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A Budget for Growth and Reform: Britain Is Open for Business

24 March 2011

On 23 March, UK Chancellor of the Exchequer George Osborne released his second budget. Unlike his first budget in 2010, which was a "rescue" budget containing a number of cuts, this budget is a "plan for growth" and is aimed at reform. His message is that Britain is open for business. The proposed reforms generally appear positive, although less so for banks and oil companies.

As a result of the new Government's approach to tax reform, in particular their increased openness and transparency, the majority of the measures had already been announced and, in many case, consulted upon. Hence, there were few surprises. As the budget is intended to be fiscally neutral, while there are a few tax cuts, they are largely counteracted with increased taxes in other areas.

Business Taxes

The key unexpected change is a reduction in the main rate of corporation tax. A 1% reduction from April 2011 (28% to 27%) had previously been announced, but the rate will be decreased by a further 1%. So, from April 2011 the main rate of corporation tax will be 26%. This rate will be further reduced by 1% per year over the following three years to a rate of 23% from April 2014. This reduction is clearly a step in the right direction towards the Government's stated objective of the UK having the most competitive corporate tax system in the G20.

To counteract the impact on the Exchequer of the reduced corporation tax take, two industries in particular will be subject to additional charges. Banks will not benefit from the reduction in corporation tax rates, as a result of a further increase to the rate of the bank levy. The bank levy applies to UK banks and also to UK subsidiaries and permanent establishments of non-UK banking groups. The banks are not happy with this further change to the bank levy, which represents the fourth rate of bank levy since the bank levy was introduced in January 2011. From January 2012, the rate will be 0.078% for short-term chargeable liabilities and 0.039% for long-term chargeable equity and liabilities.

Some energy companies will also suffer increased taxes. From 24 March 2011, the supplementary charge will be increased from 20% to 32%. The supplementary charge is an additional corporation tax paid by companies operating on the UK continental shelf in respect of their ring fenced profits from oil and gas production. Ring fenced profits also do not benefit from the reduction in the rate of corporation tax, but remain subject to corporation tax at 30%. This measure is expected to raise £10 billion over five years. Although there will be a built-in "fuel stabiliser," under which the supplementary charge will be reduced if oil prices fall below a certain level (potentially $75 per barrel), there is some concern that this additional tax will impede further investment in the UK continental shelf.

In addition to the supplementary charge, some energy companies may become subject to an increased levy under the carbon price floor to be introduced from April 2013, following a consultation. From April 2013, fossil fuel used in electricity generation will be taxed under the climate change levy and fuel duty. An intended consequence of this is that the low-carbon energy producers, including wind and nuclear, should indirectly benefit from the increased levies that will be imposed on oil and gas-fired power stations; however, direct benefits or tax credits for the low-carbon producers are not expected.

Other changes to business taxes will include a consultation on widening the real estate investment trust (REIT) scheme to remove some of the barriers to entry, and some beneficial capital allowances changes, including extending relief for short-life assets.

Encouraging Investment

A key focus of the Government is to encourage domestic and international investments in the UK. In this regard, a number of changes are to be introduced, largely to support entrepreneurs and small and medium-sized enterprises (SMEs). A significant proportion of those changes constitute proposals to deregulate industry and improve corporate governance, cutting red tape in a number of areas. It is proposed that, from 2012, many subsidiaries will be exempt from producing audited accounts. Most of these measures will not directly reduce taxes, but are designed to encourage growth and foreign investment by making the UK a more attractive place to do business. The Government has highlighted a number of industries that it would like to encourage, including life sciences, digital and creative industries, and advanced manufacturing.

In connection with encouraging growth, research and development (R&D) relief (which is available to SMEs investing at least £10,000 in qualifying R&D expenditure) will be increased from 75% to 100% from April 2011. This means that for every £1 of qualifying expenditure, the SME will obtain a deduction of £2. An additional increase to 125% from April 2012 is proposed.

Further measures to boost investment include extensions of both venture capital trusts and enterprise investment schemes. From April 2011, EIS relief (which is available as a tax credit when an individual makes an EIS investment) will be increased from 20% to 30%. In addition, a greater number of entities will qualify for EIS or VCT treatment as a result of a significant increase in the permitted gross assets and employees, and the maximum annual amount of relief for EIS investments will be increased from £500,000 to £1 million from April 2012.

Entrepreneurs' relief, under which individuals can benefit from a reduced rate of capital gains tax of 10% in respect of certain gains from qualifying business assets, will be doubled to a lifetime allowance of £10 million for gains on or after 6 April 2011.

Taxation of Foreign Profits

The tax treatment of foreign profits has been the subject of a large number of consultations and proposed changes over recent years. As previously announced, from Royal assent to the 2011 Finance Act, companies will be able to elect into an exemption from tax in the UK on all of the profits on their foreign branches. The election will be irrevocable and will cover all of their branches. The flip side of the exemption from tax will be a lack of any relief for losses incurred by overseas branches.

The proposed reform of the controlled foreign company (CFC) rules to accompany the changes to the taxation of foreign branches is not yet finalised. There will be further consultation with a view to introducing the final rules in 2012. However, there are to be some interim measures which are largely designed to exempt from tax profits of CFCs that have little or no connection with the UK. Interim measures will be introduced for accounting periods starting on or after 1 January 2011 that will do the following:

- exempt certain intra-group trading transactions with little connection with the UK,
- exempt the profits of a CFC with a main business of exploiting intellectual property that has a minimal connection with the UK, and
- introduce an extended grace period of three years for foreign subsidiaries that are brought within the CFC rules as a result of a reorganisation or change of ownership.

The goal of the additional CFC changes to be introduced in 2012 is to make the UK more competitive, while protecting the UK tax base. There will be further consultation, but the Government's intention is to introduce an entity-based regime, under which the profits that will be targeted are those that have been artificially diverted from the UK. Recent consultations have resulted in the Government acknowledging the need to deal with offshore treasury companies and subsidiaries that hold intellectual property. They intend to introduce a regime for finance companies, providing a partial exemption from tax that would effectively subject the profits of an overseas finance company to UK tax at a rate of one quarter of the main rate of corporation tax.

The Government also plans to go ahead with proposals for a new regime for patent box companies, enabling them to benefit from a reduced rate of corporation tax of 10% in respect of income from patents. There will be further consultation on this proposal during 2011, with implementation expected in 2013.

International Competitiveness

The Chancellor focused strongly on the current Government's ambition for the UK not only to have a path of sustainable, long-term economic growth, but also to create the most competitive tax system in the G20. Many of the proposals in the budget that do not constitute changes to the tax rules are aimed at deregulation with a view to making the UK one of the best places in Europe to start and grow a business. The reduction of the headline rate of corporation tax is evidently one of the steps being taken to make the tax system one of the most competitive in the G20.

The budget also announces a programme of abolition of certain reliefs as part of a tax simplification process being undertaken by the Office for Tax Simplification introduced last year.

However, while a reduction in rates is helpful, as is the repeal of excessive legislation, there must be a question mark over whether these measures will have a genuine impact on making the UK more competitive. It is thought that the UK now has the longest tax code in the world. Removing a number of reliefs, particularly if they are overly complex and potentially outdated, does not necessarily go very far towards producing a tax code that is simple and stable compared with other G20 companies. The changes to the taxation of foreign branches and CFCs will, without doubt, assist in making the UK a more attractive place to undertake business. In 1998 the UK was ranked fourth on the World Economic Forum's Global Competitiveness Index, but slipped to 12th in 2010. It will be interesting to see if the proposed measures are enough to allow the UK to slide back up the ranking, or whether the remaining complexity continues to act as a barrier.

In the last few years there have been a number of high-profile departures of UK companies redomiciling outside the UK (although interestingly generally not in other G20 countries). It remains to be seen if these reforms are sufficient either to tempt any of them back to the UK or to stem the flow of departures from the UK.

Anti avoidance

Given the precarious economic position of the UK at the moment, it seems that while on the one hand it is not feasible to reduce taxes without imposing additional cuts, on the other hand any tax increases could curtail growth. It is, therefore, not surprising that the Government is continuing to clamp down on tax avoidance. This takes two forms.

1. The introduction of a small number of specific anti avoidance rules. These are being introduced in response to disclosures made under the disclosure of tax avoidance schemes rules, and follow a pattern seen in every budget since those rules were introduced.

2. The introduction of a strategic approach to get to the root of the tax avoidance problems (perhaps the more substantial route). The Government perceives there to be a "tax gap" of £40 billion, which reflects in part (estimated to be about one-sixth) the legal avoidance of tax in instances where the tax law is used "to get a tax advantage that Parliament never intended." The tax gap is the difference between the tax the Government believes is owed and what is actually collected. As part of the budget, the Chancellor released a paper on tackling tax avoidance, which appears to presage a serious clampdown. As has been highly publicised, the Government continues to consider the introduction of a general anti avoidance rule, although such a move is largely rejected by taxpayers and stakeholders. A study group is to report on this later in 2011.

The Treasury's approach to tax avoidance will consist of prevention, detection, and counteraction. In addition to minimising opportunities for tax avoidance through more effective legislation, including drafting based on principles and improvements to the clarity of HM Revenue & Customs' guidance, further changes to the disclosure rules will be considered to see if they can be optimised further. HMRC will adopt a project-managed approach to the enquiries and challenges that relate to tax avoidance. From 2012, there may also be financial disincentives to tax avoidance, by either requiring early payment of taxes in respect of certain identified and listed schemes that are being disputed, or imposing greater penalties on taxes that are found to be due following challenges of such schemes. The Government will also focus on high-risk areas that have frequently been the subject of tax avoidance schemes in the past.

The budget raises the possibility of a general anti-treaty shopping provision from 2012. Historically, the UK has had no such general provision and is limited to specific revisions in certain treaties only.

A significant specific anti avoidance target is, as previously announced and consulted upon, "disguised remuneration". These rules will take effect from April 2011 (with certain anti-forestalling measures from 9 December 2010). They are aimed at certain arrangements involving benefits and loans provided to employees by third parties that are designed not to trigger immediate taxation, but the proposed legislation is in fact far wider than this limited target. Further changes to draft legislation that was released in December 2010 are awaited to ascertain the final scope of the new rules, but employers that offer with employee benefit trusts (a key target of the new rules), deferred compensation plans, and long-term incentive plans may need to consider whether any of their plans are caught by the rules. As currently drafted, they may be caught even if there is no tax avoidance motive, but HMRC has already indicated that it intends to limit the scope of the new rules to genuine deferred compensation plans and LTIPs. For arrangements that are caught by the new rules, the consequence will be that the employee suffers immediate income tax and national insurance contributions; this can arise where the employee benefits from assets or money (such as the use of an asset or a loan), or where assets or money are earmarked for a particular employee. The income tax and national insurance charge can arise even if the employee has no legal rights to the asset and if there is still the possibility that benefits will be forfeit.

Personal Taxes

The budget does not contain a large number of changes for personal income and capital gains taxes, but the following may be of interest.

- The Chancellor announced a desire to reduce the top rate of income tax from the present 50% when possible (which will not be this year).
- As previously announced, employer's and employees' national insurance contributions will increase by 1% in April 2011.
- Charitable giving is to be encouraged by certain deregulation of the gift aid rules and the introduction of a relief from inheritance tax in respect of estates under which at least 10% is donated to charitable causes.
- There will be a consultation with a view to introducing a statutory definition of residence, to replace the somewhat unsatisfactory current position that relies on both case law and HMRC guidance.
- An increase, from April 2012, of the fee paid by a non-UK domiciliary in order to be allowed to rely on the remittance basis of taxation from £30,000 to £50,000 where the non-UK domiciliary has been UK resident for 12 years or more.
- A removal of the tax remittance charge for non-UK domiciliaries in respect of foreign income or capital gains remitted to the UK for the purposes of certain commercial investment in UK businesses.

With respect to non-UK domiciliaries, the Government has also committed to not making further substantive changes to the rules for the remainder of the current parliament.

For more information about the issues discussed in this Tax LawFlash, please contact your Morgan Lewis attorney or the contact listed below:

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