



Business Tax Update

March 2011

Major changes to business taxation

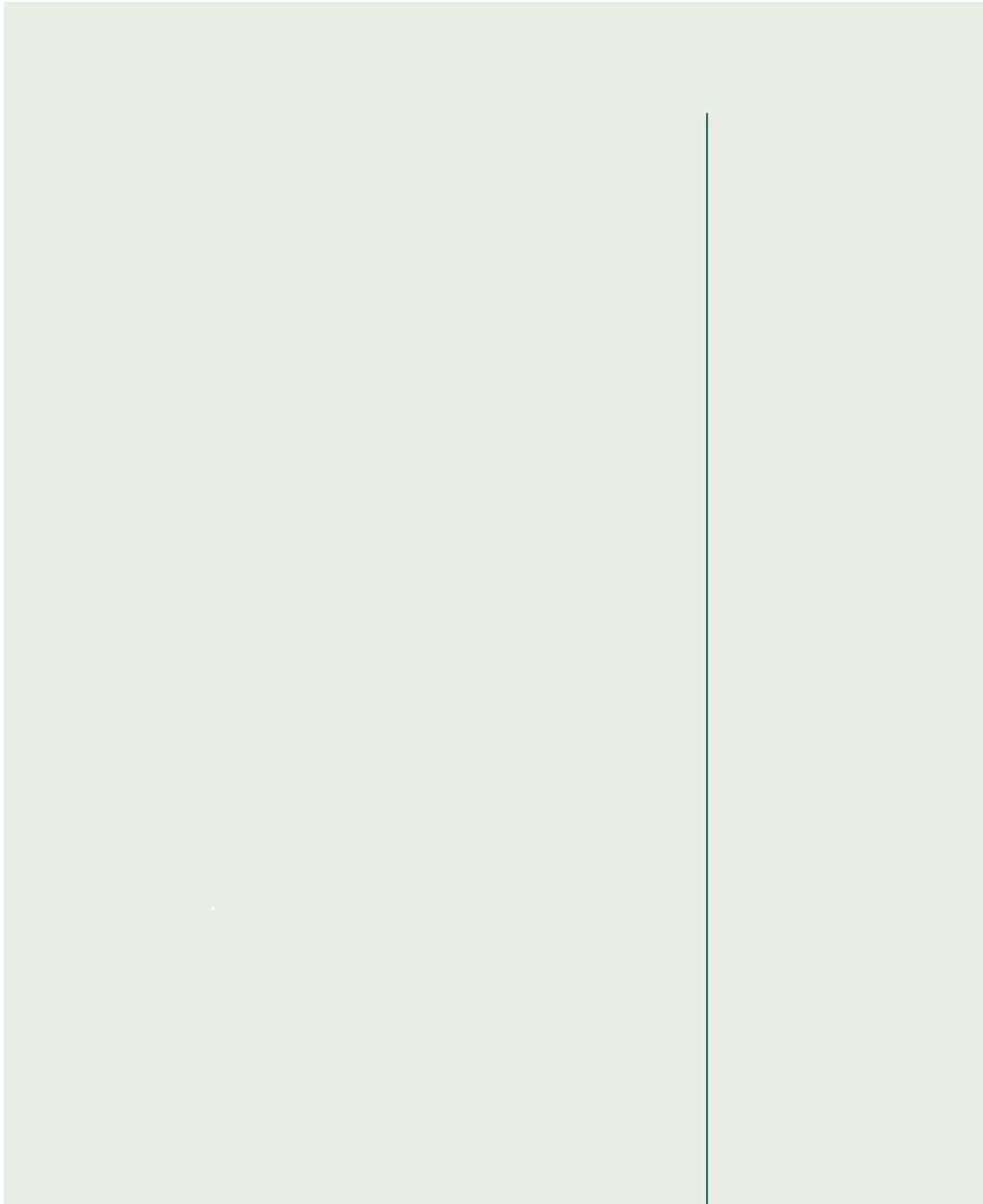
This winter the Coalition Government published its “Road Map” for corporate tax reform, together with draft tax legislation for the Finance Bill 2011. The former aims to “create the most competitive tax regime in the G20” for UK companies; the latter fulfils the Government’s commitment to publish the content of the Finance Bill at least three months before the Budget, set for 23 March.

Whilst both developments represent worthy attempts to provide greater certainty to business, and offers business the opportunity to influence the course of new tax legislation, any beneficial reform to the business tax regime must be measured in the context of the Government’s policy to impose higher income tax and National Insurance contributions (“NIC”) on the income of proprietors, entrepreneurs, key management and employees, including:

- the rise in employee’s NIC by 1% from 6 April 2011;
- the rise in employer’s NIC by 1% from 6 April 2011;
- a fall in the basic rate tax band from 6 April 2011, making more employees pay 40% income tax; and
- the retention of the 50% income tax rate for high earners.

These taxes will add significantly to the tax burden of businesses, and will need to be sensibly addressed before the Government can truly claim that the UK has “the most competitive tax regime in the G20”.

This Business Tax Update highlights the major changes to business taxation proposed by the Government, and considers the opportunities that have been created.



1 Cuts in corporation tax rate

Cuts in corporation tax rates were promised by the Chancellor, George Osborne, before the General Election and that promise is being delivered in a series of progressive 1% annual reductions to the main rate of corporation tax. April 2011 sees the rate fall to 27% and will fall again to 26% in 2012; so in 2014 we should see a new rate of 24%, the lowest corporate tax rate in the G20.

At the same time, the small profits rate, for companies with profits below £300,000, is reduced from 21% to 20%.

For company owners, the message is clear. Extracting profits through dividend payments is getting cheaper, while the cost of salary and bonus reward is at its highest since 1988.

For example, in 2011/12, if a shareholder-director paying income tax at the top rate of 50% extracts a further £10,000 by way of bonus, the combined personal and corporate tax bill will be £5,783 (i.e. an effective tax rate of 57.8%). However, a dividend from the company will be taxed effectively at 53.4% (for a company paying corporation tax at 27%) and at 48.9% (for a company paying corporation tax at 20%).

	Bonus	Dividend	
		CT@27%	CT@20%
	100.00	100.00	100.00
Employer's NIC @ 13.8%	(12.13)		
Corporation Tax		(27.00)	(20.00)
	87.87	73.00	80.00
Income Tax @ 50%/36.11%	(43.94)	(26.36)	(28.89)
Employee's NIC @ 2%	(1.76)		
Post-tax	42.17	46.64	51.11
Effective tax rate	57.83%	53.36%	48.89%

Not unexpectedly, the upper profit limit at which a company can pay the small profits rate, remains unchanged at £300,000. The last time a Government chose to increase this limit (and the threshold above which a company pays the main rate of corporation tax, currently £1.5 million) was back in 1994. Unfortunately, this Government appears unconcerned with this historical legacy.

There are two bright spots potentially:

- ⇒ From April 2011, companies associated through mere accident of circumstance, rather than any commercial dependence between them, will no longer be regarded as "associated companies". The profit limits to determine the tax rate will not, in those circumstances, be adjusted down. This is particularly relevant to companies owned by relatives – such as spouses – who may each control separate companies and operate them quite independently from each other. From April, the family or marriage ties will no longer have any bearing on the corporation tax rates paid.
- ⇒ Reform from April 2011 to the taxation of foreign branches of UK companies will allow a company to elect for its foreign branches to be exempt from UK corporation tax. Operating overseas through a branch should therefore result in similar taxation to an overseas subsidiary. If the number of associated companies is a concern for the UK group, then a foreign branch may represent a straightforward solution to keep the number of companies as low as possible.

Against this background, we can help you reappraise the assumptions on which you choose to extract profits from your business, and also advise on new opportunities to lower the tax base on which your company pays corporation tax.

2 UK patent box regime

Originally proposed by Alistair Darling, the Coalition Government has confirmed its intention to tax company profits from patents at a new corporation tax rate of 10%, with the aim to incentivise the creation and retention of intellectual property ("IP") in the UK. However, there is no pretence that this is little more than a defensive measure to

compete with other "patent box" regimes in Europe and elsewhere. Netherlands and Luxembourg, for example, both have effective tax rates below 6% which apply to IP generally (and not just to patents), and to capital gains on the disposal of IP.

The UK's patent box regime is expected to come on stream from April 2013 and only for patents "first commercialised" – an expression still to be defined – after 29 November 2010. Critics have argued that the tax break is poorly targeted, citing the fact that just four large multinationals file a fifth of all patents in the UK. The regime will also ignore other forms of IP, such as brands and copyrights.

In wanting to ensure that the UK is a location of choice for patent-rich companies, the Government is keen to consult with business in creating an incentive that works. However, competition between countries remains stiff, and the inherent mobility of IP means that companies will invariably choose the least cost option. The fear is that the Government will need more than the "carrot" of a 10% tax rate, and will want to exercise the "stick" of the controlled foreign companies' rules to negate the advantages of IP activity in low-taxed jurisdictions.

It therefore remains to be seen whether the UK's patent box will prove to be a success story of the Coalition's new "Corporate Road Map".

If your company is considering registering a patent in the UK and would like to discuss the patent box proposals in more detail, please contact your usual Rawlinson & Hunter partner.

3 Offshore finance company regime

In another strand of the "Road Map" to corporation tax reform, proposals to refocus the UK's controlled foreign companies ("CFC") regime were published. The aim of the revised regime is to ensure the rules target more closely, and impose a CFC charge on, artificially diverted UK profits (recognising the need for compliance with EC law), and to exempt foreign profits where there is no erosion of the UK tax base, thus improving the competitiveness of the UK for multinational businesses.

One type of company identified for exemption is the group finance company, typically set up by multinationals to manage a group's overseas financing operations. The Government is proposing a partial exemption from a CFC charge on the basis of the company's debt to equity ratio, with the Government considering a minimum ratio of 1:2. Therefore, if a company is fully equity funded, 66.6% of overseas finance income would be exempted from the CFC charge, equating to an effective rate of tax of 1/3 of the main UK rate; so reducing the rate to 8% by 2014.

The exemption, subject to ongoing consultation, is not expected to apply before 2012.

If you are operating internationally, we can assist in reviewing and assessing your group structure, and in developing a strategy that ensures that the taxation of the group's financing operations is optimised. Please contact your usual Rawlinson & Hunter partner for further details

4 CFC changes to offshore intellectual property

The Government's attempt to reform the controlled foreign company ("CFC") rules to bring them into line with EC law (and compliance with the Cadbury Schweppes decision in particular), so targeting the artificial diversion of profits, is to be applauded. However, the problem they face is how to draft tax legislation that fairly identifies profits that have been diverted artificially.

In dealing with the taxation of intellectual property (IP), the Government faces a dilemma. If a UK company develops IP in the UK and then chooses to relocate the asset to a low taxed jurisdiction in the EC, and then carries on "genuine economic activities" of exploiting and protecting the asset in that country, then, arguably, a CFC charge on the profits impairs the taxpayer's right to "freedom of establishment" under the EC Treaty. On the other hand, the freedom to make that choice, possibly without an exit charge, risks erosion to the UK tax base, which the Government says it cannot afford.

The Government therefore proposes to fall-back on the CFC rules, albeit with a new twist to focus on artificiality. They plan to:

- ⇒ first pick out companies that have either had IP developed in the UK, or IP transferred to them in the last 10 years, or that continue to rely on the UK to provide significant amounts of IP management;
- ⇒ then to carve out a safe harbour for companies earning a return on costs or assets below a certain level; and
- ⇒ then to impose a CFC charge on those “excessive” profits that relate to “UK activity”.

Serious questions remain as to whether these proposals, still in their infancy, will effectively target the artificial diversion of profits. Consultation continues with business and the professional bodies, so one expects this is not the end of the story.

In the meantime, an interim “improvement” has been made to the current rules, effective for accounting periods beginning on or after 1 April 2011. A new exemption is introduced for companies whose main business is IP exploitation, and both the IP and the company have “minimal connection” with the UK. Minimal in this context means that the IP must not have been transferred from the UK in the last 10 years, or have been created or maintained in the UK by a group company; and the company must not have been substantially equity funded from the UK, nor derive most of its income from the UK, nor outsource any part of the IP activity to the UK. The rules are therefore tough; unfairly so in the view of many commentators.

For many companies, IP can represent their most valuable asset but the CFC rules as they currently stand inhibit the ability to properly exploit IP multi-nationally. Reform, even if crude in its inception, should provide greater tax certainty and the opportunity to look ahead on a more commercial footing. We can help you to unravel the complexity of these new rules, and to plan to maximise the returns on your IP. Please contact your usual Rawlinson & Hunter partner for further details.

5 Temporary exemption from CFC charge

The proposed reform to the controlled foreign company (“CFC”) rules will introduce a relaxation to the so-called “period of grace” from the CFC charge. The current regime allows for newly acquired foreign subsidiaries, and for foreign businesses investing in the UK for the first time, to be exempted from charge for up to 24 months. The Government’s intention is to extend the period of grace for a further 12 months, recognising the complexity of both group reorganisations and a change in UK ownership.

The relaxation forms part of a package of interim improvements to the current CFC regime, and is included in the draft Finance Bill 2011, and is therefore likely to have effect for accounting periods beginning on or after 1 April 2011.

If you are acquiring overseas, or bringing an overseas company under UK control, we can advise on the scope of the CFC charge and exemptions, and how you may benefit from the “period of grace”.

6 Foreign branches of UK companies

Profits of a foreign branch are taxed once in the country in which the branch is located, and then again in the UK. Such double taxation is out of line with Government’s intention to make company taxation more territorial, and creates a distortion when compared with the taxation of foreign subsidiaries whose dividends to the UK are now generally exempt from corporation tax.

The Government therefore proposes, from a date still to be decided in 2011, to introduce a tax exemption, on an opt-in basis, for trading profits arising from foreign branches. The election to opt-in will be irrevocable, and will apply to all current and future branches of the company for all accounting periods following the period in which it is made.

However, a branch located in a country with which the UK has no tax treaty must remain outside the opt-in, if it is a branch of a “small” company (i.e. one with fewer than 50 employees and either turnover or assets below 10 million Euros). Tax exemption will also be denied to certain branches in low-taxed countries.

Companies opting-in must also recognise that any tax losses will not be relievable against other UK profits. Opting-in may therefore be inappropriate for companies with start-up losses. Furthermore, a company that elects to opt-in a foreign branch,

that has moved from loss to profit-making, is deferred from exemption on those profits until the losses of the preceding six years have been matched by profits.

If you are intending to set up operations overseas, or already have a branch network, we can explain your options, not only the “opt in” basis but also the choice between subsidiary company and branch, and assist you in implementing an effective offshore structure for your business.

7 ECJ challenge to exit tax charges

Belgium, Denmark and the Netherlands have been added to the list of countries that the European Commission has referred to the European Court of Justice (“ECJ”) over domestic tax rules that impose an exit tax when companies change residence or move assets abroad. The Commission consider the provisions a breach of European law and specifically a breach of the freedom of establishment in the European Treaty. Spain and Portugal have already been referred to the ECJ on this matter.

If these countries are forced to amend their domestic legislation, which is highly likely, then where does that leave the UK? Similar exit charges are imposed here but remain unchallenged by the Commission, and therefore there appears to be no immediate reason for the Government to change the provisions. However, one must assume that the Commission wishes to create a level playing field across the EU, and it can only be a matter of time before the UK becomes the next country to be leaned on to comply with the Treaty.

Indeed this is already happening in other areas of UK taxation where the Commission has written to the UK Government to request that they should amend the law - the offending provisions being the “transfer of assets abroad” legislation for individuals, and the “attribution of gains to shareholders of non-UK companies” legislation.

Our international tax expertise in London, combined with our connections with expert tax advisers across Europe, has given us extensive experience in assisting groups in restructuring their international operations. We can assist you in developing a tax strategy that recognises and adapts to the changes in European tax law so that tax optimisation can be achieved as tax barriers are removed.

8 New exemption from degrouping charges

Intra-group transfers of property prior to the sale of a company are the curse of many a corporate deal. Chargeable gains on otherwise tax-free transfers in the six years prior to sale are reinstated (commonly referred to as degrouping charges), with the liability falling on the target company, unless the parties agree otherwise.

A new rule, to be introduced later in 2011, will ensure that where the sale of the target is exempt from tax under the substantial shareholding exemption (“SSE”), any degrouping charge is also exempted from tax by being added to the exempt chargeable gain.

In addition, if a company has chosen to “hive down” a trade and assets to a new subsidiary, which is then sold out of the trading group, then the “Newco” is treated as having been held in the group for 12 months prior to disposal, and therefore the degrouping charge should qualify for SSE together with the gain on the sale of shares in Newco.

Existing provisions to allow the reallocation of a degrouping charge, and to rollover a degrouping charge, will be repealed.

These are welcome changes and provide greater opportunity for companies to restructure before a sale without triggering a tax liability. Our corporate finance and transactions tax teams have extensive experience in assisting owner managed businesses to mitigate tax on corporate sales. Hence, if you are intending to sell a business division or a subsidiary then we can help in your pre-sale planning to take advantage of these new rules.

9 Loans to employees via EBTs

“Enough is enough!” Not quite the words of the Government but certainly the sentiment in new anti-avoidance provisions to block arrangements to “disguise remuneration” using employee benefit trusts (“EBTs”) and other vehicles.

The use of EBTs, in particular family benefit trusts and employer-financed retirement benefit schemes (“EFRBS”), has long been favoured by employers to reward employees and to defer, if not avoid, the corresponding income tax and NIC liability. For instance, a contribution by an employer to an EBT, perhaps made in lieu of bonuses, which then made loans to selected employees, became the norm and tax savings were considerable.

The new rules, effective from 6 April 2011, have EBT arrangements clearly in their sights, but the rules go much further. Where any “relevant third party” - and that appears to include anyone other than the employer - pays a sum, provides an asset, or merely earmarks an amount to provide “rewards, recognition or loans” to an employee (including former and prospective employees) in connection with their employment, then that amount will count as employment income, subject to PAYE and NIC.

The Government has sensibly taken HMRC approved share plans outside the rules, but the concern is that, as drafted, the rules render any planning using trust arrangements redundant including many standard, and deliberately non-aggressive, unapproved employee share schemes. The Government has recognised these concerns by proposing further exemptions from the new rules for certain commercial arrangements. However, these changes are not yet reflected in the draft legislation, and it remains to be seen how generous the exemptions will be.

There is a further sting in the tail. If a loan is made between 9 December 2010 and 5 April 2011 that would be caught if made under the new rules, then unless that loan is repaid before 6 April 2012, the payment will still be treated as being within the new rules and therefore subject to PAYE and NIC.

If your business utilises share schemes, employee loans or EBTs then we can help to assess the impact of the new rules on these arrangements.

10 Upcoming abolition of tax reliefs

The Treasury's Office of Tax Simplification (OTS) has published an interim report on their quest to identify tax reliefs that should be amended or repealed to simplify the tax system.

Having initially established that there were over 1,000 reliefs in the tax system, the OTS have narrowed their review to just 74, and aims to make recommendations on retaining, simplifying or abolishing these reliefs by the time of the Budget in March. These reliefs include the Enterprise Investment Scheme, entrepreneurs' relief, CGT relief on the disposal of a principal private residence, exempt distributions on demergers, the short life asset election for capital allowances, potentially exempt transfers, and taper relief for inheritance tax purposes.

There is clearly merit in abolishing reliefs that have little relevance to current business needs, and to simplify those that are too complex for smaller businesses to use. However, if the agenda is to remove reliefs that merely cost the Government too much money, then we should be cautious of the outcome of the review. As the Government states quite explicitly in their Corporate Road Map, the quid pro quo to a lower corporate tax rate is fewer tax reliefs and allowances. A sting in the tail may therefore be in the offing.

11 Spotlight on VAT avoidance

We have previously written about "Spotlights" issued by HMRC which highlight the types of tax avoidance which they regard as unacceptable. HMRC have now added to the list with two new Spotlights focusing on two popular VAT avoidance schemes.

The first Spotlight relates to telecommunication service providers, internet service providers and broadcasters who provide services to non-business customers (ie the general public) in the EU. In this case, the place of supply for VAT purposes is where the supplier is “established”. Some suppliers have therefore sought to reorganise their business so that for VAT purposes these services are no longer supplied from the UK, but from another EU jurisdiction with a lower VAT rate.

HMRC are actively challenging these arrangements, and state that they have approached a number of suppliers who “have agreed that their supplies are made in the UK”. They have also said they will continue to “robustly challenge” any existing or future arrangements of this type.

The second Spotlight relates to “supply splitting” - effectively arranging for a number of different components of a package of goods and/or services to be supplied separately at different VAT rates, rather than being taxed as a single supply at a higher VAT rate.

Draft legislation has been issued in the 2011 Finance Bill which counters supply splitting involving printed matter, so that zero-rating will be withdrawn where this is connected with a supply of services and those supplies are made by separate suppliers.

Again HMRC have stated that they will continue to counter attempts to split supplies in this way, and also where there is evidence of value shifting between the elements in the package to inflate the value of an element with a lower VAT rate, in order to reduce the value of the element subject to a higher VAT rate.

If you are concerned that your business may be affected by these Spotlights, we can review your arrangements to determine whether they are likely to be caught by these provisions, and perhaps suggest other ways in which your objectives can be met.

What to do next...

This Bulletin is only intended to provide a **brief snapshot of just some of the ways available to reduce your tax cost** and all of the suggestions, no matter how routine they seem, need careful planning before implementation. If you have seen anything relevant to you which you are interested in considering in more detail, please call the Rawlinson & Hunter partner who normally acts for you. If you are not one of our regular clients but would like more information or advice, a full list of partners is provided on this page and any of them will be delighted to help you.

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