



# Making sense of the Budget\*

## The Chancellor's Pre-Budget Report 2008

24 November 2008

This is an analysis of the UK Chancellor of the Exchequer's main proposals as outlined in his Pre-Budget Report to Parliament on 24 November 2008 and in press releases and other documents published by the Government. Legislative proposals are subject to detailed legislation in Finance Bills which may be altered during their passage through Parliament. You should neither act nor refrain from acting on the basis of this analysis without first obtaining appropriate professional advice.

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# Economic analysis

## Chancellor gives the economy a £20 billion fiscal boost, but it will be a long and painful process to bring borrowing back down to sustainable levels

The Chancellor, Alistair Darling, faced a huge challenge in designing a Pre-Budget Report (PBR) package that was both effective in boosting the economy in the short term and affordable in the medium term. In the event, he announced a package involving a net fiscal stimulus of around £20 billion in 2008/09 and 2009/10, but despite this he predicted that the economy will shrink by around 1% in 2009. The budget deficit is therefore set to balloon to a projected peak of around £118 billion (8% of GDP) in 2009/10 before falling back in later years on the assumption of a robust economic recovery, public spending constraint and tax rises for high earners in 2011 and beyond. But the public finances are not projected to return to a sustainable state (defined as current budget balance) until as late as 2015/16.

How credible are these new Treasury forecasts of growth and borrowing? Will the fiscal stimulus package be effective? And what other tax and spending measures may be needed in later years to bring public sector borrowing back under control?

### ***Treasury forecasts suggest economy will recover from mid-2009 onwards***

Economic growth is now expected to average around 0.75% in 2008, but growth has been on a sharply declining path during the course of the year. The economy stalled in the second quarter and fell by 0.5% in the third quarter even before most of the effects of the global financial crisis in September had come through. Barring a statistical miracle, another sharp fall in GDP is likely in the fourth quarter, confirming that the UK economy is in recession for the first time since the early 1990s.

The downturn in the UK mirrors that in the US, the euro area and Japan in the wake of the credit crunch and earlier sharp rises in commodity prices (now reversed, but they have already had their effect in delaying interest rate cuts across Europe). Since the UK has had one of the biggest borrowing and house price bubbles, and is more dependent than most economies on the financial services sector, it seems likely that we will suffer one of the sharpest downturns. But this is no longer just a City or property market phenomenon – almost all sectors of the UK economy (except for government services) are now seeing falling output and job cuts.

The new Treasury forecasts reflect this bleak reality in the short term, projecting that:

- UK GDP will fall by around 0.75-1.25% in 2009 (despite the boost from the large fiscal stimulus package, which is discussed further below);
- consumer spending will contract by around 1-1.5% in 2009 and investment by around 8%; even with public spending rising by 2.75%, this implies a fall of around 1.5-2% in UK domestic demand in 2009;
- exports will rise by a modest 0.25-0.75% in 2009, although net trade will still give some positive impetus to GDP growth due to a projected 2-2.5% fall in imports next year; and
- inflation will fall very sharply during the next year, with CPI inflation projected to be down to just 0.5% by Q4 2009 and RPI inflation actually moving temporarily into negative territory

later next year due to mortgage rate cuts and expected further house price falls, as well as the eventual feed through of lower oil prices to domestic energy bills.

Beyond 2009, however, the Treasury remains much more upbeat, projecting that:

- UK GDP growth will rebound to around 1.5-2% in 2010 and an average of 3% in 2011-13; and
- this will be led by a strong revival in exports and investment, with consumer spending growth also picking up later in the period; in other words, the Treasury sees this as a relatively short-lived recession rather than anything more permanent.

While the Treasury view for 2009 seems reasonable enough, the risks around its medium term growth projections appear to be weighted to the downside at present given the severity of the global financial crisis. There is no guarantee that the world economy will bounce back promptly in 2010 in such circumstances. Even when it does eventually recover, this could trigger some further rises in oil and other commodity prices, pushing global inflation back up again and forcing interest rate rises in 2010 and beyond that could retard the speed of the recovery in the major advanced economies.

In the UK, it is likely that the major banks will take several years to restore their balance sheets to full health, while households will be understandably reluctant to borrow and spend as they have done during the past decade. In these circumstances, businesses are also likely to be reluctant to recruit or invest significantly until there is hard evidence that the future demand for their products will be robust. So we suspect that the medium-term pace of recovery may be somewhat slower than the Treasury is projecting.

#### ***Will the fiscal stimulus package boost the economy significantly?***

The Chancellor announced a fiscal stimulus package with a net value of around £20 billion between December 2008 and March 2010 (just over 1% of GDP over this period). The main elements of this PBR package were:

- a temporary VAT rate cut from 17.5% to 15% between 1 December 2008 and the end of 2009 (at a cost of around £12.5 billion over this period);
- child benefit, pension and tax credit increases of around £1.1 billion in 2008/09 and around £0.8 billion in 2009/10;
- other net tax cuts of around £3.5 billion in 2009/10; and
- public capital spending of around £3 billion brought forward from 2010/11 to 2008/09 and 2009/10.

This package is in addition to around £4 billion of fiscal stimulus already announced between the Budget and the PBR.

Despite the scale of the package, we doubt that this fiscal stimulus will do more than take the edge off what will still be a pretty serious recession and indeed this is also reflected in the Treasury forecasts. In particular, much of these temporary tax cuts will either be saved or spent on imports, so a significant proportion (perhaps half or more) of the fiscal stimulus will leak away rather than adding to UK GDP.

This is not to say the Chancellor was wrong to have taken some such action to boost the economy, but it would be unrealistic to expect miracles from this package alone. For the moment, further interest rate cuts and increased bank lending are probably more important requirements for avoiding a deep and prolonged recession.

***Public borrowing reduction relies on economic recovery, tight public spending control and tax rises in the medium-term***

The Treasury now estimates that public sector net borrowing (PSNB) will be around £78 billion (5.3% of GDP) in 2008/09 and around £118 billion (a record 8% of GDP) in 2009/10. This reflects both the effects of the recession and the cost of the fiscal stimulus package. Borrowing is then expected to start declining steadily from 2010/11 onwards, however, as a result of:

- a robust economic recovery starting in 2010 and accelerating in later years;
- tight public spending control from 2011/12 onwards (averaging 1.2% per annum real growth over the three years to 2013/14); and
- income tax and national insurance rises targeted mostly on higher earners to take effect in full from 2011 onwards (with some smaller increases starting in April 2010).

For the reasons discussed above, we consider that the Treasury's medium-term growth projections may prove to be somewhat optimistic. As a result, public borrowing could well turn out to be even greater than projected by the Treasury, although of course there is huge uncertainty about the extent of any such borrowing overshoot at this stage. If this risk does materialise, however, then it seems likely that further tax rises and even greater spending restraint will be needed.

Indeed we have recommended that there should be a real freeze on current public spending in the three years to 2013/14 in order to return the public finances to a sustainable position (defined as current budget balance or surplus) by that year, rather than waiting until 2015/16 as the Treasury projections suggest. We are concerned as to whether the projected net public sector debt level (excluding Northern Rock and other financial sector interventions) of 57.4% of GDP in 2013/14 and still rising will be considered acceptable by the government bond markets in the medium term.

For the moment, however, the Chancellor has probably done the most that he could have done to boost the economy in the short term and he has also at least begun to outline how he plans to restore the public finances to health in the medium-term. But more action on this will probably be needed in due course, both in terms of additional tax increases after the economy has recovered and even tougher public spending control from 2011 onwards. The process of restoring the public finances to health will be a long and painful one.

# Business taxation

## Taxation of foreign profits changes to be included in Finance Bill 2009 – overview

After nearly two years of consultation, the Government has announced its final proposals and timescale for changes to the taxation of foreign profits.

Finance Bill 2009 will include:

- a dividend exemption for large and medium groups;
- an interest cap based on net external finance costs;
- the extension of the existing ‘unallowable purpose’ anti-avoidance rules for loan relationships to cover schemes or arrangements;
- repeal of the acceptable distribution policy and holding company exemptions for controlled foreign companies; and
- a reporting requirement to replace the current Treasury Consent regime.

Draft legislation on these measures is expected to be available in December 2008.

Following Finance Bill 2009, consultation will continue on options to reform the remainder of the controlled foreign company rules, but further changes are unlikely to come into force until at least Finance Bill 2011.

### ***Final package may not be attractive to all***

Overall, the move towards a territorial basis for taxation as stated in the Pre-Budget Report 2008 is to be welcomed. However, it is far from clear that the package outlined above will be attractive for many taxpayers. In fact, a majority may prefer the status quo.

The interest cap in particular looks to be problematic for both UK and foreign-parented groups. The lack of additional interest restrictions is good news, but the original cost of the interest cap for inbounds and the cost of upstream loan disallowances for UK groups remain.

The removal of the holding company exemption also seems contrary to a territorial approach to taxation, given that this removes one of the statutory exemptions for financing from one foreign subsidiary to another.

For many groups the ‘unallowable purpose’ change to look at schemes or arrangements could have a significant impact on financing involving the UK.

### ***Further consultation***

In its letters to the CBI and The Hundred Group, it is interesting to note that HM Treasury has also asked for further input from industry into three specific areas of the controlled foreign company rules: business practices with important implications for the rules, relevant policy developments in other countries and transactions which may inadvertently be caught by provisions.

The likely impact of the package of measures to be introduced in Finance Bill 2009 will be clearer once the draft legislation is available in December 2008.

## **Dividend exemption to be included in Finance Bill 2009**

Foreign dividends received by large and medium sized groups on ordinary and most non-ordinary shares will be exempt from UK tax. A targeted anti-avoidance rule (TAAR) will be introduced to counter perceived potential exploitation of the exemption.

Draft legislation detailing the exemption and anti-avoidance rule is expected to be available in December 2008.

## **Interest cap and wider unallowable purpose restrictions for Finance Bill 2009**

As part of the package of foreign profits measures proposed to offset the cost of the new dividend exemption, further restrictions are to be introduced on the deductibility of interest. Draft legislation detailing both of the measures set out below is expected to be available in December 2008.

### ***Interest cap***

An interest cap which restricts UK interest deductions based on the group's worldwide net interest will be introduced in Finance Bill 2009, although it is worth noting that previously mooted additional restrictions (such as fat cap, thinner cap, rate cap, partial disallowance) have not been mentioned.

It should be noted that one of the main effects of the interest cap will be to disallow the deductions of interest payments on loans from foreign subsidiaries to the UK, in addition to the more obvious restriction on loans from non-UK parents into the UK.

### ***Unallowable purpose***

In contrast to the current 'unallowable purpose' anti-avoidance rule, which simply looks to the purpose of a specific loan relationship in isolation, FA 1996 Schedule 9 paragraph 13 will be tightened by extending the provision to cover the purpose of any scheme or arrangement involving that loan relationship.

## **Controlled foreign company exemptions to be repealed in Finance Bill 2009**

Changes to the controlled foreign company (CFC) rules are to form part of the package of foreign profits measures which include a dividend exemption together with other changes designed to produce what the Government refers to as "a balanced package of reforms".

### ***Repeal of exemptions***

Although more fundamental CFC changes appear to be deferred until 2011, the acceptable distribution policy (ADP) and holding company exemptions for controlled foreign companies will be repealed as part of the Finance Bill 2009 package.

There will be a 24 month transitional period in relation to the repeal of the holding company exemption. It is unclear what a transitional period means in this context: it may be that new holding company structures cannot be created but existing structures might continue to benefit from the holding company exemption for the transitional period.

For holding companies, these changes represent the withdrawal of a significant proportion of the exemptions currently available and therefore represent a dramatic change to the current CFC regime. For example, the current exemption for a holding company lending within a territory will no longer be available.

### ***Modernisation of the regime***

The Government's stated aim in modernising the CFC regime is to enhance UK competitiveness while providing adequate protection of the UK tax base. It has been stated in open letters to the CBI and The Hundred Group of 24 November 2008 that the Government is not seeking to increase the scope of the rules, although as noted above the repeal of the holding company exemption is likely to have a significant impact for many groups.

The introduction of the dividend exemption is intended to represent a move towards a more territorial system of taxing foreign subsidiaries, such that any new CFC regime should in theory not tax profits that are genuinely earned in overseas subsidiaries.

## **Quarterly reporting requirements to replace Treasury Consent regime in Finance Bill 2009**

The existing Treasury Consent rules and notification requirements will be repealed and replaced with a quarterly reporting requirement for high risk transactions, subject to a de minimis limit of £100 million. This change is part of the package of foreign profits measures.

It is interesting to note that the current general consents within the Treasury Consent regime do not appear to be replicated in the replacement regime and it is therefore possible that a large number of transactions will be picked up that were previously exempt from the consent or notification requirements. It remains to be seen whether these types of transaction may not be considered high-risk and may therefore be exempt from notification.

Draft legislation detailing the new regime is expected to be available in December 2008.

## **Corporation tax small companies' rate**

In Budget 2007, the Chancellor announced that the small companies' rate of corporation tax (SCR) would rise to 22% with effect from April 2009, to reduce the difference between the taxation of the self-employed and small companies. However, the Chancellor has now announced that the SCR will remain at its current level of 21% until 1 April 2010.

Thus companies with taxable profits of up to £300,000 will continue for the time being to be taxed at 21%. For companies with taxable profits exceeding £300,000 but not more than £1.5m, the fraction used to calculate the marginal small companies' relief remains at 7/400.

In the case of 'ring fence profits' from oil extraction and oil rights in the UK and the UK continental shelf, at 1 April 2009 the SCR and fraction will remain unchanged at 19% and 11/400 respectively.

These rates will be legislated in Finance Bill 2009.

## Consultation on the North Sea fiscal regime

The Chancellor announced in his Pre-Budget Report 2008 speech that he was consulting with industry over incentives to increase production from marginal fields. This follows on from several previous rounds of consultation which commenced following PBR 2005. The latest round of consultation runs to 13 February 2009.

The consultation document published on 24 November 2008 repeats the Government's twin objectives of promoting investment and production, whilst ensuring a fair return for the UK taxpayer.

The main points discussed in the consultation document are summarised below.

### ***Development incentives***

The Government and the oil industry have been examining different types of incentives to see whether these would promote development of oil and gas fields and optimise the recoverability of oil and gas.

The Government has rejected many of these including a cut in the supplementary charge, an uplift on capital expenditure and a 'Volume Allowance' which would enable a certain level of production to be taxed at a lower rate each year. Its conclusions are that these measures would not be targeted sufficiently to achieve the aims of the incentive, or that they would actually achieve more when oil and gas prices were rising and hence when less incentive was needed.

Further consultation is invited on a 'Value Allowance' where a certain amount of adjusted profits would be taxed at a lower rate. The objective is to design an allowance that will support the development of marginal oil fields.

### ***Corporation tax***

There is no change to the level of corporation tax or supplementary charge.

### ***Chargeable gains***

Two changes to the chargeable gains legislation are proposed.

Currently, where companies swap interests in undeveloped field licences, the consideration for the licence disposed of is deemed to be nil for capital gains tax purposes. This is to be extended to all swaps of UK continental shelf licences, such that no gain will arise to the extent that the value of the licence acquired equals the value of the licence disposed of.

In addition, any gains on arm's length disposals of UK licences will be exempted from tax where the proceeds are reinvested in other UK licences. Any such gain currently is deferred until the new licence is disposed of.

### ***Petroleum revenue tax***

Petroleum revenue tax ('PRT') is paid on oil and gas fields which received development consent prior to March 1993. Many of these older fields are nearing the end of their production lives.

The Government is continuing to discuss with industry potential options for the abolition of PRT which would put all fields in the UK onto the same tax basis going forward. The biggest objection to abolition comes from the oil industry's request for assurances that they will obtain PRT relief for their decommissioning costs in respect of fields where PRT has been paid.

One minor change would ensure that companies are able to claim full PRT relief for decommissioning costs where the licence that they held has already been terminated.

Other minor measures are proposed to reduce the administrative burden of PRT by repealing legislation that allows provisional expenditure allowances, and to allow values for blended production to be allocated on a 'just and reasonable' basis where a new field comes on stream and is blended with other production.

### ***Change of use legislation***

The 'change of use' discussions arise from the potential change of use of existing North Sea oil and gas production platforms and reservoirs to enable wind turbines to operate or gas to be stored underground. Such changes are problematic as these new activities are taxed on a different basis from existing oil and gas exploration and production activities.

The Government proposes that where a qualifying asset ceases to be used in connection with a field that is liable to PRT and instead is used for a qualifying 'change of use' purpose, rules will be introduced to ensure that no PRT charge arises on the cessation of use for a PRT purpose. It will be a condition of the relief that no disposal receipts arise within two years following the last use of the asset in connection with a PRT chargeable field.

The Government has also confirmed that it will be happy to consider any clarifications required to ensure that income from 'change of use' activities will not be subject to the oil and gas taxation regime, including corporation tax, supplementary charge and PRT.

A significant issue is the relief for decommissioning costs where assets cease to be used for oil and gas production and are instead used for a 'change of use' purpose. The Government proposes to amend the legislation to ensure that the same reliefs will be available for eventual decommissioning of such assets as would have been available had the decommissioning taken place while the assets were oil and gas assets. Consultation is invited on the need for further clarity of PRT rules which seek to apportion such expenditure between oil and gas production and 'change of use' utilisation.

Consultation is also invited on the best method for defining 'change of use' for PRT purposes.

## **Foreign exchange - derivative contracts**

Where a company invests in foreign currency denominated shares (for example, an overseas subsidiary) or other foreign investments, it is common practice for the company to hedge the resulting foreign exchange exposure with a loan or derivative contract. The basic rules for taxing a company's foreign exchange differences provide that those arising on a loan or derivative contract are taxed in the periods in which they accrue; whereas those arising on capital items such as shares are taxed on a disposal (or may be tax-exempt).

However, provided that certain conditions are met, a company may 'tax match' a loan or derivative contract with shares (or other limited forms of asset, namely ships and aircraft), where the loan or derivative contract is hedging the foreign exchange exposure arising from the shares. Where a loan or derivative contract is tax matched with shares, the foreign exchange movements on the loan or contract are deferred for tax purposes until the shares are sold. This eliminates the timing difference referred to above, and enables the company to be hedged both before and after tax in every period.

Where a UK company adopts IFRS or the modified UK GAAP standards which mirror IFRS, the accounts carrying value of a loan or derivative contract may be adjusted on transition. Where this happens, a special set of rules taxes any change in the value of the loan or contract (including

changes due to foreign exchange movements) to ensure that all such changes are taxed or relieved once over the lifetime of the instrument. In other words, the rules ensure that no changes in value are taxed twice or fall out of tax altogether.

HMRC has identified a defect in the rules for derivative contracts where there is a change in accounting practice. Where a previous foreign exchange movement is reversed on a change of accounting practice, those rules will tax such a reversal even where the amounts in question were not previously taxed due to the matching rules.

This can result in double taxation or double relief, and accordingly the rules are to be amended to disregard any foreign exchange adjustment which has been tax matched, to the extent that the amount would otherwise be brought into account after 31 December 2008, and to the extent needed to prevent double counting. Draft regulations will be published shortly for comment.

## **Late payment of interest on debts between connected companies**

Changes will be included in Finance Bill 2009 to amend the rules dealing with the late payment of interest on debts between connected companies. These rules currently deny a tax deduction, subject to some minor exceptions, where interest is:

- paid late, i.e. more than 12 months after the end of the accounting period when normally accrued; and
- paid in circumstances where the receipt is not brought into account within the corporation tax loan relationship regime.

Typically, interest accrued by a UK company in respect of a loan owing to an overseas group company would not attract a tax deduction until paid.

The changes will be effective for accounting periods beginning on or after 1 April 2009, and apply to companies which, in the relevant period, are under common control, or where one company controls the other.

The nature and effect of the proposed changes are, as yet, unclear: HMRC published a consultation document and a business brief on 28 July 2008, in response to suggestions that the existing rule is not compliant with EU law, and has today announced that the changes will reflect the impact of the consultation process.

The business brief includes what seems to be a concessionary treatment which states that HMRC will not seek to apply the late paid interest rules to interest paid to foreign connected parties. Our view is that taxpayers should have a choice in whether they exercise their freedom under the EC treaty. HMRC has confirmed that taxpayers may continue to invoke the late paid interest rules if the latter consider it advantageous to do so and follow a consistent approach until the law is changed.

Recent comments made by HMRC during the consultation suggest that its preferred option is to disapply the existing rule where the creditor company:

- is resident either in the UK or in a territory with an appropriate non-discrimination article in its double tax treaty with the UK; and
- is not seeking to achieve a tax deduction without a corresponding taxable credit.

If the changes reflect these comments, then interest paid on loans from tax havens would typically remain deductible on a paid basis only, whilst loans from other territories and without any tax avoidance motives, would typically be deducted on an accruals basis.

HMRC has also commented that:

- the option in the consultation document to extend the rule to all companies, which would have extended the late paid interest rule to all UK to UK connected party loans, would not be adopted; and
- despite consultation comments to the contrary, loans to close companies from a participator will remain on the paid basis if not paid within 12 months of the accounting period end.

It is anticipated that flexible transitional rules will be introduced.

## **Release of trade debts between connected companies**

Finance Bill 2009 will include legislation to ensure that where a trade debt between connected companies is formally released, the debtor will not be taxed on the consequential credit. Currently the creditor company is denied a tax deduction on a release, but the debtor may be taxed. This change aims to bring the two treatments into line.

It will be effective for releases made in accounting periods beginning on or after 1 April 2009. It will apply to companies which, in the relevant period, are under common control, or where one company controls the other.

This change will apply only to formal releases, which are usually written under deed. It would not protect a simple informal waiver of a trade debt, which HMRC regards as creating taxable income for the debtor company.

## **Stock lending reliefs**

Where a stock borrower unexpectedly defaults on a stock loan, for example due to insolvency, the lender will need to liquidate his collateral and use the proceeds to purchase shares equivalent to those that were the subject of the defaulted loan.

The termination of a stock loan with no return of shares results in a deemed capital gains disposal of the shares on the date of termination and, in the case of UK shares, a potential charge to stamp duty or stamp duty reserve tax (SDRT). In addition, lenders purchasing UK shares following the default of the stock loans are required to pay stamp duty or SDRT on those purchases. Any tax liabilities arising in these ways would be completely unexpected for lenders, given that transfers of shares under stock loans typically qualify for exemption from tax on capital gains and, in the case of UK shares, exemption from stamp duty and SDRT.

Finance Bill 2009 will include changes to the capital gains and stamp duty/ SDRT rules to address these concerns. Under the capital gains changes, the termination of a stock loan with no return of shares where the borrower becomes insolvent will not be considered a deemed disposal of those shares, provided that the lender uses collateral to fund the purchase of equivalent shares. These changes will be effective from 1 September 2008 (by election), but will be subject to what are described as “appropriate safeguards”.

The changes to the stamp duty/ SDRT rules mean that purchases by lenders of equivalent UK shares following default, funded by use of collateral, will not be subject to stamp duty or SDRT. Nor will

transfers of UK shares under defaulted stock loans in such circumstances be subject to stamp duty or SDRT. These changes will also be effective from 1 September 2008.

These changes follow concerns raised with HM Treasury and HMRC by individual investor firms and by the International Securities Lending Association. The fact that Government has responded positively and quickly to these concerns is welcomed.

## **Lloyd's: extension of relief for equalisation provisions**

New legislation will be introduced to extend the tax relief on equalisation provisions that is available to general insurers to Lloyd's corporate members. It is expected that the new legislation will broadly reflect the relief that would be available if the corporate members were obliged to set equalisation reserves, but adapted for the particular circumstances of members.

The legislation will apply to profits treated as arising in the year ended 31 December 2008.

## **Extending land remediation relief to derelict land and Japanese Knotweed, and giving more clarity**

Legislation will be included in Finance Bill 2009 to extend land remediation relief to expenditure on derelict land. The land must have been derelict long term and this widening of the relief is designed to bring such land back into use. Relief will only be available where the land was acquired in a derelict state. Further, relief will only be available on expenditure on the removal of:

- post tensioned concrete heavyweight construction;
- foundations of buildings or machinery bases;
- reinforced concrete pilecaps;
- reinforced concrete basements; and
- underground pipes etc for the supply of electricity, gas, water or telecommunications services or for drainage;

and related preparatory activity.

To date HMRC has denied relief where the contamination is due to a living organism such as Japanese Knotweed. FB 2009 will enable relief for Japanese Knotweed even if the infestation has occurred since the land was acquired by the claimant. Only approved methods to remedy the infestation will be allowed. For example, the costs of removing the Japanese Knotweed to landfill sites will not qualify.

Changes are also being made to clarify the types of expenditure which qualify for relief. The intention is to give developers greater certainty at an earlier stage. Only the cost of removing contaminants resulting from industrial activity will qualify; contaminants present from natural processes will cease to qualify with the exception of certain specified contaminants such as radon and arsenic (as well as Japanese Knotweed).

Where land remediation work is sub-contracted to a connected person, only certain costs qualify for relief. If the sub-contractor in turn contracts out the work, those costs will now qualify as well.

These changes will have effect for expenditure incurred on or after 1 April 2009.

## Changes to tax reliefs for company cars

As announced in Budget 2008, existing capital allowances rules for 'expensive cars' which cap the available writing down allowances (WDAs) are to be abolished. Instead, 'expensive cars' will attract WDAs according to their carbon dioxide (CO<sub>2</sub>) emissions. The changes will take effect for corporation tax from 1 April 2009 and for income tax from 6 April 2009. There are related changes for car leasing. The proposals comprise the following:

- Cars with CO<sub>2</sub> emissions of over 160g/km will attract WDAs at 10% whilst others will attract WDAs at 20%. Expenditure incurred before April 2009 will, in general, continue to be subject to the pre-existing 'expensive cars' rules for a transitional period of five years.
- Cars with a non-business use element will continue to be dealt with in a separate pool so that the private use adjustment can still be made. However, the available WDAs will be determined by the car's CO<sub>2</sub> emissions.
- The leasing restriction that applies to leases of 'expensive cars' will also be subject to reform. Expenditure under new leases on any cars with CO<sub>2</sub> emissions above 160g/km will be subject to a flat rate disallowance of 15% (but limited to expenditure on only one lease in a chain of leases). Expenditure under leases made prior to 1 or 6 April 2009 will continue to be subject to the old rules.
- Certain hire cars (for example, leased to those in receipt of certain disability allowances) that are currently exempt from 'expensive car' restrictions will be subject to the new regime.

HMRC has also issued a report on the interaction between company cars, employee car ownership scheme cars and mileage allowances payments. No reforms were announced but HMRC will continue to monitor the market in employee car ownership schemes, which can allow employees to lease cars with higher CO<sub>2</sub> emissions at less tax and national insurance cost than with equivalent company cars. The Government will also consider ways of simplifying the company car tax regime for the future in the hope of reducing the burden of administration for employers.

## Company car tax for disabled users of automatic cars

Company car tax is calculated by multiplying the list price of a company car by a percentage calculated by reference to the carbon dioxide (CO<sub>2</sub>) emissions of the vehicle. Disabled employees who have to drive automatic cars can already substitute the CO<sub>2</sub> emissions of an equivalent company car in the car tax calculation.

Legislation will be introduced in the Finance Bill 2009 to allow them also to substitute the list price of an equivalent manual car for the automatic car in the company car tax calculation.

## Relaxation of PAIF rules

Property Authorised Investment Funds (PAIF) were introduced in April 2008 as a tax efficient open-ended, property based, investment vehicle. Changes will clarify how a PAIF can operate in practice, and will, in particular, eliminate potential tax inefficiencies arising from the use of specialist funds (feeder funds) to circumvent the 10% corporate ownership condition.

The amendments will:

- permit the payment of net distributions from a PAIF to a unit trust where this is requested;

- provide an exemption from a Stamp Duty Reserve Tax charge for a feeder fund investing into a PAIF; and
- extend the manufactured payments regime to PAIFs.

These measures will be introduced from 1 January 2009.

## **Transactions between dealing companies and associated companies**

An obsolete anti-avoidance provision, ICTA 1988 section 774, is to be repealed. The section is concerned with transactions between companies dealing in securities and associated companies not dealing in securities - but the transactions originally targeted were later addressed separately in FA 1996 (loan relationships) and FA 2002 (derivative contracts). The repeal is not expected to have any practical impact.

## **Three-year carryback of company trading losses**

There is to be a temporary extension to the rules which allow trading losses to be carried back against income of the previous 12 months and to generate a repayment of tax.

It is proposed that companies will be able to claim a three-year carryback of trading losses that arise in accounting periods ending between 24 November 2008 and 23 November 2009. At present, only terminal losses can be carried back for three years.

Losses carried back will be set against profits of later periods before earlier periods. The maximum amount of losses which can be carried back to the earliest two periods will be limited to £50,000 per company. If the loss arises in an accounting period of less than 12 months, the £50,000 amount will be proportionately reduced; and if more than one loss-making accounting period ends in the specified period, the maximum which can be carried back more than 12 months will be limited to £50,000, even if the losses exceed that amount.

The relief is not limited to small and medium-sized companies, although clearly loss relief of £50,000 will be more significant to smaller businesses than to larger businesses. Perhaps surprisingly, there are no provisions to limit the amount which can be carried back by groups with more than one loss-making company; it appears that each trading company in a group can claim the relief.

Relief must be claimed within two years of the end of the accounting period in which the loss arises. Although legislation must await Finance Bill 2009, HMRC will accept a claim from 24 November 2008 if the amount of a loss can be established at the time the claim is made.

The rules allowing trading losses to be set against other profits of the same accounting period, to be surrendered as group relief, or to be carried forward indefinitely against income from the same trade in future periods, will be unaffected. Rules relating to losses other than trading losses will also be unchanged.

Similar rules will also be introduced in relation to trading losses of unincorporated businesses.

## Simplification of small companies' taxation

As announced in Budget 2008, HM Treasury and HMRC have sought the views of small businesses, their representatives and tax professionals on possible ways to simplify corporation tax calculations and statutory return obligations. The review has so far considered companies with turnover of less than £750,000 and fewer than 10 employees. The main objective is to reduce the administrative burden on business, whilst maintaining consistency with wider public policy goals and protecting against avoidance and potential abuse.

Drawing on broad discussions with stakeholders, two ideas have been found unsuitable for further consideration, namely the use of statutory accounts profits as taxable profits; and flat-rate tax allowances. However, two other proposals are now to be considered in further detail.

The first is statutory accounts that include tax obligations. There are two aspects to this proposal:

- A joint filing facility to reduce the administrative burden by enabling companies to file to both HMRC and Companies House at the same time. This is expected by 2011.
- Combining statutory accounts and tax reporting, with a new accounting standard taking tax adjustments into account in calculating profits. The result would be the same as profits chargeable to corporation tax, obviating the need for a separate tax return.

The second is using cash flow as the basis for calculating tax. Potentially aimed at the smallest of companies, an optional new tax regime would be based on cash flow, not accounting profits. Tax would be calculated on actual receipts in the period, less allowable expenditure actually paid.

Both ideas have complexities and pitfalls that need closer examination. HM Treasury invites comments by 20 February 2009 on questions raised in a 24 November 2008 discussion paper.

# Personal and employment taxation

## Continuing personal tax reform

The Chancellor announced in the Pre-Budget Report 2008 measures to assist the injection of spending into the economy by introducing a number of changes to the personal tax allowances in the next tax year. To help pay for this cash injection Alistair Darling also heralded changes, to take effect in future years, affecting those on higher levels of income.

### ***Basic rate taxpayers***

Changes were announced in PBR 2007 as part of a reform of personal tax rates. From 6 April 2008 the basic rate of income tax was reduced to 20% and the 10% starting rate was abolished, although it was retained for savings income up to £2,320 for individuals whose other income, such as pensions or earnings, was within their personal allowances.

In May 2008 the Chancellor introduced temporary measures designed to compensate basic rate taxpayer for the withdrawal of the 10% rate. Personal allowances for all taxpayers were increased and, at the same time, the rate at which 40% tax became chargeable was lowered so the benefit of the increased allowance was lost for those with income chargeable at the higher rate.

In a move to support people on modest and middle incomes the Chancellor announced that the changes made in May would be permanent and personal allowances from 6 April 2009 will be increased by £130 above indexation from £6,035 to £6,475. The starting rate for 40% tax will rise by £800 above inflation to £37,400.

### ***Higher rate taxpayers***

In PBR 2008 Alistair Darling announced revenue raising measures to come into effect from 6 April 2010 for those on incomes above £100,000. The basic personal allowances will be reduced in two stages for those with gross income above £100,000 and £140,000.

Where an individual's gross income is above £100,000 their personal allowances will be reduced by £1 for every £2 of income above the limit, up to a maximum of a half of the basic allowance so, if the basic personal allowances are set at £6,475 for 2010/11 someone with income of £106,475 or more (but less than £140,000) will only be eligible for allowances of £3,240.

Where the income exceeds £140,000 the allowances are again restricted by £1 for every £2 above the income limit, so where the income exceeds £146,475 no allowances will be available at all.

In addition from 6 April 2011 a new higher rate of income tax of 45% will apply for income above £150,000. Individuals earning sufficiently over that amount but who do not fully use their pension annual allowance, might consider deferring pension contributions until 2011/12 when relief might be at 45% rather than at the current 40% rate.

As a consequential change to the raising of the higher rate of tax, the rate at which higher rate tax is paid on dividends will increase from 32.5% to 37.5% where dividend income is within the new higher rate band.

### ***National insurance contributions***

From 6 April 2009 the upper earnings limit for employee NICs will be aligned with the higher rate income tax threshold. This will be £43,875 for 2009/2010.

From 6 April 2011:

- the NICs primary threshold will be broadly aligned with the income tax basic personal allowance;
- the main rates of Class 1 and Class 4 NICs will be increased by 0.5% to 11.5% and 8.5% respectively;
- the Class 1 employer rate of NICs will be increased by 0.5% to 13.3%. The increased rate will also apply to Class 1A and Class 1B contributions; and
- the additional rate of Class 1 and Class 4 NICs will be increased by 0.5% to 1.5%.

### ***Trusts***

Trustees of most trusts where income can be accumulated and paid out at their discretion will pay tax on income and savings at 45% (previously 40%) irrespective of the level of income within the trust. Again as a consequence of the increase in the tax rate the rate at which trustees pay tax on dividend income will increase from 32.5% to 37.5%.

## **Income shifting rules postponed yet again**

Given the current economic climate, the Government has decided to defer the introduction of legislation which was expected in Finance Bill 2009 to counter 'income shifting'. The Government will keep the issue under review as it believes the advantage obtained by individuals who enter into arrangements under which income which might otherwise be attributable to one individual is taxed on another, resulting in a lower overall tax liability, is unfair. The Government originally announced the intention of introducing legislation over a year ago and in the absence of detailed proposals many family businesses will be operating in a continuing position of uncertainty.

## **Pension schemes: lifetime allowance and annual allowance frozen**

There is to be no increase in the limits of two key controls on tax-privileged retirement savings from 6 April 2011.

The simplified tax regime for pensions, which came into effect on 6 April 2006, introduced the lifetime allowance (initially £1.5 million but rising to £1.8 million in 2010/11) and the annual allowance (initially £215,000 but rising to £255,000 in 2010/11).

HMRC has announced that both the lifetime allowance and the annual allowance will remain in place after 2011, and the respective rates will be held at the 2010/11 levels for a further five tax years, up to and including 2015/16.

Certain other limits set by reference to the lifetime allowance are expected similarly to remain constant between 2011/12 and 2015/16.

The timing of this measure coincides with the introduction of the higher 45% rate of tax on taxable non-savings and savings income above £150,000 and increased rates of tax on dividend and trust income, which are also due to take effect from 2011/12.

## **Three-year carryback of individual's trading etc losses**

There is to be a temporary extension to the rules which allow losses of an individual's trade, profession or vocation to be carried back against income of the previous 12 months and to generate a repayment of tax.

It is proposed that individuals who incur losses in their basis periods for the 2008/09 tax year will be able to claim a three-year carryback against profits of the same trade etc. Losses carried back will be set against profits of later years before earlier years. The maximum amount of losses which can be carried back to the earliest two years will be limited to £50,000 in total.

Relief must be claimed by 31 January 2011. Although legislation must await Finance Bill 2009, HMRC will accept a claim from 24 November 2008 if the amount of a loss can be established at the time the claim is made.

The rules allowing trading losses to be set against other income and capital gains of the same tax year, or carried forward indefinitely against income from the same trade in future tax years, will be unaffected. Rules relating to losses other than losses of trades, professions and vocations will also be unchanged.

Similar rules will also be introduced relating to trading losses of companies.

## **Enterprise investment scheme (EIS)**

HM Treasury and HMRC have issued a summary of responses to the recent consultation paper on the enterprise investment scheme (EIS), with the Government's own reaction. Many aspects of the relief are to be considered further, including qualifying trades, particularly where intellectual property is involved, and where EIS companies merge. There will be further consultation on EIS Funds.

It is intended to amend three aspects of the EIS by legislation in Finance Bill 2009:

- To allow EIS companies two years to employ the funds raised from investors, rather than having to employ at least 80% in the first 12 months and the remainder in the following 12 months.
- To enable EIS income tax relief to be carried back to the previous tax year, within the normal limits.
- To correct an anomaly which can occur where an EIS company is taken over - PricewaterhouseCoopers has lobbied for this change for many years.

There are a few areas where the Government has decided against widening the scope of EIS. These include allowing employees and their family members to claim EIS income tax relief; and shortening the minimum holding period.

## Qualified investor schemes (QIS)

The current anti-avoidance rule that imposes a tax charge on certain types of investor in a qualified investor scheme (QIS), where their units or shares represent rights to 10% or more of the QIS will be removed. It will instead be replaced with a 'genuine diversity of ownership' rule from 1 January 2009. Transitional rules will be put in place in relation to the removal of the current 10% rule.

The genuine diversity of ownership test will be similar to that in the new property authorised investment funds (PAIF) regime and will require the manager to make fund units available to 'eligible' investors. As with the PAIF regime, an advance clearance procedure will be made available, which will provide more certainty around tax treatment to both fund managers and investors.

The industry will welcome the removal of the 10% restriction, which placed a significant compliance burden on funds and their larger investors and which has to date hindered the development of the QIS. Given the restricted nature of the QIS market, aspects of the genuine diversity of ownership test may be more subjective than the equivalent test in the PAIF regime. For example, the requirement that units must be actively marketed in each accounting period may be difficult to satisfy at certain times during a fund's lifecycle. It is likely that HMRC will issue guidance on the test once the legislation is issued.

## Individual savings accounts and Multilateral Institutions

It was speculated that more changes would be announced by Alistair Darling in relation to individual savings accounts (ISAs) than actually materialised. Instead of an increase in the maximum allowance, as expected by many, he announced the relatively minor amendment that the Government is extending the range of qualifying investments.

Previously, where securities were to be invested in an ISA, only those issued either by or on behalf of a government of any European Economic Area (EEA) member state, including the UK, or by a company listed on a recognised stock exchange would be classified as qualifying securities.

From 16 December 2008 onwards the definition of qualifying securities will be extended to allow bonds issued by Multilateral Institutions, as defined by the Organisation for Economic Cooperation and Development (OECD), to qualify so that they may be invested in ISAs. Multilateral Institutions under the OECD definition include, amongst others, the International Monetary Fund and World Bank.

## Simplification of rules on acquisition of employment-related securities at an undervalue

Several changes are to be made to the rules on share plans which attempt to simplify the legislation and correct provisions which were seen to be unfair. The key thrust of the changes is to ensure that employees holding shares in their employer are not subject to income tax where they have received no overall economic benefit.

Where an employee pays for shares in instalments, it is possible that a tax charge can arise on their disposal if instalments remain outstanding, even though the employee has made no profit on the shares. The proposed change will remove this charge (though it may be reinstated if the obligation to pay it is later released).

A similar change is proposed to prevent a charge where there is sale of nil or partly paid shares where no profit has been made.

Finally, a change is proposed to remove a potential tax charge where an employee receives additional shares from his employer as a result of a scrip or bonus issue without the value of the overall holding being increased. Previously, this could have given rise to an income tax charge even where no profit was made.

Draft legislation implementing these changes is still to be published. It is intended that the changes will have effect from the date that Finance Bill 2009 receives Royal Assent.

## **The Saving Gateway**

The Chancellor announced in the Pre-Budget Report 2008 that following the completion of the pilot scheme the Saving Gateway will be introduced nationally in 2010.

The Government will contribute 50p for every £1 saved in the cash savings scheme aimed at those on tax credits paid at the maximum rates and other qualifying benefits. The maximum amount eligible to be 'matched' is £600 (£25 per month for 24 months) and will attract matched contributions of £300. The matched payment will be made on maturity of the account after 2 years.

# Anti-avoidance

## Financial products avoidance

In December 2007 HMRC issued a consultation document containing its proposals to deal with tax avoidance using financial products. The document dealt with two types of avoidance: disguised interest and transfers of income streams. Following a period of consultation, including meetings with interested parties, HMRC has now issued a revised consultation document, with amended draft legislation and explanatory notes.

### *Disguised interest*

The original consultation document set out a new approach for taxing company transactions which are loans in substance but, due to their legal form, are taxed more favourably than loans or not taxed at all. HMRC's previous approach to such avoidance has been to enact legislation on a piecemeal basis to target particular schemes, including legislation such as the 'shares treated as debt' rules in Finance Act 1996. The aim of the disguised interest rules is to replace these piecemeal responses with a comprehensive set of rules which ensure that an interest-like return is charged to corporation tax in all circumstances where an arrangement is structured with the intention that the return is not taxed as income.

The original draft legislation contained an over-arching principle that the rules should tax a return which is 'economically equivalent to interest', and deliberately contained relatively few detailed rules as to how the law should operate in practice. This led to concerns that HMRC would have significant discretion over how the law would operate in practice.

The revised proposals retain the original concept of taxing a return which is 'economically equivalent to interest', but now set out a series of criteria to determine whether the rules apply. These criteria are:

- the return must be by reference to a time value of that amount of money;
- the return must be at a rate reasonably comparable to a commercial rate of interest; and
- there must be no practical likelihood of the return not arising as expected.

The revised rules attempt to deal with some of the concerns and uncertainties raised during the consultation process. The key points are summarised below.

- The rules will not apply to an arrangement unless the main purpose, or one of the main purposes, of the arrangement is tax avoidance.
- The rules are intended to catch returns denominated in a foreign currency, including the foreign exchange movements.
- Straightforward intra-group share investments are excluded. In straightforward situations this should prevent double taxation in a tier of companies and should also remove controlled foreign companies from the scope of the rules.
- The rules catch an overall interest-like return which is split between different companies. However, doubts remain over the extent to which the rules will disaggregate an interest-like return which forms part of a larger (non interest-like) return.

The revised document also carves out a new proposal for preference shares which are accounted for as a financial liability rather than equity. It is proposed that such shares will be dealt with by what is effectively a revised version of the 'shares treated as debt' rules in Finance Act 1996. Broadly, if such shares (whether redeemable or not) are held for an 'unallowable purpose', the fair value movements will be taxable as interest. Again, shareholdings in group companies are outside the scope of the rules.

HMRC has requested that responses to the consultation document be submitted by 11 February 2009. HMRC's intention is to enact the legislation as part of Finance Bill 2009, so that it is in force from 1 April 2009. Arrangements entered into before that date may be outside the scope of the rules.

### ***Transfers of income streams***

The proposals deal with arrangements where a person (including a company or individual) makes a transfer of its rights to receive income from an asset without transferring the underlying asset. Where, as a result of the transfer, receipts which would have been taxable income of the transferor are not taxed, the proposed rules bring the value of those receipts into tax as income. There will be exclusions for certain specified types of straightforward transactions in land.

As for the disguised interest rules, HMRC intends to enact the rules with effect from 1 April 2009 as part of Finance Bill 2009.

## **Real estate investment trusts**

The Government considers UK-REITs, launched in January 2007 and designed to provide a new tax regime for property investment companies, to have been a marked success. However, contrary to the Government's objectives, some businesses that are not property investment companies, because they do not have a high enough proportion of income coming from the rental of property to third party tenants, have developed corporate structures that would allow them to participate in the UK-REITs regime. The Government will legislate in Finance Bill 2009 to prevent this.

The Government will publish draft legislation for consultation in the New Year to ensure that it does not create any unintended consequences for existing UK-REITs. The Government is also willing to have discussions to consider whether other parts of the tax code create any unnecessary barriers to becoming a UK-REIT.

## **Sale of intermediate lessor companies**

An HMRC Technical Note issued on 13 November 2008 addressed an anomaly in FA 2006 Schedule 10 where an intermediate lessor company is sold.

Schedule 10 applies when there is a change in ownership of a lessor company. It deems an accounting period to end on the day of the change of ownership and imposes a charge on the lessor company based upon the difference between the balance sheet value of plant or machinery and the tax written down value. This reflects the timing benefit for the lessor when the assets are written down faster for tax purposes than in the accounts. A relief of like amount is given the next day in the new accounting period when the lessor is under different ownership. In effect, Schedule 10 prevents a profitable group taking the timing benefit under a lease and then selling the lessor company to a loss group before the timing benefit reverses.

If a lessor company sells its plant or machinery and then leases it back under a long funding lease or hire purchase contract, it becomes an intermediate lessor. Although it no longer owns the asset, the

company is entitled to claim capital allowances and therefore retains the timing benefit. However, a charge under Schedule 10 only operates by reference to owned assets. As such, when the lessor company is sold, there is no charge in relation to those leased assets.

Changes are being made so that the charge on change of ownership operates by reference to all plant or machinery on which the lessor is entitled to claim capital allowances. The legislation is to have effect where a lessor company is sold on or after 13 November 2008.

## **Anti-avoidance rules for long funding leases of plant or machinery**

An HMRC Technical Note issued on 13 November 2008 targeted transactions involving long funding leases which gave capital allowances in excess of the cost of plant or machinery.

Under FA 2006 rules, capital allowances are given to the lessee under a long funding lease; the creation of a long funding lease triggers a disposal event for the lessor and an acquisition event for the lessee. It became possible to structure a sale and leaseback or lease and leaseback of plant or machinery such that the amount on which capital allowances could be claimed under the long funding leaseback was greater than the disposal proceeds on the sale or grant of the head lease. New rules will aim to ensure that the amount on which a lessee can claim capital allowances under a long funding leaseback will not exceed the amount brought in as disposal proceeds.

Related legislation will counter transactions that minimised the disposal proceeds on the grant of a long funding lease of plant or machinery or enhanced the relief obtained by a lessee at the end of a long funding lease.

This new anti-avoidance legislation will have effect for leasebacks entered into, and long funding leases granted or ending, on or after 13 November 2008.

## **Avoidance involving film leases**

On 13 November 2008 HMRC released a Technical Note announcing measures to prevent tax being avoided on rental income under long funding leases of films. Draft legislation and explanatory notes have now been released.

The new legislation has effect in relation to long funding leases of films:

- entered into on or after 13 November 2008; and
- entered into before 13 November 2008, to the extent that rents are payable after, and refer to periods of time after, that date.

The measures aim to prevent planning that sought to avoid tax by replacing existing leases with new ones that qualified as long funding leases of plant or machinery, which resulted in rentals remaining largely untaxed. The new legislation ensures that rents received under the lease are taxed in full.

## **Avoidance using authorised investment funds**

The current anti-avoidance legislation in relation to financial traders investing in authorised investment funds (AIFs) is to be revised. The amended rules will mean that corporate streaming provisions for AIFs, whereby a distribution from an AIF is streamed into a franked and an unfranked portion

dependent on the underlying investments in the AIF, will not apply where investors in receipt of a dividend from an AIF treat that dividend as a trading receipt for tax purposes.

## Tax Avoidance Disclosure

Under the Tax Avoidance Disclosure regime, users of tax avoidance schemes are required to report to HMRC scheme reference numbers (SRNs) that have previously been issued by HMRC. Finance Act 2008 and associated regulations contained changes to the way that SRNs issued by HMRC must be provided by promoters of schemes to users of schemes. HMRC has now proposed changes to the way that SRNs are reported by users to HMRC, covering the time when a SRN must first be reported to HMRC and the format in which the report must be made.

Currently, the first time that a user is normally required to report a SRN to HMRC is in the year or accounting period during which the SRN is received. The change that is proposed will mean that a user will be required to report a SRN in the year or accounting period during which the scheme is actually implemented. A user will still be required to report a SRN to HMRC for each subsequent year or accounting period during which a tax advantage arises from the scheme.

In addition, the regulations will be changed to provide greater clarity as to when a user is required to report a SRN using an HMRC form (form AAG4) rather than on a tax return. The circumstances when a user will be required to use form AAG4 will include:

- where the user is an individual who makes a freestanding claim for loss relief which is affected by the use of the scheme; and
- where there are insufficient boxes on the return for the user to report all the SRNs that it is required to report.

The changes will take effect for tax return periods beginning on or after 1 April 2009. They will be implemented by amendments to The Tax Avoidance Schemes (Information) Regulations 2004 (SI 2004/1864). Draft regulations will be issued by the end of 2008.

The changes that are proposed have been expected and are unlikely to increase the compliance burden for scheme users. It must be hoped that HMRC takes the opportunity to revisit some of the wording on form AAG4 to ensure that it is consistent with both the pre-existing requirements and these proposed changes.

# HMRC and the taxpayer

## Compliance checks – proposals for consultation

HMRC introduced a new framework for compliance checks in respect of direct and indirect taxes in Finance Act 2008 Schedule 36. However, the regime did not apply to a number of other taxes administered by HMRC including:

- petroleum revenue tax;
- stamp duty reserve tax and stamp duty land tax;
- inheritance tax;
- insurance premium tax; and
- environmental taxes (aggregates levy, climate change levy and landfill tax)

Proposals for consultation in Pre-Budget Report 2008 will extend the new regime to these taxes with some modifications. The proposals broadly mirror the FA 2008 Schedule 36 regime. The regime includes proposals to:

- require certain statutory records to be retained;
- allow HMRC access to documents and records from taxpayers and third parties for the purposes of checking a 'tax position';
- allow HMRC to inspect premises and assets for the purposes of checking a person's 'tax position'; and
- enable HMRC to access premises in order to check the valuation of assets for SDLT or IHT purposes.

'Tax position' has a broad meaning and applies to both past, present and future tax liabilities. It is intended that the new regime will enable HMRC to approach taxpayers to check compliance with a range of taxes within the same statutory framework. For example, where taxpayers have obligations to account for environmental taxes, HMRC would have the ability to check compliance with those taxes as well as with direct, indirect and employment taxes at the same time.

It is the intention of HMRC to reduce the regulatory burden on taxpayers who seek to comply with their obligations while ensuring that they can deal effectively with taxpayers who do not comply. It is anticipated that the new regime, following consultation, will enable real-time checking of tax liabilities without the need to open formal enquiries into tax returns.

In addition to introducing new inspection and document production powers, the new regime will align the assessment and claim time limits for these taxes with those to be introduced for other direct and indirect taxes. The normal time limit will be four years for claims and assessments. For direct taxes, where taxpayers have failed to take reasonable care, the time limit for assessments will be six years, and twenty years where they have deliberately failed to comply with their obligations.

As with the FA 2008 regime, a variety of Codes of Practice will be published that will address the operation of the new regime in practice.

It is anticipated that legislation will be introduced in Finance Bill 2009 with a view to its coming into effect in 2010.

## Harmonisation of penalty and interest regimes

HMRC continues to consult on proposals to bring together the penalty regimes for all taxes. FA 2007 and FA 2008 introduced new civil penalties regimes for incorrect returns and failure to notify HMRC of liability to tax. The consultation on late filing and late payment, entitled “Modernising Powers, Deterrents and Safeguards”, is intended to develop a new regime to replace the various regimes in place at present. It should be firmly based in statute, and should follow the principles enshrined in the 2007 and 2008 legislation: to influence taxpayer behaviour, to be fair and proportionate and to be effective.

Consultation will go ahead on a new penalty model for late filing and late payment across all the taxes, which would involve the following:

- An initial fixed penalty (likely to be £100) immediately after the filing date or due date.
- Daily penalties (likely to be less than the current maximum of £60 per day) three months after the filing date or due date for taxpayers making one annual return.
- A penalty based on a percentage of tax unpaid or undeclared, six months after the filing date or due date.
- A further percentage penalty 12 months after the filing date or due date.

HMRC has also indicated that it believes a more significant tax-geared penalty should be due where taxpayers have deliberately failed to comply with their obligations for longer than 12 months. The consultation document suggests that such penalties could be between 70% and 100% of the tax unpaid or not returned.

No penalties will be charged where taxpayers can demonstrate a reasonable excuse for non-payment or late filing.

The new regime is intended to be accompanied by increased support for taxpayers who fail to comply with payment or filing obligations, including reminders and offers of instalment payment. Where taxpayers engage with HMRC and take steps to make payment by instalments, it is not intended that penalties will be charged.

Consultation on the penalty models will last until 13 February 2009, with a view to legislation in Finance Bill 2009.

In a separate consultation entitled “Interest - Working Towards a Harmonised Regime”, HMRC seeks views on the harmonisation of interest charges on tax payments and refunds. There are currently a number of differences between the interest regimes for the various taxes which HMRC administers. It is proposed that interest on all taxes will be charged at a simple interest rate related to Bank of England base rate, but that there will still be a differential between interest on late paid tax and interest on tax repayments. There will be draft legislation on these changes in 2009.

## Continuing consultation on the payment and repayment of tax liabilities

HMRC is continuing to consult on new processes to harmonise the payment and repayment of tax liabilities, following changes introduced in Finance Act 2008.

The consultation, entitled "Payments, Repayments and Debt," seeks comment on payment models in order to encourage taxpayers to meet their payment obligations. The consultation suggests two new models for payment. The first is a Budget Payment Plan, under which payments are made on a regular basis up to the due date for payment. Such a scheme is already in place for individuals paying tax due under Income Tax Self Assessment, and it is proposed that this is extended to Corporation Tax Self Assessment payers.

The second proposal is for Managed Payment Plans, which would enable Corporation Tax Self Assessment payers to make payment at regular intervals both before and after the due date. It is intended that these arrangements would be voluntary and could be run along with Time to Pay arrangements, under which taxpayers with arrears of tax make arrangements under a payment plan. HMRC has indicated that its preference is to arrange for electronic payments under any of these arrangements.

In addition, HMRC proposes to consult further on -

- Proposals to recover costs in civil proceedings for recovery of debt. Currently, HMRC does not recover the costs of successful court action against debtors except in the Scottish courts.
- Proposals to obtain information from third parties to trace missing debtors.
- Increasing powers to obtain financial security from taxpayers where there is a risk of default.
- Obtaining Tax Clearance Certificates as used in some other jurisdictions

It is intended that consultation on these proposals will continue and it is possible that legislation may be introduced next year.

## Review of offshore financial centres

HMRC has indicated that it intends to review the position of offshore financial centres which are UK crown dependencies or overseas territories. Crown dependencies include the Isle of Man, the Channel Islands, Bermuda, the British Virgin Islands, etc. A complete list can be found on the FCO web site. It is intended that the review will address financial supervision and transparency, fiscal arrangements, financial crisis management and resolution arrangements and international cooperation. HMRC has taken a number of steps over recent years to increase the information available to it in respect of offshore financial centres, including obtaining information in respect of offshore bank accounts, and entering into international tax enforcement agreements with a number of jurisdictions. It seems likely that the review will result in an increased flow of information to the UK authorities in respect of taxpayers with financial links to offshore financial centres.

## **A charter for taxpayers**

The Government will consult from January 2009 on the wording of a charter for taxpayers. This follows an initial consultation during 2008 on the need for a charter. The charter will be a high-level statement of taxpayers' rights and responsibilities.

Finance Bill 2009 will include a clause to give the charter explicit legislative authority. This is particularly important as it indicates that taxpayers will have legal recourse against HMRC where it is considered that HMRC has not met its obligations under the charter.

# VAT and other indirect taxes

## VAT standard rate temporarily reduced by 2.5%

The Chancellor has confirmed widespread speculation by announcing a reduction in the standard rate of VAT from 17.5% to 15% between 1 December 2008 and 31 December 2009. This measure is described as the Government's "preferred option for a fiscal stimulus" and is intended to support families and businesses.

### *Implications for businesses*

A change in the VAT rate has a number of significant implications for many businesses. Those which are likely to feel the most immediate effects are retail businesses. High street businesses are faced with making major decisions in the next few days concerning:

- the extent to which the reduced VAT rate is to be passed on to their customers;
- changing the prices of products in their systems and on the shelves;
- amending the major software systems, on which they rely to record their sales and the VAT thereon, to cope with a new rate of VAT; and
- dealing with practicalities such as product packaging which already bears a sale price.

Other retail businesses will face other issues. For example, in the run-up to Christmas, catalogue and internet traders will have to consider how to deal with orders for goods advertised at the 17.5% rate which will not be despatched until the 15% rate has come into force.

For businesses which account for VAT on an 'invoice' basis, there will still be issues to consider. For example, VAT Act 1994 section 88 provides that, when the rate of VAT changes, the supplier has a degree of discretion to decide whether to apply the new rate to supplies of goods and services which may already have taken place and may even have been invoiced to customers. They may now face requests from their customers, particularly those which are unable to recover all of their input VAT, to cancel invoices bearing 17.5% VAT and re-invoice with VAT at the 15% rate. The Chancellor also announced that the time limit for issuing credit notes in these circumstances is to be increased from 14 days to 45 days, in order to enable more credits to be processed.

For suppliers, this may mean additional costs of not only administration, but also cash flow.

The temporary reduction will clearly be welcomed by businesses which are unable to recover input VAT in full. These include the banking and insurance sectors and also health, welfare, education and charitable organisations, for which the reduction in VAT would be even more welcome if it were permanent. For that reason, and with one eye on January 2010 when the 17.5% rate is to be restored, it was also announced that Stephen Timms, Financial Secretary to the Treasury, will announce a package of 'anti-forestalling' provisions in a Written Ministerial Statement to Parliament on 25 November 2008. These provisions will be aimed at preventing arrangements, such as prepayments for supplies to be made after the 17.5% rate comes back into force, which might be used to extend the effect of the temporary reduction in the VAT rate.

Some of the smallest businesses, i.e. those eligible to use the VAT 'flat rate' schemes, will also be affected, as the change in the standard rate of VAT will be reflected in amendments to the margin

percentages which they apply in their businesses, in preference to declaring VAT in the normal fashion.

And even those businesses for which VAT simply 'flows through', chargeable on all sales and recoverable on all VAT-bearing purchases, will still have to think carefully about the implications. Many accounting systems use 'default' settings for producing, coding and processing both sales and purchase invoices from order through to fulfilment. These automated processes will have to be upgraded to deal with not only a new rate of VAT but also invoices being received from suppliers at different standard rates, both when the 15% rate comes into force and when the 17.5% rate is restored. The cost of compliance and administration therefore needs to be considered.

## Other administrative measures

Two administrative measures have been announced.

### ***Bespoke retail schemes threshold***

The annual turnover threshold requiring retailers to agree a bespoke retail scheme with HMRC is to increase to £130 million from the current £100 million with effect from 1 April 2009. Bespoke schemes agreed by retailers between these two thresholds will continue until or unless the agreement between the retailer and HMRC ends.

### ***Simplification of eligibility for the flat rate scheme***

The VAT flat rate scheme allows small businesses to pay VAT as a flat rate percentage of turnover. The current entry tests require that taxable turnover is less than £150,000 and total income is less than £187,500. The total income test is to be removed.

If annual income exceeds £225,000 a business must leave the scheme. To simplify the scheme, this leaving test will be calculated on the same basis as the business uses in order to calculate its VAT whilst operating the scheme. Thus, if a business calculates its VAT on a cash received basis, the leaving test will be calculated in the same way.

This measure will be effective from 1 April 2009.

The flat rates applied to industry sectors are also to be revised to reflect the temporary reduction in the standard rate of VAT.

## Excise duty

A number of excise duty changes were announced.

### ***Alcohol duty***

The Chancellor announced that duties will increase by 8% in real terms for all alcoholic beverages from 1 December 2008.

The Small Brewers Relief scheme will continue to provide 50% duty relief to the smallest brewers.

### ***Tobacco products duty***

Excise duty on cigarettes and other tobacco products increased from 6pm on 24 November 2008.

Ad valorem duty on cigarettes will be increased from 22% to 24%; the specific duty will remain unchanged at £112.07 per thousand cigarettes. The rates of duty on other tobacco products will be increased by 4%.

In a separate measure, it was announced that HMRC and the UK Border Agency had formed a new partnership to take forward the existing 'Tackling Tobacco Smuggling' strategy, in order to develop the most appropriate responses to the threats from tobacco smuggling.

### ***Hydrocarbon oils duty***

The Chancellor announced the reinstatement of the fuel duty increases originally included as part of this year's Budget statement, but which were subsequently postponed due to spiralling oil prices. Further increases planned for 2009 and 2010 will be introduced via the respective Finance Bills in those years.

The reinstated increases for 2008 will have effect from 1 December 2008; the 2009 increases from 1 April 2009; and the 2010 increases from 1 April 2010.

Consequently, from 1 December 2008, the duty rates for leaded petrol, unleaded petrol and diesel, will be increased by 2 pence per litre. From 1 April 2009, the duty rates for unleaded petrol and diesel will be further increased by 1.84 pence per litre and from 1 April 2010, by 0.5 pence per litre above indexation in that year.

Also from 1 December 2008, (and subsequently, from 1 April 2009) effective rates of duty (that is, the relevant duty minus the relevant rebate) for non-road fuels will be increased by the same percentage as standard road fuels.

From 2010, the current duty differential of 20 pence per litre on biofuels for road use will cease and thereafter duty will be charged at the same rate as standard road fuels. The duty rate for natural gas will be increased to maintain the differential with standard road fuels in pence per litre equivalents up to 2010/11. In line with the alternative fuels framework, the duty rate for liquefied petroleum gas will be increased to reduce the differential with standard road fuels by the equivalent of 1 pence on a litre of petrol up to 2010/11. The duty differential applicable to biogas, equivalent to 40.88 pence on a litre of petrol, will remain at least at its current level until Budget 2012.

From 1 November 2008, a new fiscal definition for aviation gasoline (Avgas) was introduced and the rate was made freestanding.

## **Environmental taxes**

The proposal to replace air passenger duty with a new aviation duty levied on a per-plane basis from November 2009 has been abandoned. For air passenger duty purposes, destinations are to be categorised into four geographical bands, with each band having two rates (one for standard class travel and one for other classes of travel). Restrictions to the planned increases in vehicle excise duty were also announced.

### ***Air passenger duty***

The Chancellor announced that plans to introduce a new aviation duty (based on a tax per plane) have been shelved and instead, changes will be made to the existing air passenger duty, which is based on a fixed rate of duty per passenger.

From 1 November 2009, destinations will be categorised into four geographical bands, based on the distance from London. Each band will have two rates, one for standard class of travel and one for other classes of travel. The new bands for year 2009/10 range from £11 per passenger in the lowest class of travel, for distances of up to 2,000 miles, to £110 per passenger for other classes of travel for distances of over 6,000 miles.

The changes will apply to journeys beginning on or after 1 November 2009, irrespective of when the ticket for travel was booked or purchased.

Current rates of air passenger duty range from £10 in the lowest class of travel for short haul destinations, to £80 per passenger in any other class of travel for long haul destinations.

### ***Vehicle excise duty***

The Chancellor confirmed that six new vehicle excise duty bands will be introduced from 1 April 2009, taking the total number of bands to 13. However, to reduce pressure on motorists during the current downturn, duty rates will not increase by more than £5 for any car. In addition, the Chancellor also announced that there will be no significant rate changes until 2010, and no driver in any given band will pay more than £30 extra in that year.

Cars registered prior to 2001 are not subject to these reforms (because comprehensive CO2 emissions data is not available) and are taxed according to engine size.

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