even if UK residents do not hold a controlling interest.

Both the ATAD and current UK CFC rules define control by reference to whether a taxpayer can control an entity, taking account of capital interests, voting rights and entitlement to profits held by the taxpayer, as well as some interests of others that are attributed to the taxpayer. However, there is currently a difference in which rights are attributed to the taxpayer in determining control.

The ATAD provisions require the attribution of rights owned by “associated enterprises” resident in any territory. Associated enterprises exist where the taxpayer directly or indirectly holds a 25% interest in another entity or where a person directly or indirectly holds a 25% interest in both the taxpayer and another entity.
In contrast, the UK's attribution rules only take into account the rights of UK-resident persons connected with the taxpayer (with “connected” being determined by reference to control), implying a higher threshold before rights are attributed.

The UK's CFC rules will therefore need to be amended to take into account this broader attribution of rights when assessing control, which could result in more companies being treated as CFCs of UK taxpayers.

**Treatment of non-trading finance profits - UK significant people functions**

Changes are proposed to the CFC treatment of non-trading finance profits.

Under the current UK rules any apportionment resulting from profits from “qualifying loan relationships” may, by election, be calculated with reference to mechanical tests, which include conditions for full and partial exemption depending on the circumstances of the lending and the group (the group finance company exemption).

Profits from non-qualifying loan relationships (or where no election is made) are subject to apportionment to the extent that they fall within defined categories, such as resulting from key activities undertaken in the UK (UK significant people functions or UK SPFs) or from capital contributed from the UK.

The proposal is that from 1 January 2019 any non-trading finance profits that arise from UK SPFs will be chargeable profits and the current group finance company exemption provisions will not apply to these profits.

The implication of the policy note is that the group finance exemption may still apply to profits on a qualifying loan relationship to the extent that those profits do not arise from UK SPFs.

Groups currently or considering electing for the group finance company exemption to apply will need to carefully consider the extent to which non-trading finance profits arise by virtue of UK SPFs and where UK SPFs are present the profits attributable will need to be calculated. These groups will also need to consider the wider implications of this change.

Groups that have elected to apply the group finance company exemption in previous years are already considering the impact of the European Commission's State aid investigation and as part of this work may be considering profits attributable to UK SPFs.

It should be noted that the proposed changes are in response to the ATAD and not to the Commission's investigation. A decision on the State aid investigation is expected by the end of the year and groups will need to continue to consider this alongside the future implications of the proposed changes.

**Hybrid mismatches**

Although the ATAD's anti-hybrid rules do not need to be implemented until 1 January 2020, by which time the UK will have left the EU, it is likely that the UK will be required to apply the provisions of the ATAD throughout any transition period, which is currently expected to last until at least 31 December 2020.

The UK introduced comprehensive anti-hybrid rules with effect from 1 January 2017, based closely upon the G20/OECD's BEPS Action 2 report, on which the ATAD provisions are also based. However, the Government has identified two changes that it considers need to be applied by 1 January 2020, relating to disregarded permanent establishments and regulatory capital.

The proposed changes do not include any amendments relating to reverse hybrids, which are not required to be implemented until 1 January 2022. The Government intends to review whether any changes in respect of these will be required under the ATAD in due course.

**Disregarded permanent establishments**

The ATAD's anti-hybrid measures include a provision targeting structures resulting in a deduction for a payment to a company resident in a Member State without a corresponding inclusion of the income (due to the receipt being allocated to an exempt permanent establishment (PE) for the purposes of the head office's jurisdiction, while the other jurisdiction does not recognize a taxable PE). In such cases, the head office jurisdiction is required to tax the income on the payment unless it is explicitly required to exempt the income under a double tax arrangement.

The UK's anti-hybrid rules do contain provisions to deal with deduction/non-inclusion structures resulting from payments made by a UK resident company to a company with such a disregarded PE (disallowing some or all of the payment made). However, the rules do not currently cover situations where the UK is the headquarter territory and the UK company has a disregarded non-UK PE with regard to which it is claiming the branch exemption in the UK. The Government is therefore proposing to remedy this by amending the UK rules to take into account such situations.
The proposed counteraction would see the UK imposing a tax charge on an amount equal to the deduction/non-inclusion mismatch on the payments received by the branch. As drafted, the rules ignore any expenditure that the PE may incur as part of its business (and which would have been deductible against income in the UK if a foreign branch exemption election had not been made by the UK company). Groups with such structures will need to carefully assess the impact and consider whether restructuring may be necessary.

Regulatory capital
The UK's anti-hybrid rules currently use a definition of "financial instrument" that explicitly excludes anything that is a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (as amended). This means that mismatches arising from payments under Additional Tier 1 and Tier 2 instruments are not currently within the scope of the hybrid rules.

The ATAD exemption for regulatory capital (which is available up to 31 December 2022) requires that in order for the exemption to apply, the financial instrument must have "been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and the financial instrument is recognized as such in the taxpayer's loss absorbing capacity requirements."

In theory this means that a wider range of loss absorbing instruments might fall outside the scope of the revised rules. However, unlike the UK's current anti-hybrid rules, the ATAD exemption requires that the instruments are issued "in connection with financial instruments with conversion, bail-in or write-down features at the level of a parent undertaking," i.e., they require a tracing of intra-group issuances through to head office issuances in the market.

The UK Government is proposing to introduce regulations that will take into account the specific requirements set out for the exemption by the ATAD. Until the first regulations are made under the powers granted, the existing legislation will continue to apply. We will need to wait until those regulations are published to see exactly what instruments will fall within the scope of the revised exemption.

Groups will need to ensure that any regulatory capital between related parties can satisfy all the requirements for the revised exemption, otherwise mismatches may need to be taken into account. Should the UK be required to maintain the provisions of the ATAD beyond the end of the transition period following its departure from the EU, in theory the UK may also be obliged to recognize mismatches on such regulatory capital after 2022 because of the sunset clause contained within the ATAD's exemption.

Exit charges
The third area where the Government considers that changes are required relates to exit charges. The ATAD requires exit charges to be levied where assets cease to be within the charge to tax in a Member State while remaining in the same company, due to transfers among head office and PE territories, through the migration of the company's tax residence or through the transfer of a business of the PE.

Although an exit charge is brought into account under the ATAD, the taxpayer is given the right to pay the tax due in installments over five years, provided that the transfer or migration is to another Member State or European Economic Area (EEA) territory. The deferred exit charge can become due before the five-year period is up if certain events occur, such as the transfer of the assets to a third country or the sale of the company's assets to another person.

The UK's tax rules already calculate exit charges in these scenarios where relevant - the UK retains the right to tax assets held by non-UK PEs, even where the branch exemption is applied (the exemption only eliminates gains arising while the asset is allocated to the exempt branch), so this is not relevant.

However, the UK's treatment of any such exit charges is not consistent. In particular, while the UK allows "exit charge payment plans" to be entered into when companies transfer residency to another EU or EEA territory or assets cease to be within the charge to tax within a UK PE of a non-UK company resident in another EU or EEA territory, there are two methods for deferring the payment of the charge (the standard installment method and the realization method).

Furthermore, in some cases gains are deferred beyond the allowed period (and potentially indefinitely), such as where gains arising on the migration of a UK company, held by another UK company, can be deferred until the remaining UK company disposes of the shares (under section 187 TCGA 1992 or the equivalent provisions under the intangible fixed asset rules).
In order to align the UK rules with the ATAD provisions, the UK Government is proposing to create a single exit charge payment plan process covering the relevant transfers, which will follow the deferral rules set out within the ATAD. As a result, it will no longer be possible to indefinitely postpone some gains that may arise and groups should consider whether alternative approaches may be preferable.

It should be noted that the ATAD provisions only apply where the assets remain within the same company and not where assets are transferred to another company. The provisions contained within section 140 to 140L TCGA 1992 (and the equivalent under the intangible fixed asset legislation) should therefore continue to apply.

In addition to these changes, the Government is also intending to introduce provisions that ensure that the UK tax base cost for an asset brought into the UK and subject to such an exit charge in another EU or EEA territory is determined by reference to the market value used to compute that exit charge.

The amendments are intended to apply with effect from 1 January 2020.

Next steps

The draft clauses that have been published are open for consultation until 31 August 2018, with the official publication of the next Finance Bill, in which these draft clauses are expected to be included, expected shortly after the Budget in the autumn. There may be additional legislation published in advance of this date (for example, the draft CFC amendments), although it is also possible that this will only be released when the Finance Bill is published. Furthermore, many of the obligations introduced by the ATAD may depend upon the outcome of the UK’s withdrawal negotiations with the EU, which are likely to develop over the coming months. Groups should keep abreast of developments in this area and begin to consider how any of the proposed changes could impact their structures.

It is intended that the Finance Bill will be enacted in March 2019, before the end of the current tax year, although the CFC amendments will need to be applied from 1 January 2019.

Endnotes

2. Organisation for Economic Co-operation and Development.
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