# UK Budget – Some Key Changes

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The UK Budget took place on 29th October. The Chancellor, Philip Hammond, took the opportunity to make a series of targeted changes to the UK's tax system, some of which had already been announced, but several of which were new and surprising. We have summarized here of the most eye-catching changes that will be of interest to our corporate and international client base. Please contact any member of our UK tax group if you have any queries about how this year's Budget will affect your business.

**Immediate restriction on eligibility for entrepreneurs' relief**

Entrepreneurs' relief (ER) is a longstanding relief which allows, amongst others, certain manager shareholders in private fund backed businesses to pay capital gains tax at 10% rather than 20% on up to £10 million of lifetime gains realised when they sell their shares in the company that they manage. The most significant change announced in the Budget that will affect private fund-backed businesses was the immediate change to the conditions required for shareholders to be able to claim ER, which means that many management shareholders who would have qualified for ER on a future sale of the shares that they hold currently will now not qualify. While changes to the ER rules have been anticipated for a while, it is surprising that the changes have been introduced with no consultation, immediate effect and application to existing shareholdings on the basis, as stated by the Treasury, that the measure is to "address an identified abuse of the current rules".

In order to be able to claim ER on shares, the share issuing company has to be the individual shareholder's "personal company". As well as some employment requirements, this required that the individual held "ordinary shares" which entitled them to at least 5% of the issuing company's "ordinary share capital" and 5% of the votes. The ordinary share capital test is a technical one, so that the only substantive requirement was for the ER shares to carry 5% of the votes. A private fund backer of a business would generally be willing to give management as a whole 20% of the votes so that they retained 75% plus control of the company.

The change to the rules has introduced two new economic rights tests, so that in addition to the share capital and voting rights, an individual now has to be entitled to at least 5% of the profits available to equity holders and 5% of the assets available to equity holders in a winding up of the company. These tests have to be satisfied at all times through the 12 months before the disposal (being increased to 24 months from 6 April 2019). It will be extremely difficult for any portfolio company manager receiving shares as part of an equity incentive arrangement from a private fund backed business to satisfy these 5% economic tests.

As we mention above, it is not particularly surprising that these changes have been made to the rules, particularly given the Resolution Foundation's (the political think tank) report in August pointing out just how much ER has cost the Exchequer in the 10 years since its introduction and who has benefited from it. What is unfortunate, however, in a period when it is particularly important for the UK to appear an attractive jurisdiction for inward investment, is that the changes have been introduced with immediate, and effective retrospective, effect by removing a large number of existing management shares from ER without warning when the share terms were designed to comply fully with the clear and well understood requirements in place when the shares were issued. The government's claim that the change is addressing an abuse of the rules, along with the immediate effect of them, will add to the feeling of the investment management industry that they are not welcome in the UK and undermine further the UK's reputation for having a stable and certain tax regime. For these reasons, the manner in which the change has been introduced is more concerning than the change itself.

**Digital Sales Tax**

It was also announced at the UK Budget that the UK will introduce a new digital services tax (DST).  The DST will apply from April 2020 and is intended to address the rise of the digital economy and the challenges it poses to traditional tax regimes by ensuring that digital businesses pay UK tax that reflects the value generated from UK customers.

The tax will be levied at 2% of revenues generated from UK customers by search engines, social media platforms and online marketplaces. Only businesses that meet a “double threshold” will fall within the scope of the tax, meaning that they must generate at least £500m of revenue globally and the first £25m of UK revenue will not be taxable. A safe harbour will be included for businesses that are loss-making or have very low profit margins, the details of which will be subject to consultation.

The introduction of the DST makes the UK a front runner in tackling tax for the digital economy, although it is acknowledged that it may be repealed in the future as international solutions for effective taxation of the digital economy are progressed and implemented.

**Offshore Intangibles Regime**

New rules are to be published, which will have effect from 6 April 2019, to directly tax non-resident companies that realise intangible property income in low-tax jurisdictions that derives from UK sales. The measure will include embedded royalties and income from the indirect exploitation of intangible property in the UK market through unrelated parties.

The Government gives the example of a non-UK entity receiving income from the sale of goods or services in the UK, and that entity making a payment to the holder of intangible property in a low tax jurisdiction. A charge will arise under the new rules to the extent that the income receivable in the low tax jurisdiction is referable to the sale of goods or services in the UK.

This tax replaces the previously proposed withholding tax proposed in Budget 2017 to capture similar revenues. How this new tax will be collected and enforced remains to be seen, although the proposals do include joint and several liability for connected parties if the non-resident entity does not pay. There will be a £10m de minimis UK sales threshold and other exemptions where income that is taxed at appropriate levels and/or supported by local substance. In addition, non–UK resident companies located in countries with which the UK has a double tax agreement containing a non-discrimination article will not be affected.

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