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Tax tweaks

Features

Pre-Budget Report

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No great changes, just some minor adjustments to the works. Pete Miller looks at the corporation implications of the pre-Budget report.

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Key Points

- Tax reduction for small companies, tax increases for bank bonuses.
- Will National Insurance contribution increases encourage incorporation?
- Improvements to tax legislation relating to worldwide debt cap, R&D, films, and accounting standards.
- Anti-avoidance provisions are tightened up.

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On 9 December 2009, the Chancellor of the Exchequer, Alastair Darling, gave his pre-Budget report. This must have been a very difficult report to prepare, given not only the extremely precarious state of the UK's finances, in the context of the worldwide economic downturn, but also the fact that this is the last pre-Budget report of the current parliament. It is not clear how many of the measures announced will be enacted in the Finance Bill 2010 and how much might be deferred for enactment, or not, by a new parliament after next year's general election.

In that context, from the corporate perspective one might see this as a surprisingly apolitical report and there were certainly no obvious giveaways in preparation for seeking a further mandate from the British public. Indeed, with one highly trailed exception, most of the corporate changes may be seen as merely tinkering

with the current system. So let's look at what those changes are.

Small companies' rate

Starting with the good news, the Chancellor announced that the increase of the small companies' rate of corporation tax from 21% to 22%, and which was planned to come into effect from 1 April 2010, will not now take place. In the context of the current economy, this must be a very welcome deferral of a tax increase and one which will be beneficial to the vast majority of UK companies. The Government clearly has in mind the need to promote small business and to allow profits to be reinvested for the future.

Banking taxation

The highly trailed measure mentioned above is the proposal for a 'bank payroll tax', to be imposed on employers who pay bonuses in excess of £25,000 to employees. This is clearly a response to the decisions by some major banks to pay potentially very large bonuses to what they perceive as key employees.

The essence of the new tax is that where a bonus to a bank employee exceeds £25,000 the bank will be required to pay bank payroll tax of 50% of the excess of the bonus over £25,000. Thus, for example, the agreement to pay an employee a bonus of £50,000 will mean that the bank will have to pay a bank payroll tax of £12,500 (50% of the excess of the bonus over £25,000).

This new tax will apply to bonuses awarded between 9 December 2009 and 5 April 2010, so long as there was no contractual obligation to pay the bonus at the time of the Chancellor's announcement. The tax is to be paid on 31 August 2010 and the measure may be extended beyond 5 April 2010 if appropriate provisions of the Financial Services Bill have not come into force.

The tax will be structured so that it does not apply to regular salary, wages or benefits. But it will apply to all bonuses, whether cash, monies' worth, benefits or loans. Anti-avoidance provisions will ensure that the tax will apply even if arrangements are made so that the money is paid after 5 April 2010. And if a person has multiple employments within the banking industry and is awarded several bonuses, none of which individually exceed £25,000, the total amounts of bonus will be aggregated for the purposes of determining whether the bank payroll tax is payable. Similarly, the tax applies where an individual provides banking services through an intermediary that is not a bank. In such a case, it is the bank that is liable for the tax.

A non-deductible tax

Perhaps the harshest element of this tax is that the payroll tax is not taken into consideration for calculating the bank's profits or losses for corporation tax (or income tax) purposes. So, unlike employer's National Insurance contributions for example, bank payroll tax is not deductible for corporation tax purposes.

While commenting on pre-Budget reports can often involve a certain amount of 'Chancellor bashing', I suggest that in this case Mr Darling was caught between a rock and a hard place. The banking industry is widely perceived as having largely contributed to the world economic recession, whether that perception is right or wrong. This perception clearly fed the public outrage at the possibility that the very people responsible for our economic plight are to be further rewarded for their efforts and, given also that some of the banks are now, in effect, largely publicly owned, it was almost inconceivable that the Chancellor would do nothing.

In the event, the Chancellor has been quite clever: instead of charging a supertax on the bonuses received by the individuals concerned -- many of whom will feel that they have worked hard, achieved targets and hence deserve the extra remuneration -- the Chancellor has said to the banks themselves that, if they can afford to pay some of their profits out to their employees, they can also afford to pay more money to the

Government. The banks, therefore, have to decide whether to alienate their employees by not paying promised or presumed bonuses -- and hence risk losing key staff -- or to bite the bullet and pay both the bonuses and the extra tax, with the consequent impact on shareholders' funds.

As might be inferred from the above, I do not necessarily disagree with the principle of the bank payroll tax. My only quibble is that £25,000 is actually a relatively low amount for bonuses in the financial services industry and many employees who are not on huge salaries might find that this measure has a negative impact on bonuses that they were anticipating or had even been promised. I would suggest that a figure of £50,000 might be fairer.

Banking code of practice

Before we leave the subject of banks, we should note that HMRC also confirmed that the code of practice on tax for banks will be introduced, with the aim of encouraging banks 'to follow the spirit as well as the letter of the law'. The draft code of practice has been discussed previously but broadly sets out a framework with several components: it gives the Government's views on good practice for bank governance and decision making and asks banks to integrate governance around tax into business decision making; it accepts that banks may use tax planning in support of business operations, but says that banks should operate within the spirit of the law (whatever that may mean) and not attempt to achieve results that are contrary to the intentions of parliament; and it encourages banks to work with HMRC to build relationships that are 'mutually open and transparent'.

National Insurance

Although not strictly part of the corporate measures, it is worth mentioning National Insurance contributions rates. At Budget 2009 we were told that the Class 1 employer rate would increase by 0.5% to 13.3% and the additional rate of Class 1 and 4 contributions would be increased by 0.5% to 1.5%. We are now told that these rates will actually be increased by 1% each, so that the Class 1 employer rate for 2011/12 will be 13.8% and the additional rate will be 2%. At a time when unemployment is still increasing, even if the world is showing some signs of coming out of recession, it is a concern that these increased rates of National Insurance contributions will act to slow down the rate of re-employment, given the increased costs to employers of taking on staff. This is clearly a matter for all employers, corporate or otherwise, to consider.

In the same pre-Budget report note, we were also told that the main rate of Class 1 and Class 4 National Insurance contributions will now be increased by 1%, not just 0.5%, for 2011/12, so that the rates will be 12% and 9% respectively. This may act as an encouragement to small business people to incorporate into companies which only pay 21% corporation tax rather than paying higher rates of National Insurance Contributions and personal income tax as unincorporated businesses. In effect, they will then have to balance the further tax hit when taking money out of the company as dividends or salary against the immediate tax hit on the profits of an unincorporated business, whether those profits are extracted or not. No doubt if these changes do have an impact on the rate of incorporation of businesses, the Chancellor will find a way of telling us that this is a form of tax avoidance!

Improvements to legislation

A number of measures were announced to improve existing legislation to make it fairer for taxpayers. In particular, there were changes to the worldwide debt cap legislation, research and development tax relief and film tax relief, as well as measures relating to changes to accounting standards.

Worldwide debt cap

The worldwide debt cap applies to groups of companies that do not consist wholly of small or medium-sized enterprises. The legislation takes effect from 1 January 2010 and the amendments will be effective from that date although they will be introduced in Finance Bill 2010. The changes are largely technical in nature, but they include:

- the exclusion of securitisation companies from the debt cap rules;
- amendments to the definition of group treasury companies to remove anomalies where other group companies have income from treasury activities; and
- allowing the inclusion of guarantee fees from other group companies as part of a company's financing income.

Research and development

The research and development tax relief is amended for small or medium-sized enterprises (SMEs). At the moment, it is a condition for the claiming of the relief for SMEs that any intellectual property created by the relevant expenditure is vested in the company incurring that expenditure. This condition will be removed by legislation to be introduced in Finance Bill 2010 and draft legislation and an explanatory note were published on 9 December 2009.

Film tax relief

The legislation relating to film tax relief is also amended because there was an unintended restriction on the tax credit claimable where films were produced over more than one accounting period. In essence, the available tax credit was inadvertently restricted where there was an increased spend on qualifying expenditure after the first period and the proposed revision should remove that unintended restriction.

Accounting standards

The final measure will impact on companies that have adopted IAS39 or FRS26 on the recognition and measurement of financial instruments. The IASB has proposed changes to IAS39 which will affect the way in which such instruments are treated for accounting purposes and the UK's ASB is likely to follow suit. This will have tax implications as the tax treatment of such instruments is based on the accounting treatment. The changes to accounting standards may require changes to the tax code and the proposed legislation -- to be introduced in Finance Bill 2010 -- will give the Government the power to amend the tax rules on loan relationships and derivative contracts through secondary legislation, so that the appropriate changes can be made outside the normal Finance Bill timetable.

Anti-avoidance provisions

It will come as no surprise that there are a number of anti-avoidance provisions to be brought forward in Finance Bill 2010. Most of these are highly technical and have probably arisen from disclosures made under the 'DOTAS', disclosure of tax avoidance schemes, regime.

Large multi-national groups of companies may be affected by legislation that should restrict losses on over-hedging and under-hedging structures to the amount of the real economic loss. In effect, any losses

from such arrangements that exceed the real economic loss at group level will be ring-fenced and will only be relieved against profits from those same arrangements. This will have effect from 1 April 2010.

Companies carrying on a plant or machinery leasing business may be affected by three changes to the anti-avoidance legislation in FA 2006, Sch 10 relating to the sale of lessor companies, as follows.

- There is a scheme involving the lessor company becoming owned indirectly by a consortium which means that the full impact of the anti-avoidance legislation cannot be applied. This weakness in the legislation will be removed with effect from 9 December 2009.
- On the positive side, FA 2006, Sch 10 will also be amended to remove an unfairness. The legislation effectively imposes a tax charge to prevent the timing benefit of the disposal of a lessor company, but then allows a matching relief, too. Some groups have been unable to use the full benefit of the matching relief and this inequity in the legislation will be amended, again with effect from 9 December 2009.
- Finally, legislation will be introduced to counter two new avoidance schemes so that lessor companies will not be able to get tax relief in excess of the value of taxable income and will also not be able to turn a tax timing advantage into a permanent advantage by ceasing to be within the charge to tax. Again, these provisions will have effect from 9 December 2009.

Finally, the Government announced changes to the capital allowances rules, in a technical note published on 21 July 2009, to prevent companies transferring an entitlement to capital allowances where the tax written down value of the plant or machinery exceeds its balance sheet value (usually where the company has previously disclaimed capital allowances). This legislation is effective from 21 July 2009, but further revisions were announced on 9 December 2009 and will have effect from that date. The changes ensure that the new legislation will apply where an unincorporated shareholder sells a company, not just where a company is sold from one group to another; they will prevent manipulation of the tax written down value; and the new rules will be extended to qualifying expenditure on ships.

Other announcements

A number of other potential changes, consultations, and the like were also announced with the pre-Budget report. Space does not permit detailed discussion of these, but the headlines are as follows.

- From April 2013, the Government has announced an intention to introduce a 'patent box'. This will be a reduced rate of corporation tax for income from patents. There will be consultation on the detailed design of the patent box and it will only apply to patents granted after the legislation is passed.
- The enterprise investment scheme (EIS) and venture capital trusts (VCT) schemes will be better targeted by improving the definition of a 'small' enterprise. And both of these schemes, along with the enterprise management incentives (EMI) will be amended in line with an agreement with the European Commission so that these incentives will be authorised state aids.
- A consultation document will be published 'soon' on proposals for the simplification of capital gains rules for groups of companies. This follows the discussion document published on

7 July 2009.

- HMRC published a summary of responses in respect of the consultation document on transactions and securities and the discussion document on the unallowable purpose tests. So far, there has been no further announcement as to the results of these consultation exercises.
- Finally, the business payment support service, helping viable businesses spread their tax payments during a period of temporary financial distress, will continue and will, again, be a very welcome change for all businesses.

Conclusions

Overall, the package of measures announced on 9 December 2009 does not constitute any fundamental change to the tax system as we know it. That said, the bank payroll tax is, whatever its merits, very much a piece of social (one might even suggest political) engineering and it will be very interesting to follow the results of this experiment. Otherwise, the majority of the changes announced appear to merely tweak the tax system -- tightening up some nuts and bolts here, applying some oil there -- either to improve it in areas where it clearly is not working properly or to prevent or close down avoidance schemes. Arguably, for most of us, nothing to get too excited about.