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Japan tax alert

Ernst & Young Tax Co.

UK Finance Act 2016

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The UK Finance Act 2016 has become law after receiving Royal Assent on 15 September 2016. The Act includes a number of new rules and requirements that are relevant to Japanese businesses, including a further reduction to the UK corporation tax rate, a requirement for UK operations to publish a tax strategy, and an associated law that may facilitate a public CbCR requirement in the future.

UK corporation tax rate reduction

The new Finance Act 2016 confirms that the main rate of corporation tax, which applies to most companies subject to UK tax, will be cut from the 19% rate applying from 1 April 2017 to 17% from 1 April 2020.

This additional 1% cut in the corporation tax rate follows the Government's ongoing policy trend of reducing the rate and, as highlighted in the Business Tax Roadmap, is intended to help support investment in the UK and ensure that the UK has the lowest rate in the G20.

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For accounting periods ending after the date of substantive enactment (under IFRS and UK GAAP) or enactment (US GAAP), companies will be required to measure deferred tax asset at differing rates depending upon when the deferred tax asset is expected to reverse. An additional proposed change which is not in the current Finance Act is a limitation of loss offset (to 50% of UK taxable profits over GBP5m) and liberalization of group relief rules. These changes are under consultation, but if they are introduced in 2017 will also need to be considered going forward in terms of future tax payment forecasts and deferred tax calculations.

Furthermore, the UK corporate tax rate reduction to 19%/17% will continue to have implications for (the current) Japanse Controlled Foreign Corporation (JCFC) rules. Japanese businesses may need to consider the JCFC position of their UK holdings and monitor any developments for JCFC reform.

Tax strategy

The Finance Act 2016 sets out a mandatory requirement that large businesses must publish their UK tax strategy for accounting periods starting after the receipt of Royal assent.

The requirement applies to all businesses that have UK turnover of more than £GBP200m or a UK balance sheet total of more that £GBP2b. Also included are businesses falling below these thresholds but subject to the CbCR rules, where the threshold is global revenues exceeding €EUR750m, meaning that large Japanese businesses with small UK operations should be subject to this requirement.

The legislation stipulates that the published tax strategy must cover:

- Approach of the UK group to risk management and governance arrangements in relation to UK taxation
- Attitude of the group to tax planning (so far as it affects UK taxation)
- Level of risk in relation to UK taxation that the group is prepared to accept
- Approach toward dealings with HM Revenue & Customs (HMRC)

The strategy must be revisited and reviewed each year and should be appropriately detailed for the complexity of the business.

The requirements that must be addressed by the tax strategy are broad, which gives a company discretion over the level of disclosure that is published. Organisations need to be able to evidence that their approach to tax, as published in their tax strategy, aligns to the reality of how they go about managing their tax affairs. There is therefore a need to "operationalise" their tax strategy and embed it into the culture of the business.

The tax strategy must be published on the internet, as a stand-alone document or as a self-contained part of a wider document. Therefore, it is possible that the strategy can be included within the pre-existing CSR reports that are currently disclosed on a company's website.

For a business that is expecting to publish minimal disclosure and make each response generic, HMRC have stated that generic disclosures will show that the company has not thought about the strategy and that this will be taken into account for any future risk reviews. If a business fails to publish their UK tax strategy, or the tax strategy does not comply with the legislation set out in Finance Act 2016, the penalty to the business will be £GBP7,500, alongside greater scrutiny from HMRC.

Areas of uncertainty and concern

A concern for Japanese businesses is where overall group global revenues are over €EUR750m but the UK operations are very small. These UK operations will be subject to the rules, and proposals for a de minimis rule to ease the requirement were not accepted.

There is also some concern as to what to do if there are several distinct UK entities or sub-groups. In this case it may be more appropriate to publish multiple strategies as one may not fit all. In addition there have been queries concerning which website the strategy should be published on as not all Japanese groups will have a UK company website. If this is the case the parent company website with clear reference to the UK sub-group may be appropriate.

Country by country reporting (CbCR)

The Finance Act 2016 gives HM Treasury powers to introduce public country-by-country reporting (CBCR) alongside the tax strategy. The Finance Act 2016 allows, but does not compel, HM Treasury to bring forward regulations to require groups to include a country-by-country report in their published group tax strategy (assuming they are required to publish their tax strategy). For these purposes, a country-by-country report would be defined by the existing UK regulations, implementing the Action 13 proposals of the Organisation for Economic Co-operation and Development (OECD) to counter base erosion and profit shifting (BEPS), which require such a report to be filed with HMRC.

The Finance Act 2016 does not set out a timeframe or detailed rules for public CbCR. However, the Act reinforces the UK's push for further transparency,

Furthermore, a draft European Union (EU) Directive is also currently under discussion which would introduce public CbCR in the EU, although the UK may not participate in that Directive, given its "Brexit" vote to leave the EU.

Although the date for UK public CbCR has not yet been set, the new law means that CbCR requirements may be introduced relatively quickly and easily alongside the tax strategy publication. For Japanese businesses with UK operations this should be a strong incentive to begin implementing CbCR and reviewing the results in preparation for potential future public disclosure.

Other developments

Brexit

The amendments contained in Finance Act 2016 continue the UK Government's push to increase investment in the UK and ensure that the UK has the most business friendly tax regime in the EU.

The UK's Brexit vote has introduced some uncertainty to the UK's ongoing relationship with the EU and may cause concern to Japanese businesses with a UK tax presence. The timing of the UK's actual exit from the EU is currently considered to be early 2019 at the earliest, The outcome of Brexit from a tax perspective is still dependent on whatever is negotiated with the EU.

UK Patent Box

Finance Act 2016 includes updated legislation to amend the patent box rules to comply with the OECD's BEPS proposals dealing with preferential intellectual property (IP) regimes.

Most notably, flexibility is now provided for grandfathering products which contain both pre-1 July 2016 IP qualifying rights (old IP) and post-30 June 2016 IP qualifying rights (new IP). The income from a product can be fully grandfathered either where the "value" of the product is wholly or mainly attributable to old IP or where the proportionate number of old IP rights compared to total qualifying IP rights is 80% or more. Where that is not the case but the proportionate number of old IP rights compared to total qualifying IP rights is between 20% and 80%, then that proportion of income from the product can be grandfathered. Companies qualifying for the grandfathered regime should review their future pipeline of products based on these criteria.

The new regime reduces the benefits of the patent box by the "R&D fraction" based on the proportion of research and development (R&D) incurred by the company as opposed to outsourced to related parties or acquired IP. As expected, the Act now includes a rebuttable presumption allowing for an increase in the "R&D fraction" in exceptional circumstances. Where it applies, the company may elect to increase the R&D fraction to the amount which, on a just and reasonable assessment, represents the proportion of value of the IP rights attributable to R&D carried on by the company or on the company's behalf. However, as required by the OECD recommendations, a company must have an R&D fraction of at least 0.325 to elect for this uplift.

Hybrid mismatch arrangements

The Act includes new rules to address hybrid mismatches, implementing the best practice recommendations in the OECD's BEPS Action 2. Hybrid mismatches are defined as cases where an amount is deductible in one jurisdiction but not taxed in any other (a deduction/non-inclusion mismatch), or where an amount is deductible more than once (double deduction mismatches). It is thought that the number of Japanese groups with such hybrid arrangements is minimal.

Royalty payments and deduction of income tax at source

The Act includes a package of three measures with regard to royalty payments and the deduction of income tax at source (withholding taxes). Essentially groups will need to review their connected party royalty payment structures to determine whether there is a tax avoidance motive to the arrangements, in which case this domestic treaty override may apply to charge withholding tax at 20%. The rules apply from 17 March 2016 and also broaden the definition of royalty for these purposes.

Overall the package of changes introduced by Finance Act 2016 is consistent with the desire of the UK Government to maintain a tax regime that is attractive to investors, but transparent and difficult to manipulate in terms of tax avoidance, consistent with OECD BEPS recommendations. For Japanese groups this will mean potential tax benefits, but with increased risk around JCFC and greater reporting and disclosure requirements.

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