KPMG

# M&A Matters

**Autumn 2016**

kpmg.com/uk

# Welcome to the autumn edition of M&A Matters

M&A Matters incorporates the latest topical tax updates with a broader review of M&A insights.

We begin the autumn issue with Tim Jones and Hiral Bhatt providing an update on the best practice approach in respect of input VAT recovery on deal costs, including practical guidance on how to implement such practice.

Next, Nick Roome and Ben Brafman from KPMG's Legal Services team discuss whether it is possible for UK companies to hold shares in their overseas parents – which can sometimes occur as an intermediary step in a wider transaction (e.g. triangular merger structures).

Colm Rogers from KPMG in Ireland then runs through recently announced changes to Section 110 holding companies, which will be of particular relevance to groups holding real estate through Irish holding structures.

Then, Chris Barnes and Edward Groves from KPMG's Rewards team give an update on management incentives and investments, including changes to Employee Shareholder Status, Entrepreneurs' Relief and the new 'financial products' Disclosure of Tax Avoidance Scheme hallmark.

We are then given an update on capital reductions by way of reducing share capital by Iain Kerr and Rob Norris, following recent clearance granted by HMRC.

Important changes to Stamp Duty relief are outlined by Sean Randall and Sinisa Butina, following amendments made to Finance Bill 2016 at the Committee Stage that took immediate effect on 29 June 2016.

We are then given an overview of the impact of Brexit on tax by Abe Amoo and Sarah Beeraje, including an outline of the different models that the UK Government may follow, along with potential direct/indirect tax consequences.

Serena Bell then takes us through the proposals to clarify partnership taxation, following the publication of a consultation document in August.

Finally, Fredrik Klebo-Espe and Paul Freeman provide an update on the hybrids legislation following recent amendments included in Finance Bill 2016.

We hope you will enjoy our autumn edition of M&A Matters. If you would like further detail on the articles in this, or any previous issue, please call us, the authors, or your usual KPMG contact.

**Editorial Team**

**Alistair Haley**
Director – KPMG in the UK
**T:** +44 20 7694 4383
**E:** alistair.haley@kpmg.co.uk

**Saul Russo**
Manager – KPMG in the UK
**T:** +44 20 7311 4461
**E:** saul.russo@kpmg.co.uk

# Contents

# Input VAT recovery on transaction costs

The issue of input VAT recovery in respect of deal related costs has been an area of intense interest to HMRC for a number of years. HMRC have revised their policy a number of times over the years following landmark case law decisions. Currently we are aware that HMRC are reviewing their latest published policy and associated guidance notes in view of recent cases such as Larentia + Minerva. We are expecting the latest guidance to set out what HMRC will now consider to be the criteria for input tax deduction in an acquisition vehicle and clearly this is keenly awaited by business and advisors alike.

This article sets out the suggested best practice approach in respect of input VAT recovery on deal costs incurred by an acquisition vehicle ("BidCo") on the purchase of a Target Group, and provides practical guidance on how to implement what is required.

### The best practice principles

In order to be in as strong a position as possible (until HMRC publish their guidance) to facilitate recovery of input VAT on deal costs, we advise that Bidco should:

a. be registered for VAT at the time of incurring costs (i.e. when the invoice is issued);

b. receives the relevant transaction related supplies (and can clearly evidence commissioning the supplies). Typically this means ensuring that Bidco has a contractual agreement with the supplier or has formally assumed a contractual relationship and receives VAT invoices in its name;

c. undertakes a genuine, demonstrable taxable economic activity (for example, management services) which have been documented. Bidco should also document its intention to carry out this taxable economic activity as soon as practicable after its creation;

d. enters into a VAT group with the Target Group as soon as possible. Note that the entering into a VAT group itself will not give Bidco the right to recover input VAT on deal costs and separate taxable economic activity by Bidco will be required (see point c. above);

e. have executed management services agreements prior to the receipt of any invoices or otherwise has such agreements in place as soon as possible after it is incorporated;

f. charges management services to the Target Group;

g. charges management services at an arm's length value, including an appropriate margin on costs, and should look to recoup the value of the relevant acquisition fees from the Target Group over a reasonable period of, say, 5 to 10 years; and

h. not have entirely wholly common directors as the entities to which management services are being charged.

▶Continued

## The direct and immediate link question

HMRC take the view that a direct and immediate link is required between the deal costs and the management services carried out for VAT to be recoverable on the deal costs.

HMRC appear to accept that there is such a link between the typical deal costs an acquisition vehicle incurs and the typical management services the acquisition vehicle would provide to its subsidiaries. This position has been confirmed by the ECJ in the Cibo case .

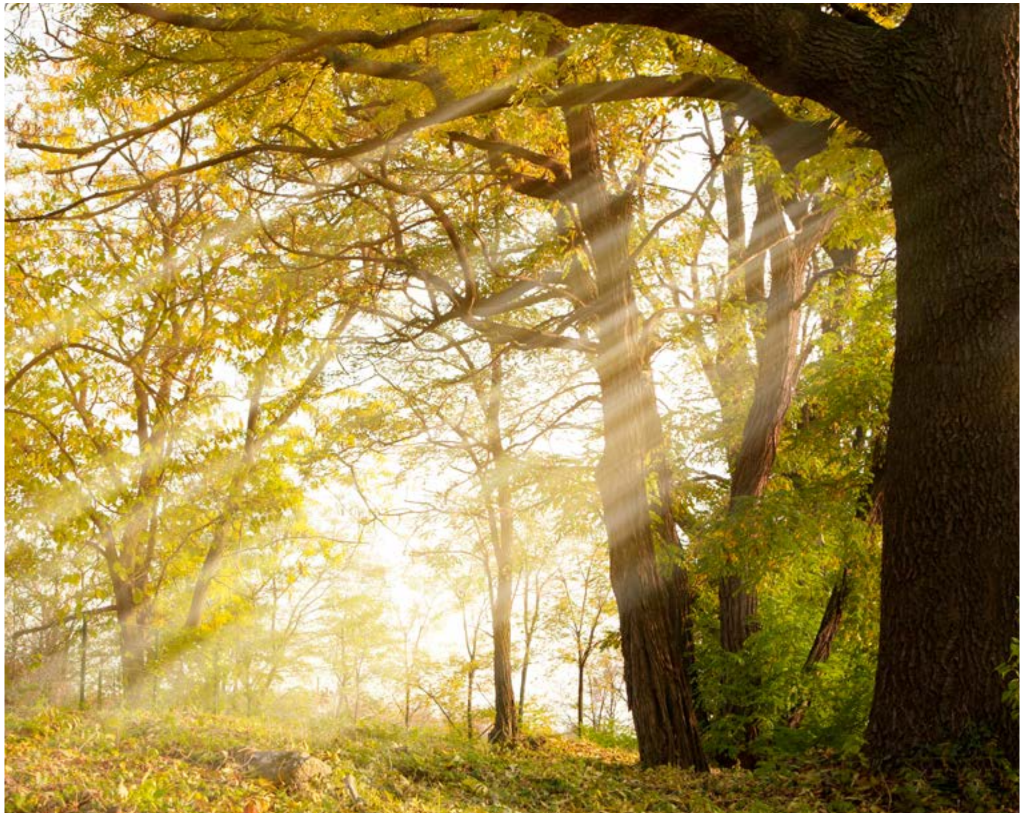
Following the decision of the ECJ in Larentia + Minerva , the European Court held that deal costs do not necessarily need to be a cost component of onward taxable supplies made by an acquisition vehicle for those taxable supplies to give rise to a right to recover input VAT on relevant deal costs. This position is a departure from HMRC's traditional view where deal costs had to be a cost component of taxable supplies made by an acquisition vehicle. Final updated guidance from HMRC is anticipated on this point as noted above.

Despite this, it would still be advisable for deal costs to be a cost component of the relevant management services provided by Bidco, in the interim period whilst we await final updated HMRC guidance. This position if ultimately confirmed, would allow for welcomed flexibility in the calculation of management services (see below), for example deal costs can be included as a cost component of management services fees where a higher management services fee value is required, but can be excluded where a lower management services fee is favoured for commercial or non-VAT related tax reasons.

## Which Target group members should be supplied with Management Services?

Following comments of the Court of Justice of the European Union in Larentia + Minerva, careful thought should be given to the extent to which management services should be provided to the subsidiaries within the Target group by the acquisition vehicle if this vehicle is to obtain a right to recover 100% of input VAT on deal costs incurred. The rationale of the Court of Justice of the European Union suggests that if an acquisition vehicle actively manages only some of its subsidiaries, it will be making taxable supplies but will also be carrying out non-business activities, in the form of the passive holding of investments (of subsidiaries it does not manage). As a result, the acquisition vehicle's right to recover input VAT on general expenditure (such as deal costs) the taxable versus non-business activities carried out.

The above can be practically problematic where the Target group has large numbers of subsidiaries, and it would become administratively burdensome to document, provide and invoice for management services to all entities. However, the effect of the above requirement can often be manageable because excluding subsidiaries which contribute little to overall group turnover or EBITDA from receiving management services will consequently have an immaterial or very limited effect on an input VAT pro-rata recovery calculation. The administrative burden can also be managed by invoicing once a year only It will be interesting to see how HMRC intend to address the comments of the Court of Justice of the European Union in their revised guidance.



▶Continued

### Alternative taxable economic activity

The economic activity required to give rise to a right to input VAT recovery on deal fees could also take the form of lending (on commercial terms) to non EU subsidiaries (as opposed to management services). Interest on such debt is a service which is exempt from VAT but which explicitly carries the right to recover input VAT as what is known as a "specified supply". The above best practice guide broadly applies equally where non EU loans are the taxable economic activity being used to generate input VAT recovery. It is important to note that the pairing of the provision of management services with the granting of non EU loans would make the input VAT recovery case even stronger.

Interest on EU loans is a service which is exempt from VAT without the right to recover input VAT. This will mean such loans will likely impact overall input VAT deal recovery on deal costs and should therefore typically be avoided at Bidco level.

Interestingly, however, on the basis that the provision of credit (e.g. loans, advances) also constitutes an economic activity, HMRC may consider that lending to subsidiaries on proper commercial terms, could be supportive in terms of VAT recovery in certain (specific) circumstances. For example, were Bidco to make loans to UK subsidiaries, and crucially is part of a VAT group with these subsidiaries, this lending could potentially be sufficient to satisfy the economic activity requirement for input VAT recovery. Loans within a VAT group are outside the scope of VAT rather than exempt supplies, and therefore would not in themselves taint input VAT recovery. If this were to be confirmed by HMRC, it could mean that where a UK Bidco purchases a UK Target group, lends funds to the UK Target group (e.g. to refinance debt) having formed a VAT group with this UK Target group, the UK Bidco could (subject to the other best practice guidelines and normal recovery rules set out above) potentially be able recover input VAT on deal costs without actually providing any management services.

▶Continued

## Impact of Brexit

The “leave” vote in the referendum on EU membership has raised numerous questions concerning the UK’s tax rules post Brexit. The UK’s VAT system is currently governed by EU law in the form of the VAT Directive and decisions of the ECJ. However the exit is managed, leaving the EU will mean that UK VAT law will no longer be required to adhere to EU VAT law. At the same time, the current expectation is that historic EU case law will remain very influential in the future as the UK will want its VAT system to be a level playing field with the rest of the EU as far as possible, so as not to act as a disincentive to investment.

It should be kept in mind that the UK will technically be required to continue to implement existing EU case law into UK law through HMRC’s application of its policies until such time as it has formally left the EU. This creates a tension between HMRC’s stated preference for deal costs to be a cost component of taxable supplies made by the acquisition vehicle to allow for input tax recovery and the ECJ’s decision in Larentia + Minerva that downplays the requirement for costs to be a cost component of the onward supply in order to allow for input tax recovery.

It will be interesting for the industry to see what HMRC’s anticipated, updated guidance says when it is finally released. While the natural expectation would be for HMRC to fall into alignment with the ECJ view during the final period of EU membership, if HMRC were to retain its cost component position it remains to be seen how the Commission would react and whether there would be appetite to start infraction proceedings for a departing Member State. While we await HMRC’s latest guidance, the best practice principles outlined here represent a sensible policy to adopt, though close monitoring of future developments will of course be essential.

## Final thoughts

With early planning and careful adherence to the guidance noted above, it should be possible for Bidco to recover all or at least part of the input VAT it incurs on its deal costs. It should be noted, however, that some risk will always remain that HMRC will challenge VAT recovery on deal costs and impose at least some level of restriction on VAT recovery. Practically, care should be taken when recovering VAT on deal costs as the VAT component on certain deal costs will never be recoverable (for example VAT costs which do not fall to be input VAT), such as where the acquisition vehicle is settling fees for a supply made to another party (e.g. a bank).

Additionally, it should be noted that where a Bidco is a newly registered entity for VAT purposes and submits a repayment VAT return, HMRC are likely to scrutinise such returns closely to ensure they are happy with the VAT recovery position adopted.

[1] Participations SA v Directeur Regional des Impots du Nord-Pas-de-Calais (C-16/00)
[2] Beteiligungsgesellschaft Larentia + Minerva GmbH & Co. KG and Finanzamt Hamburg-Mitte v Finanzamt Nordenham and Marenave Schiffahrts AG (ECLI:EU:C:2015:496 previous ref C-108/14 and C-109/14)


**Tim Jones**
Partner – KPMG in the UK
**T:** +44 (0) 20 7311 2006
**E:** Tim.Jones2@KPMG.co.uk


**Hiral Bhatt**
Senior Manager – KPMG in the UK
**T:** +44 (0) 20 7694 3033
**E:** hiral.bhatt@kpmg.co.uk

# Can UK companies hold shares in their overseas parent companies?

In certain overseas jurisdictions there are commonly used mechanisms in which subsidiaries hold shares in their parent companies as an intermediary step in a wider transaction. For example, in the US, "hook stock" (i.e. stock issued by a parent company and held by its subsidiary) is often utilised in various triangular merger structures.

Where the subsidiaries in question are incorporated in the UK, we are often asked to consider these structures from a UK tax and legal perspective. A common question is whether such structures are prohibited by Section 136 of the Companies Act 2006 (the "CA 2006"), which prevents a subsidiary from being a member of its holding company in certain circumstances. This article examines whether this section applies to overseas holding companies, and notes some of the wider issues.

## Section 136 of the CA 2006

Section 136 of the CA 2006 provides that "a body corporate cannot be a member of a company that is its holding company" and states that "any allotment or transfer of shares in a company to its subsidiary is void", subject to various narrow exceptions (for example in relation to pension schemes or employees' share schemes). The relevant definitions of "holding company" and "body corporate" expressly include entities incorporated outside of the UK. Therefore, at first blush, it appears that Section 136 prohibits UK subsidiaries from holding shares in their overseas parent companies.

## The Meaning of "Company"

However, Section 1(1) of the CA 2006 provides that "unless the context otherwise requires" the word "company" means a company formed and registered under the Companies Acts (i.e. the CA 2006 and its predecessors), that is to say: a UK company. Therefore, since Section 136 only prohibits a body corporate from being a member of "a company that is its holding company" and only voids an allotment or transfer of shares "in a company to its subsidiary" this section will only prohibit UK companies from holding shares in their overseas holding companies if it can be shown that the context of Section 136 requires the normal definition of "company" to be expanded: in other words, if the context of Section 136 does "require otherwise" in these situations, as Section 1(1) contemplates that it may.

'There is a strong argument that Parliament's inclusion of the word "company" in these provisions evidences a clear intention to exclude situations in which the relevant holding company is an overseas entity.'

▶Continued

There is a strong argument that Parliament's inclusion of the word "company" in these provisions evidences a clear intention to exclude situations in which the relevant holding company is an overseas entity. We are aware of clients who have been challenged on this point in the past, including by revenue authorities, on the basis that the words "unless the context otherwise requires" in Section 1(1) allow the context of Section 136 to be taken into account, and that this Section is intended to apply in relation to all holding companies, whether or not incorporated in the UK. It is therefore important to consider the history of these provisions, relevant case law and the consultations that led to the provisions being adopted.

## The Purpose of Section 136

The provisions of Section 136 originate from the Cohen Committee Report of 1945. This recommended amendments which were eventually adopted by the Companies Act 1989, and carried over without any substantive changes into the CA 2006.

It is clear from this report that the amendments had two purposes:

1. To prevent directors of a holding company from maintaining themselves in office using the voting rights attached to shares held by a subsidiary.

2. To prevent the capital of the holding company from being indirectly depleted by the purchase of its shares by a subsidiary.

The second purpose, the maintenance of capital, was considered by Millett J in Arab Bank Ltd v. Mercantile Credit Plc [1994]. In this case the Court was considering the meaning of the same terms (i.e. "company" and "subsidiary") in a similar formulation, although the case addressed a different issue, namely the scope of financial assistance under the Companies Act 1985. However, Millet J made several observations which apply to the interpretation of Section 136. In particular, he noted that "the capacity of a corporation, the regulation of its conduct, the maintenance of its capital and the protection of its creditors and shareholders are all matters for the law of the place of its incorporation" and that there is a presumption (unless a contrary intention can be shown) that UK legislation does not apply to foreign corporations whose acts are performed outside of the UK.

## The DTI Consultation and Parliamentary Debate

The CA 2006 was enacted following a consultation by the Department of Trade and Industry ("DTI"). The consultation document was published in 2000 and specifically considered the prohibition on a subsidiary holding shares in its parent company.

It noted that the prohibition "only applies to parent/subsidiary relationships. It does not prevent more complex reciprocal relationships which may disguise the fact that there is little or no "external" capital in any of the companies involved… We also suspect that attempts to close off all the potential scope for abuse would result in an overly complex set of provisions…and that reliance on disclosure is a better solution".

In addition when Section 136 was discussed at the Commons Committee it was noted that although the clause had a long history there had been no lobbying of which the Committee was aware for any changes to the existing provisions. The Committee noted "It is probably true to say that this is one of those things that are best left alone unless there is another reason for consideration". Accordingly the old provisions were adopted into the CA 2006 without any substantive amendments.

▶Continued

## Conclusions

The above analysis suggests that, in general, Section 136 should not prohibit a UK company from holding shares in its overseas holding company, unless it can be shown that the context of Section 136 requires the normal definition of "company" to be expanded.

However, there are several strong arguments that the context of Section 136 does not require this:

- the inclusion of the word "company" in the relevant provisions suggests an intention to exclude overseas holding companies;
- the history of the provisions suggests that their original aim was to protect the capital of the parent company, and prevent its directors from maintaining themselves in office using voting rights acquired by a subsidiary;
- case law on similar issues has affirmed that there is a presumption, unless a contrary intention can be shown, that UK law does not seek to regulate the capital or governance of foreign corporations;
- it appears that there was no intention to change this provision when it was adopted into the CA 2006, and there is no evidence of which we are aware that Parliament intended the provision to apply to overseas holding companies; and
- the Commons Committee noted that Section 136 is not intended to prevent all possible issues which may arise in structures with circular ownership.

### Practical Implications

The above analysis suggests that in general Section 136 of the CA 2006 should not prevent a UK company from holding the shares of an overseas holding company. However, the effect of Section 136 should always be considered in the light of the full facts. For example, if a UK subsidiary receives enough shares in an overseas parent to become that parent's holding company, Section 136 may be breached, since the parent/subsidiary relationship will have in effect been inverted. In addition, it will always be necessary to consider the applicable law of the overseas parent company whose shares are being purchased by the UK subsidiary, as well as the laws applicable to the wider transaction and group.

Finally, it should be emphasised that even where Section 136 does not apply, it is still necessary to consider UK company law more generally (for example, in relation to corporate benefit, the maintenance of capital or financial assistance), as well as any other relevant regimes, for example applicable regulatory requirements or investment exchange rules. In addition, structures which entail circular ownership ownership may have adverse accounting, tax and governance implications, which will also need to be considered carefully before they are implemented.

'Structures which entail circular ownership may have adverse accounting, tax and governance implications, which will also need to be considered carefully before they are implemented.'


**Nick Roome**
Partner – KPMG in the UK
**T:** +44 (0) 161 246 4184
**E:** nick.roome@kpmg.co.uk


**Ben Brafman**
Manager – KPMG in the UK
**T:** +44 (0) 20 7694 8345
**E:** ben.brafman@kpmg.co.uk

# Irish holding structures - changes to section 110

On 6 September 2016 an announcement was made by the Irish Department of Finance applying new tax rules to certain Section 110 companies which hold debt interests secured on or deriving their value from Irish real estate. These changes will have effect in respect of income and gains arising (accruing) from 6 September 2016 onwards.

TA brief overview of the changes below is set out below. Given the change in the rules took immediate effect, existing structures should be reviewed to assess the impact of the changes.

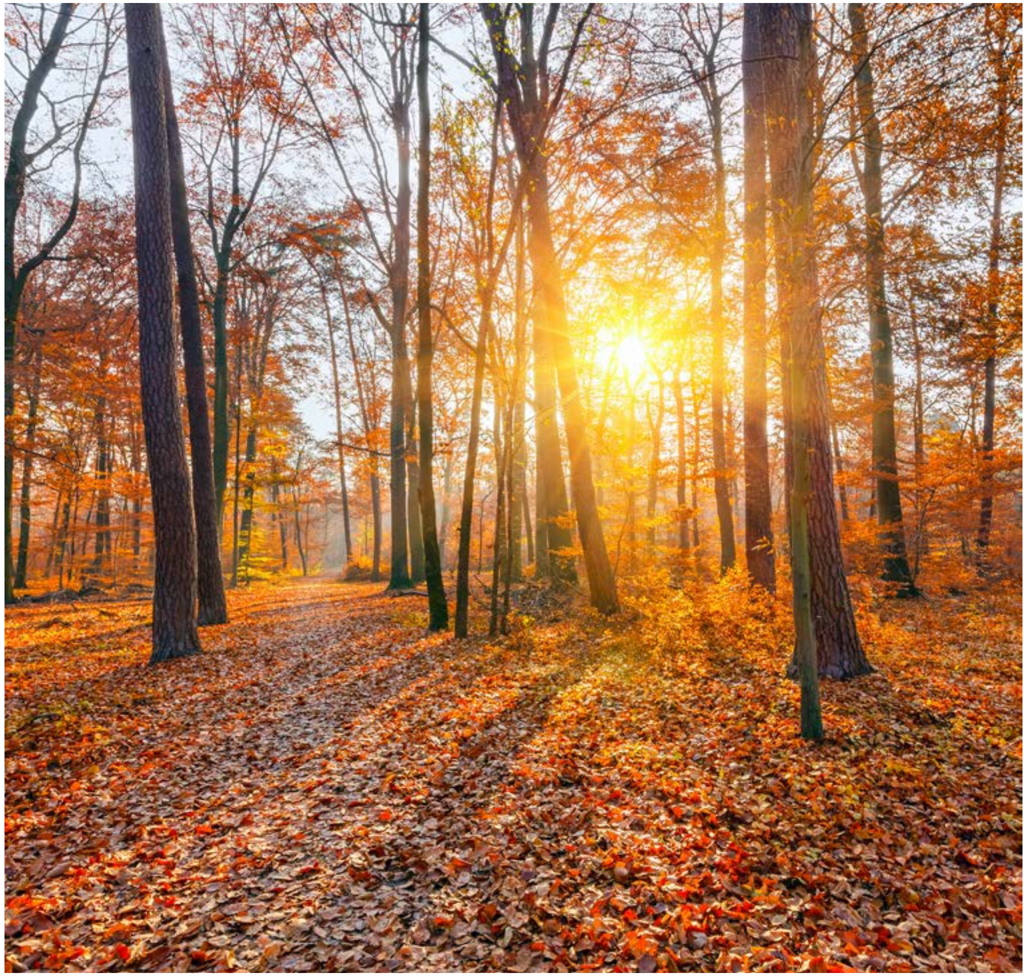
## Background

There has been extensive media coverage over the past number of months of certain investors acquiring debt secured on Irish real estate (e.g. home mortgages and small business loans) at significant discounts and realising the return on those investments tax-free through the use of Section 110 Special Purpose Vehicles ("SPVs"). There has also been significant commentary on the tax-free returns earned by exempt Irish funds on real estate assets.

The Department of Finance has decided to introduce changes to the Section 110 legislation which, although they will be enacted at a later date, are stated to apply from the date of the announcement (i.e. 6 September 2016).

While the announcement acknowledges the positive contribution of the securitisation industry, the Minister of Finance is quoted as saying "[a] number of concerns have been raised recently about the possible use of aggressive tax practices by some Section 110 companies to avoid paying tax on Irish property transactions".

The announcement does not include any changes in relation to the taxation treatment of Irish funds which hold Irish real-estate assets. However, it is understood that some changes in this regard are likely to be made as part of the upcoming Finance Bill which will be published in October.



▶Continued

## Proposed changes

The main thrust of the proposed changes is to deem any financial assets which derive (directly or indirectly) all/most of their value from Irish real estate to be held in a separate (parallel) business (to be known as an "Irish Property Business").

This Irish Property Business will continue to be taxed under the Section 110 rules but subject to a new restriction on the ability to deduct interest on profit-participating debt. The restriction will operate such that deductions will be capped to the amount of interest that would have been payable had the loan been entered into by way of bargain made at arm's length and where the coupon was not dependent on the results of the Irish Property Business.

Essentially, therefore, a tax deduction for that amount of interest which could have been raised on a non-profit-participating basis from a third party should be deductible but interest payments in excess of this would be restricted.

The resulting taxable profits will be taxed at the rate of tax applicable to all securitisation activities i.e. 25%.

## Exclusions from new restriction

This new restriction will not apply in all circumstances. In particular, it will not apply where the interest on the profit-participating loan is paid to:

a. A person who is within the charge to Irish corporation tax in respect of the profit-participating loan interest (i.e. an Irish resident company or a foreign company which holds the loan through an Irish trading branch);

b. Certain Irish pension funds; or

c. A person who is resident under the local law of another EU/EEA member State where that interest income is subject to a tax in that country which generally applies to foreign source profits, income or gains received in that country received by local residents (provided that the recipient does not have the benefit of a tax deduction for notional interest computed with reference to the amount of interest income received on the loan).

However, the exception in (c) above, will only apply where it is reasonable to consider that (i) it would not be reasonable to conclude that the profit-participating loan forms part of any arrangement of which the main purpose (or one of the main purposes) is the avoidance of a liability to (Irish) tax; and (ii) genuine economic activities are carried on by that non-resident in the other EU/EEA country.

While the three above-mentioned exclusions from these new restrictions are welcome, there is a lack of clarity as to the conditions attaching to exception for interest paid to persons who are resident in other EU/EEA member States. In particular, as of yet, there is no guidance as to precisely what circumstances the Revenue Commissioners would consider "reasonable" when evaluating whether there is a tax-avoidance motivation; nor is there any guidance as what would constitute "genuine economic activities".

It is worth noting that this new interest restriction is very similar to an existing restriction on the deductibility of all interest on profit-participating loans. However, the existing restriction is not applicable where the interest is paid to most taxable and exempt Irish and treaty-country recipients (provided that, in the case of a treaty recipient, it is not entitled to a notional interest deduction based on the amount of Irish interest received). The existing restriction also does not apply to quoted Eurobonds and wholesale debt instruments except in certain circumstances. As a result, this new, narrower restriction (although only applicable to part of the profit-participating interest) will impact on a wider constituency of Section 110 companies.

▶Continued

### Two Businesses

As outlined above, a Section 110 company which has financial assets which derive (directly or indirectly) all / most of their value from Irish real estate as well as other assets, will have two separate business. Where this occurs, the legislation provides for a just and reasonable allocation of expenses between those activities.

By treating the Irish Property Business as a separate securitisation business this may preclude the use of any losses arising from the other securitisation business from sheltering profits on the Irish Property Business (or vice versa).

### Application

We expect that the new legislation will be enacted as part of the upcoming Finance Bill but it will be applicable to profits arising from the Irish Property Business after 6 September 2016.

It is likely that there will be some discussion between interested parties and the Revenue Commissioners before the Finance Bill is enacted and, as a result, further changes may occur.

> ‘The new legislation will be applicable to profits arising from the Irish Property Business after 6 September 2016.’

**Colm Rogers**
Partner – KPMG in the UK
**T:** +35 314 102 166
**E:** colmrogers@kpmg.com

# Management incentives and investments update

Management incentivisation and the tax treatment of any management return and/or re-investment remains a key part of a successful M&A transaction. This article sets out a summary of the recent UK tax changes relevant to management incentives and investments.

## Background

Many management incentive or investment structures remain focussed on seeking to ensure that any growth in value is not taxed as employment income (at rates of up to 47%), but instead taxed as investment income (for debt or debt-like returns) or capital gains (for equity returns). This is particularly true since the April 2016 reduction in the maximum rate of capital gains tax ("CGT") from 28% to 20%. However, CGT also gives access to some potentially valuable Government sponsored employee tax reliefs which can further reduce, or even eliminate, an employee's tax bill on their shares.

It therefore remains important to balance the commercial, legal, tax and administrative considerations when developing an incentive plan in order to seek to ensure it is affordable to employees and administratively workable, as well as meeting its primary objective of providing an appropriate incentive to drive the development of the business.

## Changes to Employee Shareholder Status ("ESS")

ESS is a Government initiative that was introduced for UK based employees in autumn 2013 pursuant to which employees could agree to assume ESS and surrender certain employment rights, in consideration for an issue of shares. The benefit to UK employees of assuming this status was that, provided certain conditions were met, any gains on the disposal of the shares acquired should be exempt from CGT. This applied to ESS shares worth up to £50,000 at the date of award.

Since its introduction, ESS has been popular as a feature of management incentive plans implemented either immediately following a change of control, or subsequently.

Budget 2016 announced that, for shares issued pursuant to an ESS arrangement entered into on or after 27 March 2016, the CGT exemption that applies on a disposal of ESS shares is limited to £100,000 of lifetime gains. This limitation does not apply to ESS shares issued prior to this date.

Whilst ESS does still offer a tax saving on gains to UK employees, given the formalities required to issue shares in accordance with the ESS legislation, we have noticed a change in focus in the use of ESS as part of management incentive plans introduced since Budget 2016, as businesses have evaluated the tax benefits against the complexities and legal formalities of using ESS. This type of arrangement can still offer significant tax benefits to employees, but in our experience is now more typically used on broader based incentive plans, rather than those which just involve a handful of participants.

However, one advantage of ESS (particularly considering the withdrawal of the Post Transaction Valuation Check ("PTVC") service – considered further below) is that it is possible to agree the tax market value of ESS shares with HMRC in advance of issuing the shares, which provides both the employee and the employer with certainty of the tax value of the shares in advance of their issue.

> 'We have noticed a change in focus in the use of ESS as part of management incentive plans introduced since Budget 2016.'

▶Continued

## Withdrawal of HMRC PTVC

HMRC have historically allowed companies to agree the tax market value of shares acquired by employees via the PTVC facility. This facility allowed employers to obtain certainty of the valuation of shares, to protect against (or quantify) potential PAYE and NIC liabilities.

With effect from 31 March 2016 the PTVC facility has been withdrawn by HMRC, such that employers now no longer have the ability to agree the tax market value of shares, other than in specific circumstances (i.e. issuing ESS shares or granting awards under HMRC tax advantaged share plans).

Whilst this means that certainty is no longer available, provided an employer seeks independent tax valuation advice in relation to each relevant transaction, HMRC should accept that the employer has fulfilled its PAYE 'best estimate' obligations so any challenge to the tax market value should be a matter for the employee rather than assessable under PAYE and NIC. This can also help protect against any uncertainty as to tax treatment on a future exit.

## Changes to entrepreneurs' relief ("ER") rules

ER remains a popular Government sponsored tax relief for key members of UK management which reduces the rate of CGT payable on capital gains from 20% to 10% (subject to a lifetime allowance of £10 million of gains).

In order to qualify for ER, UK managers broadly need to hold shares which represent at least 5% of the voting rights and 'ordinary share capital' of: (i) a trading company; or (ii) the holding company of a trading group, for a period of 12 months immediately prior to the relevant disposal upon which ER is to be claimed.

Historically some businesses have used 'ManCo' structures pursuant to which employees have acquired their incentive / investment interests in the relevant trading company / holding company via a special purpose vehicle (a "ManCo"). These ManCos were generally used to not only provide a pooling vehicle for the employee investment but also on some occasions allow employees to gain access to ER in circumstances where they may not otherwise have been able to access ER.

Finance Act 2015 introduced provisions which sought to prevent employees gaining access to ER via a ManCo by amending the 'joint venture' ("JV") elements of the ER legislation. However, these changes meant that even if an employee would have had an effective 5% interest in the relevant trading company / holding company via their ManCo interests, the employee was prevented from claiming ER by virtue of holding their interest via a ManCo. The amended rules also created problems for groups with JVs further down the group structure.

Finance Act 2016 will relax these changes to allow those employees who would have an effective 5% interest in the relevant trading company / holding company to be able to claim ER provided certain conditions are met (and also to deal with some of the problems created for groups with JVs below the holding company).

Therefore whilst it should now be possible to use a ManCo without disadvantaging any employee who would have naturally qualified for ER, care should still be taken when seeking to include ManCos in any incentive structure, as there are various other tax implications of ManCos to consider.

▶Continued

## Anti-avoidance legislation

In February 2016, HMRC expanded the scope of the Disclosure of Tax Avoidance Scheme ("DOTAS") regime to include a new 'financial products' hallmark which applies to shares, loan notes, and other securities. Amongst other factors, this considers whether "arrangements contains at least one term which is unlikely to have been entered into by the persons concerned were it not for the tax advantage".

To the extent arrangements put in place post-February 2016 are considered to fall within this expanded DOTAS regime, those arrangements must be disclosed to HMRC under the DOTAS regime, which could increase the likelihood of HMRC challenging the expected tax treatment of the arrangements. This area should be covered by tax advice you receive.

## Disguised interest rules

Although not such a recent development, those undertaking transactions are also now grappling in certain cases with the disguised interest rules. Finance Act 2013 introduced new income tax rules which provided that, in relation to arrangements entered into on or after 6 April 2013, the extent to which a return not otherwise considered as 'interest' but is economically equivalent to interest, that amount should be subject to income tax (as investment income at rates of up to 45%, rather than employment income) at the point of payment.

Where employees hold existing interests in a business, often a proportion of the value of those interests is re-invested in the business in connection with a change of control.

For these purposes, it is important for employees to calculate their after tax returns available for re-investment so the potential application of the disguised interest rules should be considered in relation to existing interests held by employees (such as, for instance, on the disposal of preference shares 'cum-div'), as well as in relation to any new interests to be acquired by employees.

**Chris Barnes**
Director – KPMG in the UK
**T:** +44 (0) 20 7694 2738
**E:** chris.barnes@kpmg.co.uk

**Edward Groves**
Senior Manager – KPMG in the UK
**T:** +44 (0) 20 7896 4931
**E:** edward.groves@kpmg.co.uk

# Capital reduction by way of reducing share capital - recent clearance

Typically, one of two methods is used to reduce a company's share capital to create distributable reserves, either shares are cancelled or the nominal value of each share is reduced.

A reduction in the nominal value of shares does not involve a disposal for capital gains purposes, so there is no need to rely on the reorganisation provisions.

A cancellation of shares results is an actual disposal of the shares as it involves the extinction of an asset (s24(1) TCGA 92), but the reorganisation of share capital provisions (s 126(1) TCGA 92) should apply such that no disposal is deemed to have occurred for capital gains purposes (s127 TCGA). However, this may not be the end of the analysis.

Where the reorganisation provisions apply, it is provided that if the shareholder receives or is deemed to have received any consideration (other than the new holding of shares) there is deemed to be a disposal (s128(3) TCGA). In addition, where an asset is disposed of otherwise than by a bargain made at arm's length, the asset is deemed to have been disposed of for consideration equal to the market value of the asset (s17 TCGA). Therefore, one possible view is that, in the case of the cancellation of shares, the shareholder is deemed to receive market value consideration such that there is deemed to be a disposal (via s128(3) TCGA).

▶Continued

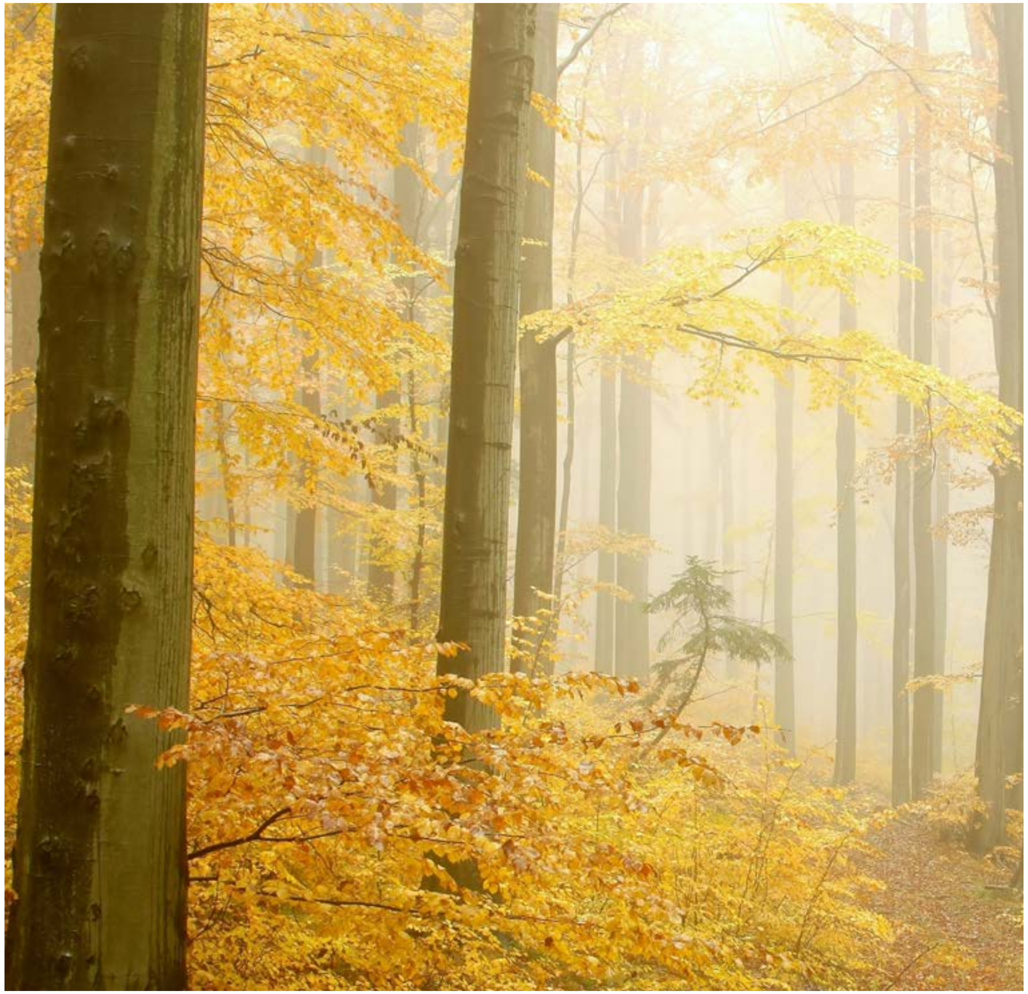
This leads to the question as to whether the shareholder is deemed to receive consideration when shares it owns are cancelled. HMRC have previously stated that they had no fixed views on whether the market value rule could apply to a share cancellation. This has resulted in uncertainty such that there is a preference to reduce share capital by reducing the nominal value of shares.

In a recent situation, a taxpayer chose to achieve a capital reduction by cancelling preference shares in a wholly owned subsidiary. HMRC have provided a clearance that the market value rule does not apply in the particular circumstances. In summary, the rationale in the clearance application was as follows:

- The cancellation of shares in a wholly owned subsidiary should not be characterised as a bargain otherwise than at arm's length; the shareholder owns 100% of the equity of the subsidiary before and after the transaction and the value of the subsidiary has not been reduced as a result of the share cancellation. As a result, there is no gratuitous intent to dispose of an asset at less than market value (CG14542) and the shareholder is not making an economic profit or loss.

- Although it is provided that "where a person acquires an asset and the person making the disposal is connected with him" the transaction is treated as being otherwise than by way of a bargain at arm's length, this should not apply here because there is no acquisition of the shares (s18 TCGA). Even if shares are purchased, there is deemed to be no acquisition of an asset (s195 FA 2003).

This rationale could be relevant where ordinary shares in a wholly owned subsidiary are cancelled.




**Iain Kerr**
Director – KPMG in the UK
**T:** +44 (0) 78 7965 1557
**E:** iain.kerr@kpmg.co.uk

**Rob Norris**
Director – KPMG in the UK
**T:** +44 (0) 77 1570 5038
**E:** Rob.Norris@KPMG.co.uk

# Important changes to stamp duty relief

Stamp duty relief for insertions of new holding companies (under s77 FA 1986) is now denied where there is an arrangement for a particular person (or persons) to obtain control of the new holding company. While the relief will probably continue to be available for share-for-share transactions prior to Initial Public Offerings ("IPOs"), it will not be available in circumstances that until the change was announced (June 2016) were thought to be benign.

### What is the stamp duty relief?

Section 77 of the Finance Act 1986 (acquisition of target company's share capital) gives a full exemption from stamp duty where a new holding company is put on top of an existing group. It is an important relief for corporate reconstructions driven by a reasons that include demergers and IPOs.

### What is the change?

The relief has always included a 'motive test': the transaction must not be part of an arrangement or scheme to avoid stamp duty (or certain other prescribed taxes). This prevents a new offshore company being put on top of a UK company as part of an arrangement to avoid stamp duty.

Government amendments were made to the Finance Bill 2016 at Committee Stage with immediate effect and no consultation to prevent a perceived threat to the revenue base. They make provision for a new condition to be inserted into section 77 and a new section 77A to be inserted into the Finance Act 1986 with effect from 29 June 2016.

Together they restrict the availability of the relief where there are there are arrangements for a particular person (or persons together) to obtain control of the new holding company. Their aim is to ensure that stamp duty is paid on all takeovers of UK companies. They follow a change to the Companies Act 2006 last year that stop a UK company from reducing its share capital as part of a takeover or merger.

The new changes are subject to only one exception – arrangements for a change of control are not disqualifying arrangements in the unusual situation where a new holding company is inserted on top of a group before acquiring all the shares in another company.

### Soft interpretation

In response to concerns expressed by us and others based on a plain reading of the legislation, HMRC are expected to indicate in guidance that the following arrangements will not be treated by them as disqualifying arrangements:

**1. Greenshoe**

An underwriter's obligation to take over-allotments of shares in the new holding company on an IPO.

**2. Takeovers on IPOs**

A numerical or theoretical change of control of the new holding company by subscribers of shares.

**3. Liquidation**

The appointment of a liquidator on a members' voluntary liquidation.

▶Continued

## The new normal

Neither the pre-existing motive test nor the new 'arrangements' condition deny the relief (or claw it back) if after the share-for-share exchange there is a takeover of the acquiring company by an unidentified buyer at some, as yet, unascertained point in the future. But they do place emphasis on corporate reconstructions that use the relief for reasons that include a potential exit to be carried out strategically.

If, for example, there is a demerger prior to a sale of part of a trading group to an identified buyer, stamp duty will be chargeable on that demerger if it involves inserting a new company above the company that runs the target business. Some have argued that that is unfair and goes beyond the policy of the new provision. HMRC and the Treasury are not, so far, persuaded. Consequently, those undertaking corporate reconstructions should consider starting them earlier and obtain specialist advice to ensure that the relief is available.

HMRC's guidance is expected to draw a distinction between capital reduction demergers and liquidation demergers. The relief is expected to be available in connection with liquidation demergers but not capital reduction demergers. The policy (if any) for drawing this distinction is unclear. Nevertheless it may mark a return to liquidation demergers as the preferred route to partitioning businesses.

> 'The relief is expected to be available in connection with liquidation demergers but not capital reduction demergers.'

**Sean Randall**
Director – KPMG in the UK
**T:** +44 (0) 20 7694 4318
**E:** sean.randall@kpmg.co.uk

**Sinisa Butina**
Assistant Manager – KPMG in the UK
**T:** +44 (0) 20 7694 3887
**E:** sinisa.butina@kpmg.co.uk

# Impact of Brexit on tax

This article considers the models currently in existence which the UK may choose to adopt once it has ceased to be a member of the EU whilst also considering the likely impact on direct and indirect taxes.

## Background

On 23 June 2016 the UK voted to leave the European Union ("EU"). Whilst the decision has been made for Britain to exit the EU ("Brexit"), Britain will likely remain part of the EU for up to two years following the time it notifies the European Council of its intention to leave the EU by triggering Article 50 of the Lisbon Treaty. This two year period may be further extended if the European Council unanimously agrees with the UK to extend the notice period.

Although it is difficult at this stage to provide specific details of how the UK taxation system will be impacted by Brexit, the likelihood is that there will not be any immediate change to direct and indirect taxes. The actual tax impact of Brexit will be better understood once terms of any post-Brexit agreement have been concluded with the EU.

## Existing models

There are a number of models which the UK may choose to adopt once it has exited the EU. Of the several models available, the UK may adopt one of three models currently being used by various non-EU countries who interact with EU member states.

Alternatively, it may also be the case that the UK seeks to enter into its own separate agreements with the EU rather than adopting one of the already existing models however, it is likely this would result in a long period of negotiation.

Recent comments made by the UK Prime Minister suggest that it is most likely the UK Government will opt to adapt an existing model rather than adopt the terms of an already existing model.

Three of the existing models which could be adopted by the UK include the following:

### *The Norwegian model*

Being a member of the European Free Trade Association ("EFTA"), Norway has access to a network of global free trade arrangements. Norway are also eligible to be party to the European Economic Area Agreement resulting in Norway being included in the EU single market. As a consequence of being an EFTA member, Norway must comply with EU rules and restrictions including the four fundamental freedoms: movement of goods, workers, capital and services.

### *The Swiss model*

Switzerland are also a member of the EFTA Agreement however, unlike Norway, they are not party to the EEA Agreement. Switzerland instead has a regularly updated bilateral agreement which it uses to (partially) access the EU single market.

### *WTO Model*

This model will be the default outcome if no other model is successfully negotiated. Under this model, the UK would apply WTO tariffs on imports and exports from and to the EU. EU member firms would also apply the WTO import and export tariffs when trading with the UK.

The WTO rules do not provide preferential access to the single market or any of the 53 free trade agreements which the EU have negotiated with non-EU countries. The UK are already members of the WTO which is increasingly becoming a forum for harmonizing international trade and business practices.

▶Continued

## Direct taxes

Direct taxes are imposed by UK law and as such, the majority of the UK's direct tax law will remain unchanged following Brexit. The UK's direct tax rules must however comply with EU laws such as the four freedoms (the free movement of goods, services, people and capital). Post-Brexit, some UK tax law may no longer be required to comply with some EU laws and some EU directives should no longer apply to UK companies.

Directives such as the EU Parent Subsidiary Directive, which provides relief from withholding taxes on dividend payments made between associated companies in different EU states and provides double taxation relief to parent companies on profits of subsidiary companies, will no longer be available. Therefore the UK will need to rely on the double taxation treaties in place to benefit from preferential withholding tax rates.

The EU Interest and Royalties Directive will no longer be available to relieve withholding taxes on royalty and interest payments between UK companies and associated companies in the EU and it will therefore be important for UK companies to explore the extent to which relief from interest and royalty withholding is available under any double taxation treaty.

Although there are numerous double taxation treaties in place with the UK, it may be the case that full relief (for all withholding taxes, whether on dividends, interest and royalties) is not available in some cases.

The EU Merger Directive offers tax relief to cross-border reorganisations. Once the UK has left the EU, the sections of the EU directive relating to EU member shares would no longer apply to the UK and this could give rise to increased tax costs in the UK for businesses undertaking merger transactions.

▶Continued

## Indirect taxes

### *VAT*

UK law derives from European law. Current EU principles ensure that no UK VAT is charged on cross-border supplies of goods or business to business services provided by the UK to another EU member state.

On leaving the EU, the UK would not have to give effect to the VAT Directive and therefore UK businesses will no longer be required to charge and pay VAT on domestic supplies of goods and services. However, VAT generates a large amount of revenue for the UK Government and it is therefore unlikely the UK Government will repeal VAT or, if VAT were to be repealed, another indirect tax would likely replace it.

### *Customs duties*

EU membership means that customs duties do not apply to trade within the EU and the EU has agreed rates for imports from outside the EU with various non-EU countries. Customs duties are largely governed by EU law and therefore new legislation will be required for transactions the UK enters into with EU member states and also with non-EU member states.

### *Exercise duties*

The UK is currently restricted in its ability to set the rates of excise duties by reference to given thresholds set by EU directives. Post-Brexit, the UK should be able to vary the rates of excise duties without being restrained by EU law.

### *Capital duties*

Current EU directives imposes a restriction on tax charges by member states on companies raising capital i.e. via the issue of shares. Post-Brexit, the UK would no longer be bound by the Capital Duty Directive and related case law.

## Conclusion

Although there are some existing models in place which the UK may use once it has left the EU, there is no certainty on which model the UK will adopt, if any. The post-Brexit tax environment will be better understood once decisions have been made by the Government and negotiations have concluded with EU member states.

**Sarah Beeraje**
Senior Manager – KPMG in the UK
**T:** +44 20 7694 4705
**E:** sarah.beeraje@kpmg.co.uk

**Abe Amoo**
Assistant Manager – KPMG in the UK
**T:** +44 20 7311 4437
**E:** abe.amoo@kpmg.co.uk

# Partnership taxation: overview of consultation document

On 9 August 2016, HMRC published a consultation document on proposals to clarify the tax treatment of partnerships. The consultation covers areas of partnership taxation that HMRC has identified as being potentially unclear or which produce an inappropriate outcome. HMRC state that they do not expect the consultation to have an effect on the vast majority of partnerships, and proposes to clarify the income tax and corporation tax rules for partnerships to ensure that they fit with modern commercial practice.

The consultation is as a result of the Office of Tax Simplification ("OTS") review of partnership taxation. The OTS published its final report in January 2015 which made some key recommendations regarding streamlining the administrative requirements for partnership, most of which HMRC rejected. The consultation document contains a number of proposals and questions regarding how partnership taxation could be improved to make calculating and reporting profits easier for partnerships.

It is split into seven key areas, which are described further below. The consultation applies to general and limited partnerships as well as foreign entities treated as partnerships for UK tax purposes and limited liability partnerships. While investment partnerships are specifically carved out of some of the areas, some of the proposals are potentially very onerous for investment partnerships being used in private equity or similar fund structures.

The key areas of consideration are outlined below.

### Clarification of who is the partner chargeable to tax

The first proposal is that for tax purposes a person will be treated as a partner in a partnership if they are included in the partnership tax return. This is to remove any uncertainty over legal ownership compared to beneficial ownership. The partners listed on Companies House or in the partnership agreement may be the legal owners, who are not liable to tax on partnership profits.

This proposal could have an unintended impact where a nominee company holds the interest on behalf of a number of individuals, and the profit sharing arrangements at the nominee level may not be known by the underlying partnership. This would usually be the case for investment partnerships, rather than trading partnerships.

▶Continued

## Business structures that include partnerships as partners

HMRC specifically exclude investment partnerships from the second proposal, which looks to introduce legislation to ensure that where there is a partnership (the first partnership) which has another partnership (the second partnership) as a partner, then the partners in the second partnership will need to be reported by the first partnership.

This could create some confidentiality issues (as the first partnership is not necessarily going to know the profit sharing arrangements in the second partnership) and will require extra information to ensure that the allocation of profits is reflected correctly.

This would increase the amount of information required to complete partnership tax returns, and therefore could increase potential penalties for late or incorrect filing.

Where the second partnership is a UK partnership, or indeed a foreign partnership being allocated UK trading profits, then HMRC should already have this information from the second partnership's tax return, albeit it has not been set out explicitly in one place.

## Investment income – tax administration

The consultation document contains a specific section in relation to investment funds which are structured as partnerships.

HMRC acknowledges that investment partnerships often have unnecessary administrative requirements due to large numbers of non-UK partners or partners who are not taxable, and that the legislation should be changed to make the tax compliance for these partnerships easier.

There is no proposal in this section, instead HMRC are looking for suggestions on how the tax administration of partnerships with investment income could be improved.

## Trading and property income – tax administration

This section applies to partnerships that carry on a trade or property business and recognises that while for investment partnerships there may be partners who do not have a UK tax liability, for trading and property partnerships typically all partners will have a UK tax liability.

It suggests that in situations where the partnership is unable to obtain details of all partners to include on the partnership tax return, then options should be considered to ensure that the right amount of tax is paid to HMRC. One of the options being put forward is that the partnership could make a tax payment to HMRC on behalf of any partners whose details are not included on the tax return.

## Allocation and calculation of partnership profit

This section focuses on the allocation of taxable profits in partnerships. It proposes to legislate the following:

- the profit sharing arrangements set out in the partnership agreement are the determining factor in identifying how to allocate the taxable profits;
- tax adjusted profits should be allocated on the same basis as accounting profits;
- profits allocated to companies subject to income tax (e.g. non-resident landlords) should be calculated as if the non-UK resident company is carrying on the business; and
- if a partner is not subject to UK corporation tax or income tax (because they are themselves a partnership), if they do not provide details of their ultimate partners to the first partnership then their share of profit or loss would be calculated as if it is a UK resident individual.

### Next Steps

The consultation runs until 1 November 2016, so there is plenty of time for business' views to be heard. KPMG are working on a response to the consultation. If you have any matters which you would like us to consider as part of our response, speak to your usual KPMG contact

**Serena Bell**
Senior Manager – KPMG in the UK
**T:** +44 (0) 20 7311 2663
**E:** serena.bell@kpmg.co.uk

# Anti-hybrid rules: an update

Since the release of the draft clauses of the Finance Bill 2016 in December last year, the "anti-hybrid" rules have been subject to important updates as they have passed through the Parliamentary process. This article provides a high-level overview of the rules, which are now substantively enacted, and flags some key updates since the initial draft legislation.

## Overview

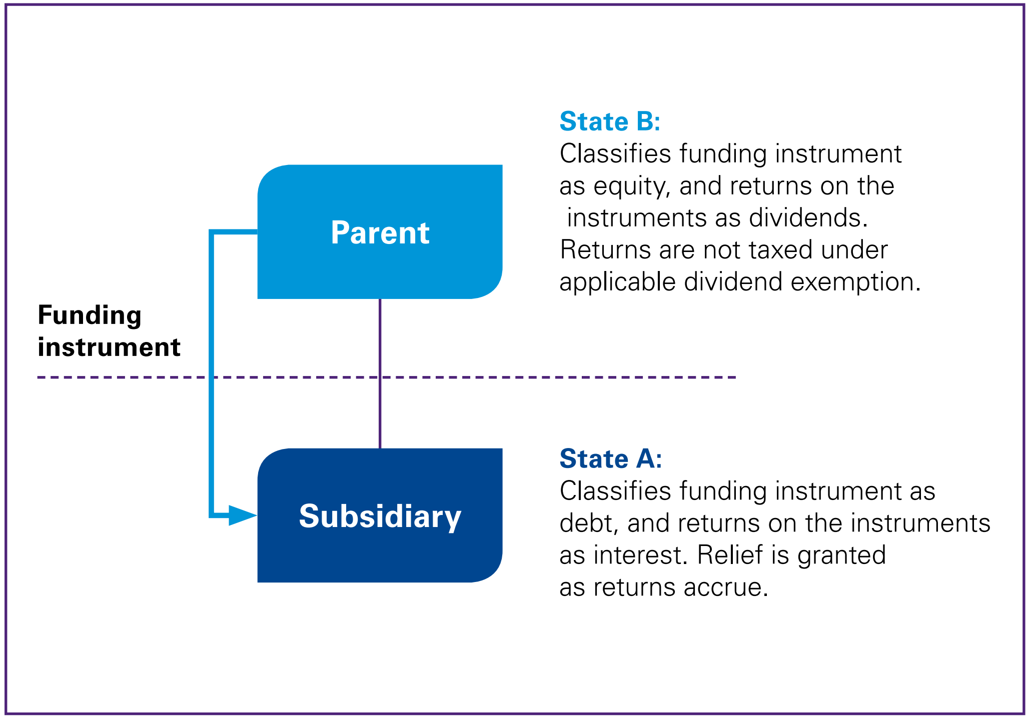
The new Part 6A TIOPA 2010, "Hybrid and Other Mismatches", seeks to implement the OECD's recommendations in BEPS Action Point 2 report, "Neutralising the Effects of Hybrid Mismatch Arrangements". The rules are broad and aim to counteract the mismatch arrangements identified in the OECD's report involving hybrid instruments, hybrid transfers and/or hybrid entities.

### *Hybrid arrangements*

A "hybrid" arrangement exists where, broadly, two jurisdictions take differing views of the same arrangement or entity, and consequently apply different tax treatment. A simple example would be where State A regards a funding instrument as debt (allowing relief for returns on the instrument), while State B regards that same instrument as equity (applying a different tax treatment, e.g. a dividend exemption, to the same returns).

The rules are targeted at structures or instruments exploiting these classification differences between jurisdictions to achieve one of the following outcomes:

- Relief / deduction for a payer with no taxable inclusion, or inclusion at beneficial rates, for the payee (a "deduction/non-inclusion outcome" – as above); or
- Relief / deduction in multiple jurisdictions in respect of the same item of expenditure (double deductions).




▶Continued

It is important to note that a tax avoidance motive is not in general a condition for the rules to operate. This is a key difference to the UK's existing anti-arbitrage rules which these provisions replace. The fact that there may be valid commercial reasons driving a specific arrangement does not in itself prevent the application of the rules which operate mechanically. This means that it is insufficient in an M&A context to consider the existence of any "tax planning structures", as the rules are capable of catching unintended mismatches and may even bite in some cases where "mismatch" does not in reality deliver any economic benefit.

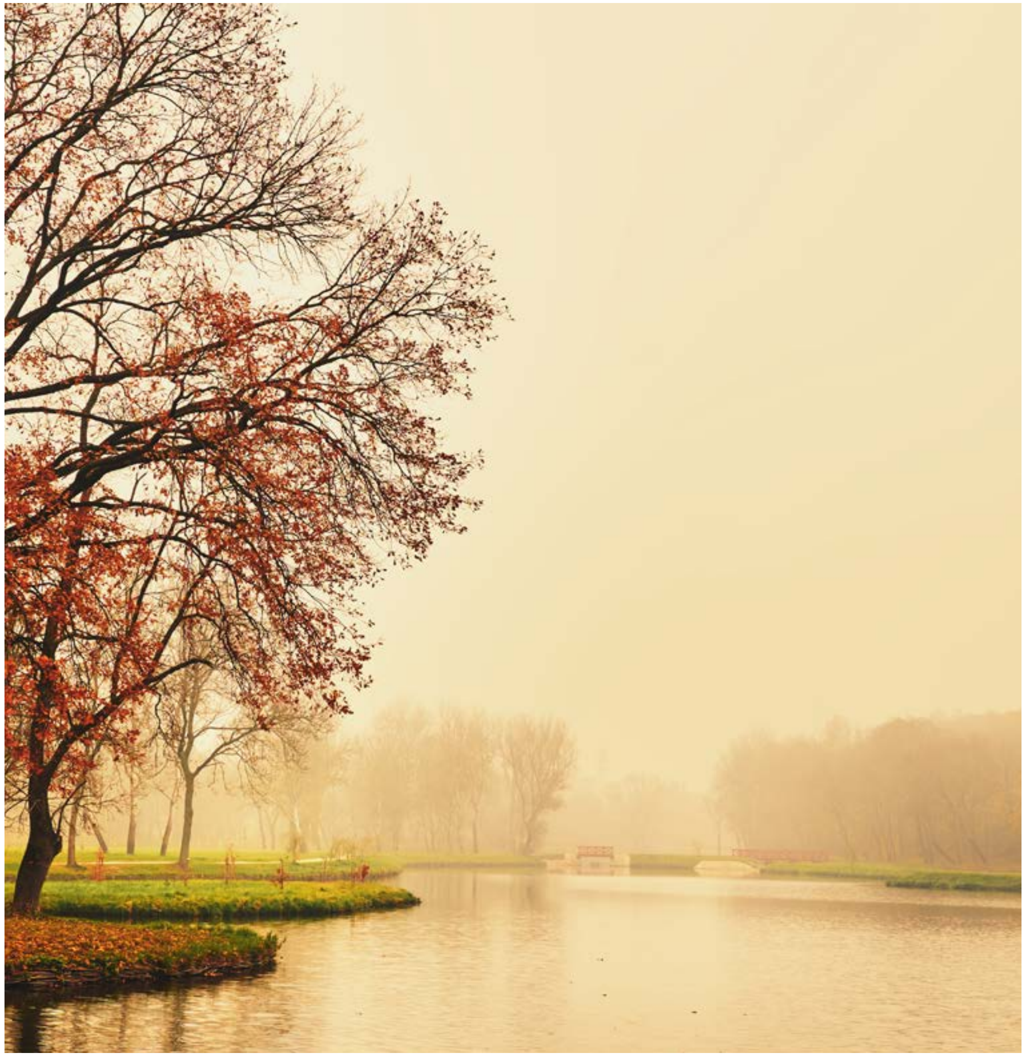
It is expected that the new UK rules will be effective for payments (or "quasi-payments" – broadly accruals) made on or after 1 January 2017. There will be no grandfathering of existing arrangements, and many groups are in the process of taking steps to identify potential exposures.

## Some points to note

### *Hybrid acquisition vehicles*

An important example of the type of situation which can be caught by the rules is where a US group establishes a UK entity to undertake an acquisition. In corporate acquisition structures, it is common for the UK acquisition vehicle to be treated as transparent for US tax purposes by virtue of the US "check the box" regime. Treating the UK company in this way can mean that interest costs on funding provided to it to enable it to make the acquisition will technically give rise to either a "deduction/non-inclusion" mismatch (where funding is provided by the US parent) or a "double deduction" mismatch (where funding is provided other than by the US parent). Structures which seek to derive an economic benefit from this are unsurprisingly clearly within the intended scope of the rules, which would typically seek to counteract any benefit by denying UK tax relief for the funding costs.

In many cases, however, there is no economic benefit intended or obtained. The transparent nature of the acquisition vehicle can result in income being taxable in both the UK and the US. The UK legislation is intended to reflect this, so that deductions are not restricted when relief is given against "dual inclusion income" of this kind, but the exception is narrowly drawn and it is not unusual to come across cases where deductions are denied notwithstanding the lack of any economic advantage.



▶Continued

*Imported mismatches*

In the past some groups sought to circumvent the application of anti-hybrid rules by funding investments in the jurisdictions concerned using vanilla debt and then sheltering the corresponding receipts through a structure intended to create a hybrid mismatch in a different jurisdiction with less stringent rules. Arrangements such as this, designed to effectively import the benefit of a mismatch arrangement, are targeted by the "imported mismatch" provisions of the new regime.

The new rules also go further than the existing anti-arbitrage rules in this respect, in that they can restrict deductions in the UK even when there is no direct hybrid arrangement in the UK. The rules provide that relief can also be restricted where the hybrid arrangement is part of a series of arrangements which gives rise to a deductible payment (or accrual) in the UK and which also involve a mismatch arrangement not currently counteracted by the other jurisdictions involved.

Going forward it will therefore be insufficient for UK companies to focus narrowly on the arrangements they are directly party to in order to determine the deductibility of payments made. Wherever relief may, prima facie, be claimed, it will be crucial to ascertain the tax treatment given to the corresponding receipt and whether the arrangement under which the payment is made is itself part of a larger over-arching series of arrangements. If it is, then it will potentially become necessary to understand the tax treatment of all the payments made under that over-arching series of arrangements to conclude on the UK position. This can rapidly become a fairly complex exercise, especially where there are multiple parties in multiple jurisdictions, but one which the self-assessment nature of the regime requires to be undertaken.

**Numerous amendments have been made to the draft legislation since it was originally published.**

### Key amendments to the draft legislation

Numerous amendments have been made to the draft legislation since it was originally published.  Among the most important are the following.

*Application of the rules to permanent establishments*

The extension of the scope of the regime to arrangements involving permanent establishments significantly increased its potential impact. The extended scope reflects the fact that a permanent establishment will often be taxed locally as if it were a standalone entity but as part of the larger entity in the head office jurisdiction, creating similar potential for mismatches as hybrid entities. The amendments therefore apply many of the rules originally targeted at hybrid entities to permanent establishments. The main impact of this is on loss-making permanent establishments, with increased restrictions on using the loss in the UK and the risk that any loss may be forfeited altogether in certain circumstances, although all groups with permanent establishments will now need to assess the potential impact of the rules.

*Restriction of "permitted reasons" exclusions*

The original draft legislation followed the OECD in targeting mismatches caused by hybridity. It therefore identified various "permitted reasons" which might cause a mismatch to arise (e.g. the receipt corresponding to a deductible payment was received by a tax exempt entity) and broadly excluded mismatches attributable to these from counteraction.

Subsequent amendments to the legislation have significantly tightened these rules. In particular, rather than it being sufficient to show that a mismatch does arise for a permitted reason, it is now effectively necessary to show that it does not arise from hybridity. This is achieved by requiring an assessment of whether a mismatch could still arise if the relevant "permitted reasons" did not apply (e.g. if a tax-exempt payee ceased to be tax exempt).

This creates a risk of a UK disallowance in cases where, e.g. the UK is funded using a hybrid financial instrument, even though the same mismatch would have arisen (and not been counteracted) had the UK been funded with vanilla debt.

▶Continued

*Hybrid payees*

A further amendment provides that where a payee is (i) a hybrid entity, (ii) that is not subject to tax in any jurisdiction, and (iii) whose income is not brought into tax through the application of Controlled Foreign Company legislation (or equivalent) at investor level then any mismatch would potentially be within the scope of the rules. Although targeted at "reverse hybrids" this provision should be considered, in particular, where a structure includes "checked-open" entities in no-tax jurisdictions or checked-open US LLCs which are also potentially caught.

*Introduction of an anti-avoidance provision*

The rules now include a broadly drafted anti-avoidance provision, primarily aimed at arrangements intended to circumvent the new regime. An important carve out protects those arrangements where the non-application of anti-hybrid rules is in line with the "principles and policy objectives" behind the regime, but in the absence of any clear guidance from HMRC the extent of this exclusion can be expected to be an area of debate.

## Concluding remarks

In an M&A context, the new rules are potentially relevant when considering the tax position of the target, the funding of the acquisition itself, and the suitability of the ongoing post-acquisition structure. In many cases the analysis will require a greater awareness of the bigger picture in which the transaction itself is an element.

Whilst the anti-hybrids legislation is now substantively enacted, it is not yet certain how HMRC will seek to apply the rules in practice. It is anticipated that HMRC will publish guidance ahead of the rules coming into effect on 1 January 2017 and it will be important to assess any potential impacts from this when it becomes available.

**Fredrik Klebo-Espe**
Manager – KPMG in the UK
**T:** +44 (0) 20 7694 3860
**E:** Fredrik.Klebo-Espe@KPMG.co.uk

**Paul Freeman**
Senior Manager – KPMG in the UK
**T:** +44 (0) 79 0111 0973
**E:** Paul.Freeman@KPMG.co.uk

# CEO Outlook 2016 - It's now or never

KPMG's 2016 Global CEO Outlook study provides a vivid image of global CEOs' expectations for business growth, the challenges they face and their strategies to chart organisational success. This annual study by KPMG International captures the perspectives and insights of nearly 1,300 CEOs from companies across 11 industries in 10 countries.

Collaborative deals were a noticeable feature of the report as, while the regulatory hurdles of mega deals make headlines, CEOs are facing ever-increasing pressures to create real deal value. In today's 'new normal' of rapid disruption, big data and a low growth environment, the public struggles of some deals have led CEOs in our survey to shift their strategies to favor Alliances and JVs. This is particularly true among high performing firms.

Collaborative deals should be part of any M&A playbook. The best playbook takes into account complexity at every turn, holistic advisors enabled with the right technology, and the ability to deliver value at deal speed. Business as usual is simply not viable.

Key findings from the report include:

- Forty-one percent of CEOs anticipate that their company will be significantly transformed over the next 3 years
- The vast majority (89 percent) of CEOs feel they can succeed in transforming their company and are confident in future growth
- Cyber security climbed the list to become the top risk over the next 3 years (30 percent)
- Fostering innovation is one of the top (21 percent) strategic priorities for CEOs over the next 3 years
- Sixty-five percent are concerned that new entrants are disrupting their business models and more than half (53 percent) of CEOs believe that their company is not disrupting their industry's business models enough
- Collaborative growth is how 58 percent of CEOs intend to drive shareholder value for the next 3 years
- Eighty-eight percent of CEOs are concerned about the loyalty of their customers and 82 percent about the relevance of their products or services

Download the full 2016 CEO Outlook report. (PDF 2.8 MB)

In an upcoming point of view article from the Global Head of Deal Advisory, Leif Zierz, provides his unique perspective on this significant report from KPMG. We seek to answer some critical questions like:

- What extraordinary efforts will CEOs make to achieve this level of change?
- What kinds of deals or transactions strategies are most relevant in this environment?
- How should M&A transactions adapt in order to stay relevant to CEOs?
- How are the top-performing CEOs thinking differently than the rest?

The report will launch in October of 2016 and will be available on the Global Deals Institute. Should you wish to be informed of its release, please contact Jeff Ho.

# Your contacts

**For more information,** speak to one of the KPMG Advisers listed below, or your usual KPMG contact.

## Tax

**Philip Brook**
**Partner**
KPMG in the UK
**T:** +44 20 7311 4865
**E:** philip.brook@kpmg.co.uk

**Tony Cheadle**
**Partner**
KPMG in the UK
**T:** +44 20 7311 4583
**E:** tony.cheadle@kpmg.co.uk

**John Cox**
**Partner**
KPMG in the UK
**T:** +44 20 7311 4783
**E:** john.cox@kpmg.co.uk

**Steve Heath**
**Partner**
KPMG in the UK
**T:** +44 161 246 4087
**E:** steven.heath@kpmg.co.uk

**Naz Klendjian**
**Partner**
KPMG in the UK
**T:** +44 20 7311 6509
**E:** naz.klendjian@kpmg.co.uk

**Margaret Stephens**
**Partner**
KPMG in the UK
**T:** +44 20 7311 6693
**E:** margaret.stephens@kpmg.co.uk

**Martyn Till**
**Partner**
KPMG in the UK
**T:** +44 20 7694 1077
**E:** martyn.till@kpmg.co.uk

## Deal Advisory

**Richard Lee**
**Associate Director, M&A Advisory**
KPMG in the UK
**T:** +44 20 7311 8215
**E:** richard.o.lee@kpmg.co.uk

**Andrew Nicholson**
**Partner, Head of M&A UK**
KPMG in the UK
**T:** +44 20 7694 3782
**E:** andrew.nicholson@kpmg.co.uk

**Sanjay Thakkar**
**Partner, Head of Deal Advisory UK**
KPMG in the UK
**T:** +44 20 7311 2755
**E:** sanjay.thakkar@kpmg.co.uk

**Additional KPMG publications you may find of interest are listed below**

Tax Matters Digest

KPMG's weekly newsletter which covers the latest issues in taxation and government announcements relating to tax matters.

Tax Matters Strategies: M&A, Tax and Brexit

In this issue of Tax Matters Strategies we examine the implications of tax on M&A activity both for the sale and buy side. We also take another look at the UK as a place for foreign direct investment in light of the 'leave' vote in the EU Referendum.

As part of this edition, we also released a Brexit tax survey in collaboration with ITR magazine – if you're curious about how your organization benchmarks with others in terms of awareness and preparation for the tax implications of Brexit, take our survey here.



Create Graphics I CRT057874_H I September 2016

KPMG