Business Tax Update

Autumn 2008

THE GOVERNMENT'S BUSINESS TAX POLICY IS IN A STATE OF FLUX

Over recent months, the Government has postponed and scrapped a number of previously announced tax changes. This indecisiveness is perceived by many as damaging to the UK economy and its international competitiveness.

Furthermore, due to their unhappiness with the UK tax regime, several companies have announced that they will be leaving the UK to take up residence in lower tax jurisdictions, thus heaping more pressure on the Government over tax policy.

The uncertainties within the Government over tax policy mean that now is the perfect time to raise concerns over recently announced tax changes. This is because, given the current political climate, any tax change that is widely opposed by businesses could well be postponed or abandoned.

The following articles highlight some of the Government's recent pronouncements on tax matters that impact on business.

THE PROPOSED FOREIGN DIVIDEND EXEMPTION IS POSTPONED

The Government has issued a technical note setting out its latest thinking on the proposed reforms to the taxation of foreign profits.

In relation to the proposed exemption for foreign dividend income received by UK companies, the note states that "*the Government remains attracted to providing as wide a dividend exemption as possible*". However, the note then goes on to focus on the possible change in behaviour of taxpayers arising from the introduction of such an exemption, and, in particular, the resulting potential loss of tax revenues.

The note concludes by stating that the Government has yet to reach a decision on this matter. As a result, the Government is proposing to delay the introduction of the dividend exemption until at least 2010 to allow time for further consultations with corporate taxpayers.

THE GOVERNMENT ABANDONS ITS PLAN TO TAX FOREIGN CAPITAL GAINS

Last year, the Government announced proposals to tax certain overseas profits earned by the overseas subsidiaries of UK companies. The profits at risk were overseas capital gains arising on the sale of investments and investment companies, and all overseas intellectual property income.

These proposals proved highly controversial and resulted in many businesses lobbying the Government to amend its proposals. The lobbying proved to be successful, and the Government has now abandoned its proposals.

A COMMON EU CORPORATE TAX SYSTEM IS ANNOUNCED

The European Commission has announced that multinational businesses will in future be permitted to adopt a common consolidated corporate tax base ("CCCTB") for their EU-wide activities. CCCTB means the ability to compute and file one EU-wide corporate tax return for all group entities within the EU, using the same tax compliance rules for all EU countries.

The aim of CCCTB is to reduce compliance costs, to eliminate transfer pricing issues within the EU, to permit consolidation of profits and losses within the EU, to simplify cross-border restructuring, and to avoid double taxation, whilst still ensuring the preservation of each individual EU state's tax revenues.

CCCTB will only be available to those entities that meet the greater than 75% ownership test, and will be optional. However, once a group opts for CCCTB, all of its European operations (whatever their legal form) will be included for a minimum of five years.

There are many technical and political hurdles that need to be overcome before the CCCTB legislation becomes law. However, our current best estimate is that CCCTB could come into effect in five years. As a result, EU businesses should begin to familiarise themselves with the CCCTB proposals, and begin to consider the possible advantages of adopting CCCTB status.

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MAJOR CHANGES TO CAPITAL ALLOWANCES ARE INTRODUCED

The Government has introduced major changes to the capital allowances regime which impact significantly on businesses, both large and small. These changes are detailed below, and were introduced with effect from 1 April 2008 for corporation tax purposes, and from 6 April 2008 for income tax purposes:

- The main rate of writing down allowances (WDAs) on the plant and machinery general pool has been reduced from 25% to 20%. For chargeable periods straddling the implementation dates, a hybrid rate will be applied;
- The rate of WDAs on long life assets has been increased from 6% to 10%;
- First year allowances for small and medium sized enterprises have been abolished, and a new annual investment allowance has been introduced for all businesses irrespective of size - see below;
- A new 10% 'special rate' pool has been introduced for capital expenditure on certain 'integral features' in a building - see below;
- There will be a phased withdrawal of industrial buildings and agricultural buildings allowances up to March 2011; and
- Where the unrelieved expenditure in either the general pool or the special rate pool is £1,000 or less, businesses can claim a WDA of the balance of the pools.

Annual Investment Allowance

The annual investment allowance provides that the first £50,000 of expenditure on most plant and machinery each year will be available for full tax relief in that period. Where more than £50,000 is spent in a chargeable period, the excess will qualify for WDAs in the normal manner. The limit of £50,000 of expenditure per annum is per group, and can be allocated across the group as the group sees fit. Any unused annual investment allowance cannot be carried forward.

Integral Features In A Building

Expenditure on 'integral features' in a building will be treated separately from other capital expenditure, and will be excluded from the main capital allowances pool. WDAs will be given at a rate of 10% (rather than the standard 20%) on a reducing balance basis. Finance Act 2008 introduced the following list of assets which will qualify as integral features:

- Electrical systems, including lighting systems;
- Cold water systems;
- Space or water heating systems, powered ventilation systems, air cooling or air purification systems, and any floor or ceiling comprised in such a system;
- Lifts, escalators or moving walkways; and
- External solar shading.

All items on this list will be deemed to be plant and machinery and therefore qualify for WDAs, regardless of the functionality test that exists for other capital expenditure. Integral features may also qualify for the £50,000 annual investment allowance.

Repairs To Integral Features

A new rule states that if repairs to integral features exceed 50% of the “replacement cost” in any twelve month period, then the cost of the repairs will not qualify as tax deductible revenue expenditure. Instead, the repairs will qualify for integral features WDAs at a rate of 10% on a reducing balance basis. This new rule overrides previous tax law and accounting practice on what constitutes capital or revenue expenditure, and its impact will be quite severe as a 10% allowance may only be available instead of a 100% deduction.

The compliance burden in this area could also be significant. This is because, at the outset of any project involving repairs to a building, the taxpayer will need to calculate an estimated replacement cost for any integral feature involved in the repairs, in order to determine the tax treatment of those repairs.

THERE IS A TAX REFUND OPPORTUNITY FOR UK COMPANIES WITH INTRA-GROUP LOANS

There is a long-standing corporate tax rule that states that interest paid late to an overseas connected company is not tax deductible on an accruals basis, where the interest is paid more than twelve months after the year end.

However, HMRC recently announced that this rule is contrary to EU law, and hence they are now looking to change the rule to make it compliant with EU law.

Crucially, because the current rule contravenes EU law, HMRC have reluctantly stated that, until the law is amended, they will now permit a UK tax deduction on an accruals basis for interest paid late (or not paid at all) by a UK (non-close) company to an overseas connected company.

Non-close companies therefore have an opportunity to claim a corporation tax refund for any accrued interest payable to overseas connected companies in the past six years.

This opportunity may also apply to UK close companies where the lender is an EU company. HMRC's announcement tries to limit the scope of the EU-enforced law change to just non-close companies. However, our view is that the law change is potentially wider than this, and may well apply to relevant transactions within the EU involving UK close companies.

The opportunity to claim a corporation tax refund therefore potentially applies to any UK company that has not claimed a tax deduction for accrued unpaid (or late paid) interest, in the last six years, where the company is either:-

- Non-close, or
- Close, but where the lender is not a shareholder; or
- Close where the lender is a shareholder, but where the lender is an EU company.

A company in this position should seek specialist tax advice as soon as possible, and seek to submit a tax refund claim at the earliest opportunity. This is because delaying a refund claim may be detrimental to the company because HMRC’s promised amendments to the law may attempt to limit the number of years a refund claim can cover.

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