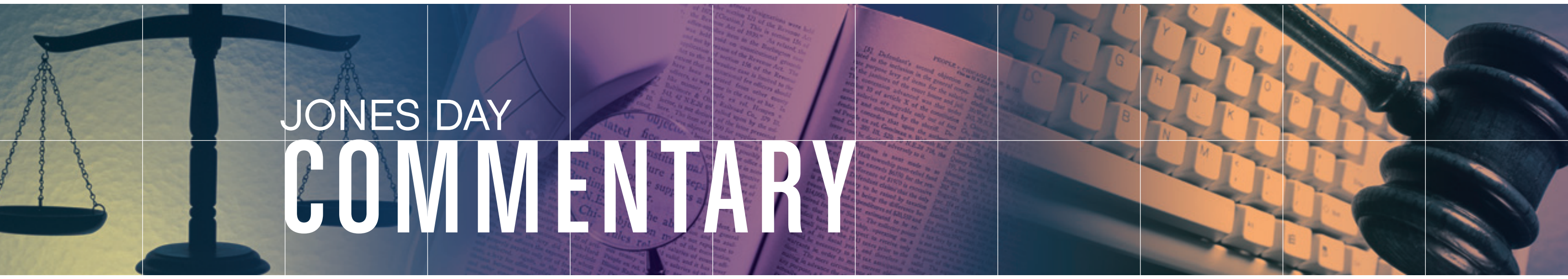
MARCH 2012



BUDGET 2012

INTRODUCTION

The 2012 Budget was eagerly anticipated. There was little consensus among commentators about what the Chancellor of the Exchequer would do and could afford to do. Certain measures, such as the increase in the income tax personal allowance and the decrease in the highest rate of tax had been widely discussed beforehand.

In the end, most of the measures which the Chancellor announced in the Budget had been raised as possibilities beforehand and, subject to one or two notable exceptions, there were not that many surprises. There may even be a sense of relief at the fact that some of the measures which had been discussed as possibilities (such as the restriction of the relief for pension contributions by higher earners) were not part of the package.

Some of the devil might yet be found in the detail. Although details are given of most of the significant measures which were announced during the Budget speech, it seems that there is still quite a lot of detailed information which will be released at a later date. For example, the government has been consulting on changes to the Real Estate Investment Trust regime. Although the available Budget documents mention this consultation, no further detail is given of its outcome. We will probably have to wait until the publication of the Finance Bill, which is expected to be at the end of March, before we have all the details of the relevant proposals.

CORPORATE TAXES

Rates and reliefs

Legislation will be introduced in the Finance Bill 2012 to reduce the main rate of corporation tax by 2 per cent. reducing the main rate of corporation tax from 26 per cent. to 24 per cent. with effect on 1 April 2012. The main rate of corporation tax will be reduced by a further 1 per cent. in each of the next two years.

To counter the effect of the change in the main rate of corporation tax on the banking sector, the rate of the bank levy will increase to 0.105 per cent. for the full rate and 0.0525 per cent. for the half rate. The changes to the rate of the bank levy will apply from 1 January 2013.

The reduction in the main rate of corporation tax will not apply to ring fence profits. Following the increase in the supplementary charge from 20 per cent. to 32 per cent. in Budget 2011, the Government stated that provided oil prices remained below a trigger price on a sustained basis, the rate of the supplementary charge may be reduced during such times. A threshold has now been announced and oil prices will be assessed annually, starting in 2013. Changes to the supplementary charge that are required as a result of the trigger price being satisfied will be announced in the budget in the year in question.

Companies with profits attributable to qualifying patents and certain other intellectual property will be able to elect to apply a 10 per cent. rate of corporation tax from 1 April 2013 (subject to a transitional period). The regime will apply to all qualifying patents (regardless of their date of commercialisation).

Initially the patent regime will only apply to patents granted by the UK Intellectual Property Office (IPO) and the European Patent Office (EPO). Until the Government finalises a list of EU Member States whose patents will also be eligible under the patent regime, companies may need to apply for patents through either the IPO or the EPO in order to take advantage of the reduced corporation tax rate. In addition, unincorporated entities will need to incorporate to fall within the scope of the patent regime.

Secondary legislation will be introduced later this year to create a new £3 billion field allowance for new fields that meet certain criteria to encourage further investment in the United Kingdom Continental Shelf. This new allowance is expected to apply to the West of Shetland. The existing field allowance given to small fields will be increased to £150 million as will the size of fields that are eligible for the maximum allowance.

As previously announced, the Finance Bill 2012 will include legislation restricting tax relief for supplementary charge purposes in respect of decommissioning expenditure to 20 per cent. Consistent with this policy, the legislation will also broaden the scope of the extended loss carry back rules so that they apply to losses arising from mineral extraction allowances in respect of decommissioning expenditure.

100 per cent. first-year allowances will be available to trading companies investing in plant or machinery for use primarily in designated assisted areas within Enterprise Zones. These Enterprise Zones will include the Black Country, Humber, Liverpool, North Eastern, Sheffield and Tees Valley Enterprise Zones.

Controlled Foreign Companies (CFCs)

The CFC regime has been the subject of consultation and reform since the 2008 Pre-Budget Report with the "final" legislation to be included in the Finance Bill 2012. The new "gateway" exemption, separation of income streams for the purposes of determining profits liable to apportionment and changes to the remaining exemptions, are designed to make the UK a more attractive place for overseas companies to invest. For established UK companies with overseas subsidiaries, the new regime may result in lower CFC charges arising on attributed profits if not falling outside the regime entirely. More detailed advice will be published when the new regime is finalised.

Regulatory capital

Following consultation with the banking sector and advisors, legislation will be included in the Finance Bill 2012 to introduce a power to determine the tax treatment of regulatory capital instruments issued in accordance with Basel III and the Capital Requirements Directive IV (CRD IV). Regulations will subsequently be enacted under this power to take effect from the commencement of CRD IV.

Tax transparent funds (TTFs)

Legislation will be included in the Finance Bill 2012 to permit the authorisation of TTFs later this year. Secondary legislation will be enacted to address the tax treatment of UK investors' holdings in TTFs (and the treatment of transactions for stamp duty purposes). The position of investors in collective investment schemes including TTFs will also be clarified in respect of the capital gains rules regarding mergers and reconstructions of collective investment schemes and what constitutes a disposal.

PERSONAL TAXATION

Abolition of the 50p rate

A significant part of pre-Budget commentary and speculation had been devoted to the highest rate of income tax. When the then Labour government announced that it would increase the highest rate, it initially announced a rate of 45%. However, before that rate become effective, the government decided that in light of the severity of the economic crisis, the rate would have to be increased to 50%. In the run-up to the Budget, there had been much discussion on whether this rate could and should survive. It was not clear whether the rate was bringing in as much revenue as had originally been expected and it appeared that the Conservative members of the coalition were determined to jettison the rate as soon as they could. Against this, there was some doubt whether the government could, politically, justify the abolition of the rate at a time when public finances are still under great strain.

The Chancellor announced that, with effect from 2013, the top rate of income tax will be cut to 45%. By way of justification, he explained that the 50% rate was one of the highest in the western world, higher than the rate of tax applicable, for example, in the US and other G 20 countries. In addition, in a report published by HMRC immediately after the Chancellor delivered the Budget, HMRC calculated that the estimated yield of the measure at the time of its introduction had been materially overstated and that the behavioural response of individuals to the forthcoming introduction of the 50% rate much greater than expected.

It was important for the Government to be seen to help lower earners and not be seen to be soft on higher earners. As had widely been expected, the Chancellor announced that he would raise the income tax personal allowance to £9,205 in 2013, very close to the £10,000 to which the coalition is committed.

Measures affecting high earners

For higher earners, one of the ways in which it had been assumed the Chancellor might pay for the abolition of the top rate was to further restrict the tax relief for pension contributions by higher earners, for example by restricting such relief to 20%. The good news for higher earners is that no such restrictions were announced. In its place, however, the Chancellor introduced a number of measure targeted at high end residential property and a restriction of tax reliefs.

The possibility of an increase in the rate of stamp duty land tax on the sale of high value residential properties had been widely trailed before the Budget and the Chancellor did not disappoint. With effect from 22 March 2012, SDLT will be payable at 7% on residential property where the consideration is in excess of £2m. For properties between £1m and £2m the rate will remain at 5%.

There had also been much discussion regarding the fact that residential properties which were held by offshore companies could be transferred free of stamp duty land tax. The Chancellor announced that a 15% stamp duty land tax charge would apply when a residential property is transferred to one of the non-natural persons which will be specified in the legislation. The government is also going to consult with a view to introducing an annual charge on non natural persons holding high value UK residential property. For many non-domiciliaries, holding a property through a corporate vehicle was at least in part designed to mitigate UK inheritance tax. That avenue now seems extremely expensive and unattractive.

The final announcement regarding residential property was more surprising. The Government is to consult on introducing a charge to UK capital gains tax on the disposal by non natural foreign persons of UK residential property or the sale by shareholders of shares in such persons. Although this type of measure has been discussed from time to time, this would be the first time that the UK would charge tax on the disposal of an investment property by a non-resident or an indirect charge on the sale of a “land-rich” holding vehicle. The design of the “land-rich” tax charge will be interesting, but it may be that the introduction of the very high stamp duty land tax charges on residential land held by non-natural persons will mean that it will not often apply.

As usual, the government announced that it was closing a number of loopholes (perceived or real). However, the most interesting announcement in this area is that the government intends to limit tax reliefs, where they are not already capped on their terms. If an individual claims more than

£50,000 in tax reliefs he will be subject to an additional restriction such that the relief claimed cannot exceed 25% of his taxable income. The restriction is expected to apply from 2013 and the government will publish a consultation document on the changes later this year.

VENTURE CAPITAL AND EMPLOYEE SHARE OWNERSHIP

As part of the Treasury's drive to encourage investment in small and medium sized companies, steps have been taken in the Budget to simplify qualification for tax relief under the enterprise investment scheme ("EIS") and the Venture Capital Trust ("VCT") codes and increase relevant thresholds in relation to EIS, VCT and enterprise management incentives ("EMI").

VCT and EIS simplification

Under current rules an individual is restricted from obtaining EIS tax relief from an investment in a company with whom that individual is 'connected', i.e. where that individual possesses or is entitled to acquire more than 30% of the loan capital or issued share capital of the company. In addition, relief is not available in respect of shares which are entitled to present or future preferential rights to dividends. Further, an individual is only entitled to EIS relief in a tax year if he has subscribed for a minimum of £500 in the relevant company.

From 6 April 2012, the EIS rules will be simplified by (i) disregarding loan capital for the purpose of determining whether an investor is 'connected' with a company, (ii) allowing investments in shares which carry preferential dividend rights (provided they are not dependent on a decision by the company and are not cumulative), and (iii) removing the £500 minimum investment threshold.

In addition, from 1 April 2012, the £1m limit on an investment by a VCT in a single company will be removed (except for companies in a partnership or joint venture).

Increase of VCT and EIS thresholds

In conjunction with the simplification measures set out above, various thresholds under the EIS and VCT legislation will be increased as follows (i) the maximum amount an individual can invest under EIS will be increased from £500k to £1m, (ii) the company size thresholds for EIS and VCT to gross assets of £15m (before investment) and £16m (thereafter) from £7m and £8m respectively, (iii) an increase in the maximum number of employees from fewer than 50 to fewer than 250, and (iv) an increase in the maximum amount which can be raised by a company through EIS and VCT from £2m to £5m.

The amendments will apply in respect of shares issued on or after 6 April 2012 (subject to relevant state aid approvals).

Amendments to the EMI

Under the EMI legislation, certain qualifying businesses can grant tax advantaged options to their employees in respect of shares with a total value of no more than £120k as at the date of grant. The Budget 2012 announced that this limit will be increased to £250k, thereby significantly increasing the amount of tax advantaged options an EMI qualifying company can grant. The threshold will be increased as soon as possible following state aid approval.

The Budget 2012 also announced future amendments to increase the attractiveness of the EMI regime by (i) indicating that gains from shares acquired through exercise of EMI options will be eligible for capital gains tax entrepreneurs' relief (thereby potentially reducing the tax rate on gains to 10%), and (ii) consulting on ways to allow academics to benefit from EMI relief who are employed by the qualifying company.

Although no details are provided, the Treasury has indicated that it will begin consultation on the simplification of tax advantaged share schemes, which will be dealt with in future finance bills.

ANTI-AVOIDANCE

General Anti-Avoidance Rule (GAAR)

In December 2010 the Chancellor announced in the pre-budget report that the Government had asked Graham Aaronson QC, a leading tax barrister, to form a study group to establish whether a GAAR could be effective in the UK tax system to prevent tax avoidance and, if so, to suggest how such a GAAR could be drafted. Graham Aaronson published his report in December 2011 and concluded that a moderate GAAR could be beneficial as a tax avoidance deterrent without undermining the ability of businesses and individuals to manage their tax affairs in a sensible way. He also produced draft legislation to go with his report and suggested that the GAAR should only apply to corporation tax, income tax, capital gains tax and petroleum revenue tax (notably not to VAT, stamp duty and inheritance tax). The GAAR proposed by Graham Aaronson applies to abnormal arrangements which, but for the GAAR, would achieve an abusive tax result. The draft GAAR includes a number of safe-guards intended to ensure that the "centre ground of responsible tax planning is effectively protected". In particular, protections are included for reasonable tax planning and the draft GAAR places the burden on HMRC to prove that an arrangement is not reasonable tax planning. Central to Aaronson's conclusion that a GAAR could be beneficial is the attendant need to reduce and simplify existing specific anti-avoidance rules.

The Chancellor announced in the Budget that the Government would publish a consultation document this summer with a view to introducing GAAR legislation in the Finance Bill 2013. Notably, the Government has stated that it will extend the GAAR to SDLT. Whether the Government will, post consultation, support Aaronson's conclusion that simplification of the existing anti-avoidance legislation must go hand in hand with the introduction of a GAAR, and repeal the myriad of mini GAARs and targeted anti-avoidance rules, must be highly questionable.

Disclosure of Tax Avoidance Schemes (DOTAS)

The Government has announced that it will be consulting over the summer on extending the type of tax avoidance schemes which are subject to the notification requirements of DOTAS. The so-called "hallmarks" are likely to be expanded. Draft regulations will be published later this year.

DOTAS Prompted Anti-Avoidance Legislation

A number of changes have been made as a result of schemes being notified to HMRC under the DOTAS provisions.

Debt buy-backs: Legislation will be introduced in the Finance Bill 2012 to ensure that arrangements which are entered into and which are designed to avoid the deemed release tax charge in debtor companies on debt buy backs are, nevertheless, caught. The legislation will apply to transactions entered into on or after 27 February 2012, but some arrangements which HMRC found particularly offensive will be caught even though they were entered into prior to 27 February 2012. Basically, these are schemes where a loan was purchased by a company, unconnected with the debtor, for less than the face value of the loan and the company then became connected with the debtor as part of a tax avoidance arrangement. Under current legislation, this would not trigger a deemed release tax charge in the debtor company, but HMRC view such arrangements as unacceptable manipulation of the deemed release provisions and so legislation is being introduced to counter such arrangements with retrospective affect.

Sale of lessor companies: Amendments to the existing legislation which impose a tax charge on an amount equivalent to any deferred tax profits in a lessor company on a change of ownership will take effect in respect of transactions entered into on or after the Budget. These changes broadly (i) deem there to be a change in ownership when a lessor company comes within the tonnage tax regime, thereby triggering a tax charge; and (ii) (b) prevent losses generated in accounting periods following a change of ownership being carried back to relieve the tax charge generated on the change in ownership.

Plant and Machinery leasing – changes to disposal values. Under current legislation a lessee of plant and machinery under a long funding lease is entitled to claim capital allowances and is required to bring in a disposal value at the end of the lease. The disposal value is calculated according to a specified formula. Schemes have been devised whereby payments are made which fall outside the formula, thereby undermining the intention of the legislation that a lessee should obtain capital allowances equivalent to the lessee's net expenditure under the lease. The legislation is being widened in respect of transactions entered into on or after 21 March 2012 so that any untaxed amounts which are paid in connection with the lease arrangements and which are payable for the benefit directly or indirectly of the lessee or a connected person will be taken into account in computing the disposal value.

Capital allowances: tax avoidance purpose

Under current law capital allowances on plant and machinery expenditure are restricted where plant and machinery is sold, assigned or let under hire purchase contracts and the main benefit of the transaction is to obtain capital allowances. The legislation is to be changed in the 2012 Finance Bill to make the test one of purpose rather than benefit, so that if the transaction has as its main purpose or one of its main purposes tax avoidance, it will be caught by the anti-avoidance legislation. This change brings this anti-avoidance provision in line with other specific anti-avoidance tax rules where the test is generally one of purpose, rather than benefit.

In addition, the exception to the capital allowance restriction which currently applies for acquisitions from manufacturers or suppliers of plant and machinery is to be repealed where the transaction has tax avoidance as its purpose or one of its main purposes.

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