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Tax Alert

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U.K. Autumn Statement 2016: Key Implications for Investment Funds

On Wednesday 23 November 2016, Philip Hammond delivered the U.K. Autumn Statement, which included a number of announcements of relevance to the financial services industry. While relatively few new tax measures were announced, a number of previously announced proposals have been confirmed. Draft legislation for a number of the measures, in the form of the Finance Bill 2017, will be published on 5 December 2016.

This is set to be the last Autumn Statement for the foreseeable future, as the Chancellor announced that it is being abolished. In 2017 there will be a Budget both in the spring and autumn and from 2018 there will be a Spring Statement (intended to address the Office for Budget Responsibility forecast) and an Autumn Budget.

Performance Fees – Offshore Reporting Funds

U.K. taxpayers holding interests in offshore reporting funds are subject to tax on their share of the fund's annual reportable income, whether or not the income is distributed to them, and on gains arising on a disposal of their interest in the fund.

In an unexpected announcement, legislation will be introduced to provide that performance fees incurred by such funds, and which are calculated by reference to any increase in the fund's value, will no longer be deductible when determining the fund's reportable income. An increase in reportable income will result in a corresponding decrease in the chargeable gain on disposal of the investor's interest in the fund.

This will primarily impact U.K. individual investors, who are now likely to pay more tax, and pay it earlier, on their investments in offshore reporting funds which incur performance fees. Offshore funds that have elected into the reporting fund regime should consider the impact this change will have on the tax liabilities of their U.K. investor base.

The government stated that this measure was to equalize the treatment of offshore and onshore funds, however it is understood that offshore funds are far more likely to pay performance fees than U.K. funds.

The measure will take effect from April 2017.

Substantial Shareholding Exemption

The substantial shareholding exemption (**SSE**) provides an exemption from U.K. tax on capital gains arising to companies when disposing of shares in other companies, provided certain conditions are met.

Following consultation, the government has confirmed that it will expand the SSE by removing the "investing requirement," which is understood to refer to the current condition that in order to qualify for the

SSE the company making the disposal must be a trading company or a member of a trading group throughout a qualifying period.

The revised rules will also provide a more "comprehensive exemption" for companies owned by "qualifying institutional investors."

Further details are expected in the draft Finance Bill next month, but these changes should materially improve the U.K.'s tax regime for equity holding companies.

The changes will take effect from April 2017.

Partnership Profit Allocation

Following consultation, the government has confirmed that legislation will be introduced to change the tax rules relating to the allocation of partnership profits. Under current law, the profits and losses of a partnership are, subject to certain provisions, allocated in accordance with the partnership's profit sharing agreement in force during the period of assessment.

Draft legislation will be published for technical consultation.

Restriction on Deductibility of Corporate Interest Expense

In line with the government's recent consultation, rules will be introduced to limit the ability for large U.K. corporate groups to reduce their taxable profits through interest deductions. These rules will take effect from April 2017 where (i) the group has net U.K. interest expense of more than £2 million; (ii) U.K. net interest expense exceeds 30 percent of U.K. taxable earnings; and (iii) the U.K. group's net interest to earnings ratio exceeds that of the worldwide group.

There will be certain provisions affording protection to investment in public benefit infrastructure projects (a very capital intensive sector) but, in spite of industry representations, banking and insurance will be subject to the rules in the same way as other groups.

The introduction of these rules does not come as a surprise, given the government's 2016 consultation on the subject. The rules are also broadly in line with the proposed EU Anti-Tax Avoidance Directive, which will require all EU Member States to introduce similar interest limitation rules by 1 January 2019 and are consistent with the general trend in the international tax context of seeking to prevent base erosion through over-gearing.

Extension of Corporation Tax to Non-Resident Companies

Non-U.K. resident companies fall within the scope of U.K. corporation tax where they carry on a trade in the U.K. through a U.K. permanent establishment. Non-U.K. resident companies can, however, fall within the charge to income tax in the U.K. if, for example, they receive U.K. property rental income or trade in the U.K. with or without a permanent establishment.

The income and corporation tax regimes differ in several important respects (for example, the restriction on deductibility of corporate interest expense outlined above would apply to the corporation tax, but not income tax, regime). The government is therefore considering bringing all companies chargeable to U.K. tax within the corporation tax regime to ensure more equal treatment between onshore and offshore companies.

A consultation process will be launched at Budget 2017.

Employee Shareholder Securities

The income and capital gains tax reliefs linked to shares awarded under the Employee Shareholders Securities (**ESS**) regime will be removed for arrangements entered into on, or after, 1 December 2016 (the effective date being 2 December 2016 where independent legal advice was received before 1.30 p.m. on 23 November 2016).

This move comes in response to evidence that the ESS regime is not being used as intended, and follows the introduction in March 2016 of a £100,000 lifetime limit on gains exempt under the ESS regime.

Insurance Linked Securities

In its on-going bid to make the U.K. a leading market for alternative risk transfer, the government has launched a consultation on draft regulations introducing a new regulatory and tax framework for Insurance Linked Securities (**ILS**). This follows an initial policy consultation that closed in April 2016.

Measures such as a corporation tax exemption for ILS vehicles and a withholding tax exemption for foreign investors are intended to create a regime that is internationally competitive and reflects the U.K.'s general approach of taxing investors as if they had invested in the underlying assets directly.

The consultation closes on 18 January 2017, and the government intends to place final regulations before Parliament in spring 2017.

Hybrid Mismatch Rules

Following consultation, the government will issue a technical note in relation to the hybrid mismatch rules introduced as part of the Finance Act 2016, in order to ensure that the legislation works as intended.

The note (to be published on 5 December 2016) will set out minor changes relating to financial sector timing claims and the rules concerning deductions for amortisation. The changes will have effect on 1 January 2017 and will be included in the Finance Bill 2017.

Authorised Investment Funds (AIFs)

The government has announced its intention to "modernise" the rules relating to dividend distributions by AIFs to some corporate investors.

Currently, U.K. tax-exempt corporate investors (such as pension funds) are not subject to corporation tax on dividend distributions by AIFs. However, to the extent that the distribution is of "franked investment income," that is, income on which the AIF itself has already paid corporation tax, a tax-exempt corporate investor does not normally receive a credit in respect of the tax paid by the AIF. AIFs are liable to pay corporation tax on income at the basic income tax rate of 20 percent although they are generally exempt from corporation tax on chargeable gains.

Draft legislation allowing U.K. tax-exempt corporate investors to obtain a credit in these circumstances will be published in early 2017.

Corporation Tax Rates

There had been speculation that this Autumn Statement would see a further reduction in corporation tax rates, following the Prime Minister's suggestion on Monday that the U.K. should maintain the "lowest corporate tax rate in the G20." However, the government reaffirmed its commitment to the reductions in corporation tax previously set out in its "Business Tax Road Map" published in March 2016, which are as follows:

- Current rate: 20%
- Year beginning 1 April 2017: 19%
- Year beginning 1 April 2020: 17%

Loss Relief

From April 2017, the amount of annual taxable profit capable of being offset by carried forward losses will be restricted to 50 percent (subject to a £5 million allowance for each stand-alone company or group). There will also be greater flexibility over the types of profit that can be relieved by losses incurred after that date. However, banks will remain subject to more stringent restrictions: the amount of profit that banks can offset with losses incurred prior to April 2015 will continue to be restricted to 25 percent.

These changes are as expected, following previous announcements. Responses to the recent consultation on this topic, and draft legislation, are expected to be published in December 2016.

Taxation of Non-Domiciled Individuals

The government has confirmed that from April 2017 non-domiciled individuals who have been U.K. resident for 15 of the past 20 years, or who were born in the U.K. with a U.K. domicile of origin, will be deemed U.K.-domiciled. However, affected non-domiciled individuals who have established a non-U.K. resident trust before they become deemed-domiciled will not be taxed on income and gains arising outside the U.K. which are retained in the trust. Furthermore, the Business Investment Relief rules will be changed in April 2017 to facilitate investment in U.K. businesses by non-domiciled individuals who are taxed on the remittance basis.

On the inheritance tax side, U.K. residential property held indirectly by a non-domiciled individual through an offshore structure will fall within the scope of inheritance tax from April 2017.

These measures are in line with previous announcements, and come as no surprise. Further detail is anticipated in draft legislation to be published in December 2016.

Registration of Offshore Structures

A consultation will be launched on the introduction of a requirement for intermediaries that arrange complex structures for clients holding money offshore to notify HM Revenue & Customs of the structures and the clients.

While further detail on the scope and timing of any such new requirement is awaited, this proposal seems likely to be in keeping with the sentiment behind the consultation launched in August on proposed sanctions against ‘enablers’ of tax avoidance, and wider international information reporting under the Common Reporting Standard.

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