

A Budget, by George!

Did the new Chancellor, George Osborne, have the right formula for economic recovery? For the latest information on what the emergency Budget contained and how it could affect your business, please visit www.pwc.co.uk/budget.

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The Chancellor's emergency Budget – 22 June 2010

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The Chancellor delivered what he described as a “tough but fair” Budget, a tag-line that we are sure to hear a lot in the coverage in the coming days. In his speech, the Chancellor set out his five-year plan to reduce the Budget deficit, rebalance the British economy, and design a new model for economic growth.

Many of the changes announced had been trailed in the weeks preceding the Budget, but the reaction of taxpayers will be undoubtedly mixed.

Businesses will broadly welcome the reductions in corporate tax rates and the proposals to consult on corporation tax reform. However, the banking sector will have to bear the cost of a new bank levy. The rise in capital gains tax to a flat rate of 28% from 23 June 2010, was less than many had feared. However, the Chancellor's desire to keep the tax simple means entrepreneurs will be disappointed he did not introduce a lower rate for business assets. The greatest revenue raiser was the increase in the standard rate of VAT to 20% from January 2011, although there will be relief that the Chancellor did not alter the scope of zero rating.

Whilst the Budget notes have confirmed a number of headline grabbing changes to be made to tax rates and allowances, there are also a number of areas to be addressed through a period of consultation. These include the taxation of foreign profits, the potential introduction of a general anti-avoidance rule and further changes to pensions tax relief to name a few.

Outlook for the economy and the public finances

The Office for Budget Responsibility (OBR) central forecasts for economic growth were revised down slightly to 1.2% in 2010 and 2.3% in 2011 as compared to those published last week, which were 1.3% and 2.6% respectively. These differences reflect the impact of the tax rises and spending cuts announced in the emergency Budget. However, the Budget forecasts are slightly more bullish than before from 2013 onwards, which reflects the benefits from faster fiscal consolidation in terms of lower long-term interest rates.

Overall, the forecast for a gradual recovery that picks up speed to around 2.8% growth from 2012 seems reasonable and is broadly in line with PwC's own main scenario.

Public sector net borrowing (PSNB) forecasts were revised downwards relative to the pre-Budget figures, reflecting the effect of tax rises and spending cuts. The latest projections are for the budget deficit to decline from £149bn (10.1% of GDP) in 2010/11 to £37bn (2.7% of GDP) by 2014/15. By that year, the deficit is projected to be around 2% of GDP lower as a result of the measures contained in the emergency Budget.

The Chancellor introduced a new forward-looking fiscal mandate in the emergency Budget. The Government must achieve cyclically-adjusted current budget balance by the end of the five year forecast period (2015/16 in this case). As a temporary measure this is supplemented by a target that net debt as a share of GDP should be declining by 2015/16. OBR forecasts suggest that both of these targets should be met one year earlier by 2014/15, giving an extra margin of prudence to the Budget plans.

The emergency Budget projections are for net debt to peak at around 70% of GDP by 2013/14 and then decline gradually. This compares to the peak debt ratio of 75% of GDP in 2014/15 projected under the plans in the March 2010 Budget.

The 2010 emergency Budget contained a large number of tax and spending initiatives, which are projected to deliver an additional fiscal consolidation of around £40 billion by 2014/15, over and above the measures included in the March Budget. The consolidation is heavily weighted towards spending cuts rather than tax rises – with a ratio close to the 4:1 promised by the Conservatives prior to the election.

The most significant tax measures (with their impact on Treasury revenues in 2013/14 shown in brackets) were a VAT increase to 20% (+£13.5bn); a phased increase in income tax personal allowances (-£3.9bn); and a new Bank Levy (+£2.4bn). The net tax rise will be around £8bn by 2014/15. Reductions of £32bn in public expenditure by 2014/15 were also announced. These savings will come through cuts in welfare spending (£11bn) and departmental spending (£17bn), as well as lower debt interest (£3bn).

Overall, the emergency Budget puts in place a credible plan to eliminate the UK's structural current budget deficit over the lifetime of this Parliament. The medicine is tough and may dampen growth in the short term, but it should help to support a more sustainable economic recovery in the longer term.

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Personal taxes

Income tax allowance and basic rate limit

With effect from 6 April 2011, the personal allowance for individuals aged under 65 years of age will increase to £7,475 but the basic rate limit will be reduced so that higher rate taxpayers will not benefit. It is unclear at this stage whether this represents a real tax increase for individuals over £100,000 who will have had their personal allowances withdrawn.

National insurance thresholds (NI)

Also from 6 April 2011, the upper earnings/profit limit for employee's NI will be reduced so as to align with the higher rate threshold. The secondary threshold will be increased by an extra £21 per week above indexation. This is in addition to the previously announced increase in the primary (employee) threshold already planned for 2011-12 and the 1% rise in rates.

Capital gains tax (CGT)

From 23 June 2010, the rate of CGT will increase from 18% to 28% for higher rate tax payers. The rate of CGT will remain at 18% where a taxpayer's total income (including gains) does not exceed the upper limit of the income tax basic rate band. For trustees and personal representatives of deceased persons, the normal rate will be 28%. However, annual exemption limits will not be reduced (currently £10,100).

To support investment in enterprise, the Government announced it will extend the lifetime-gains limit for entrepreneurs' relief from £2m to £5m. This relief provides for certain qualifying gains to be taxed at 10%. This increase is effective from 23 June 2010.

Tax credits and welfare reform

In accordance with the Government's stated focus on spending reductions outweighing tax increases, the Chancellor announced a number of reductions to tax credits and welfare benefits.

From April 2011, tax credit eligibility will be reduced for families with household income above £40,000. The Government will make further changes in 2012-2013 with the aim of focusing tax credits on lower income families. In addition, child benefit will be frozen for three years from April 2011.

Pensions

Following much pressure from pension professionals, the Chancellor is going to work with the pensions industry to review the higher earners pension tax regime due to come into effect in April 2011 and look to replace it with a reduced annual allowance limit.

In consequence, we should see a somewhat simplified system, and one that keeps higher-earners in the workplace pension system, at least for some of their savings. With a lower annual allowance, employers will still need to review pension provision for higher-earners, including seeking different ways for long-term saving, but administration and compliance will be much simplified.

Enterprise Management Incentive (EMI) and Venture Capital Trusts (VCT)

The previously announced changes to amend the EMI rules and VCT schemes will be introduced later this year. The changes are to make the rules more compliant with EU State aid guidelines

Corporate and business taxes

Corporation tax rates

Finance Bill 2010 will include legislation to reduce the main rate of corporation tax from 28% to 27% from 1 April 2011. Further reductions to the main rate are proposed to reduce the rate by 1% per year to 24% by 1 April 2014. Corporation tax on 'ring-fenced' profits from UK oil extraction and oil rights will remain at 30%.

In addition, Finance Bill 2011 will introduce legislation to reduce the small profits rate from 21% to 20% from 1 April 2011.

Capital allowances

To balance the proposed reduction in corporation tax rates, the Government has announced a reduction in the rate of relief for capital expenditure. Although companies will continue to receive full relief for their capital expenditure, the relief will be spread over a longer period as follows:

- The main plant and machinery writing down rates will reduce from 20% to 18% per annum.
- Longer life/special rate plant and machinery writing down rates will reduce from 10% to 8% per annum.

To help allow businesses to plan for the changes, these changes will apply to chargeable periods ending on or after 1 April 2012 for businesses subject to corporation tax and on or after 6 April 2012 for businesses subject to income tax. Transitional rates will apply for periods which span the above dates.

In addition, from April 2012 the Annual Investment Allowance will reduce from £100,000 to £25,000 to ensure the relief is focused on small and medium-sized businesses.

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Bank levy

This will be introduced from 1 January 2011 based on the banks' balance sheets. Details of the levy will be published following consultation. It is proposed that this will be set at a rate of 0.07%, with a lower initial rate of 0.04% in 2011.

Research and development tax relief (R&D)

As previously announced in the 2009 Pre-Budget Report, the Government will abolish the rule which requires small and medium companies who claim R&D tax relief to own the intellectual property deriving from those R&D activities. This change is effective for accounting periods ending on or after 9 December 2009.

Worldwide debt cap legislation

Following consultation with UK businesses, a number of changes will be made to the debt cap legislation originally proposed in the previous Budget. This will clarify areas of uncertainty in order for the rules to work as originally intended.

Capital distributions

As anticipated, the rules in relation to the corporation tax treatment of certain capital distributions received by UK companies have been confirmed today. This ensures that certain distributions will not be prevented from falling within the distribution exemption rules introduced in 2009. This addresses some specific concerns in relation to distributions from reserves following a capital reduction. The legislation will be introduced retrospectively to 1 July 2009; however, there will also be an 'opt out' by election from the retrospective impact of the change.

Consortium relief

Legislation to be introduced later this year will include two changes to the consortium relief rules for claimant companies. From the date of legislation later this year, companies in the European Economic Area will be able to act as link companies for consortium relief claims.

In addition, further rules for consortium members will be included to limit the amount of losses that can be claimed by additional tests based on voting rights and the extent of control the member holds in the consortium.

Indirect taxes

VAT

The standard rate of VAT will be increased from 17.5% to 20% from 4 January 2011. Anti-forestalling legislation will have effect from 22 June 2010 to counter arrangements that seek to apply the 17.5% rate to goods and services to be delivered or performed after 4 January 2011. There is no change in the scope of the rules for zero-rating, VAT exemption and the 5% reduced rate.

Other measures

The following measures announced in the previous Budget were also included in this emergency Budget:

- The higher rate of insurance premium tax will also rise from 17.5% to 20%. The standard rate will increase from 5% to 6%, coming into effect from 4 January 2010.

- Supplies of postal services by the Royal Mail which are not made under a licence duty (such as those made by Parcelforce) and services provided on terms and conditions that have been freely negotiated will, from 31 January 2011, be subject to VAT at 20% rather than being VAT exempt.
- The definition of aircraft for zero-rating purposes will change from 1 January 2011. Supplies of aircraft will be zero-rated only where used by "airlines operating for reward chiefly on international routes". The previous Budget expected the changes to be introduced from 1 September 2010.
- The 'place of supply' rules on the supply of gas, heating and cooling, will be amended from 1 January 2011, as will the changes to the 'Lennartz' principle announced in the previous Budget.

Aggregates levy

The Chancellor's Budget also included an announcement to extend the 80% aggregates levy tax credit for aggregates producers in Northern Ireland for a further 10 years.

Anti-avoidance and tax administration

Anti-avoidance

Some specific measures have been introduced by the Budget to prevent corporate tax avoidance using accounting 'derecognition' rules in relation to loans and derivatives, and specific schemes involving Alternative Investment Funds relating to UK tax credits for corporate investors where no UK tax has been paid.

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The Government has also stated their intention to take a more strategic approach to dealing with the risk of tax avoidance in order to prevent increasing complexity and frequent legislative change. Part of one possible element of such an approach includes further consideration and consultation in relation to a general anti-avoidance rule (GAAR).

HMRC powers, deterrents and safeguards

The Budget introduces a number of very specific measures to continue to bring harmonisation in the way interest is charged on late paid tax and reclaiming overpaid tax. In addition, some specific measures have been introduced to work towards a common regime on penalties for late filing and late payment of tax, a process which began in 2008.

Proposed consultations

As part of the material produced on Budget Day, the Government released a document titled 'Tax policy making: a new approach'. This discussion document set out a number of proposals for improving the framework for developing, legislating and implementing tax policy. The Government is planning to meet interested parties to discuss its overall approach over the summer.

It was also confirmed that the Government proposes to consult on reforms in a number of areas, including:

- Corporation tax reform – a business forum will be established, chaired by the Exchequer Secretary to the Treasury, to look into corporation tax reform and tax competitiveness in the UK.
- Controlled foreign companies (summer 2010) – on interim improvements to the rules to be legislated in spring 2011. New rules are to be introduced in spring 2012.
- Taxation of foreign branches (summer 2010) – looking at a move to a more territorial approach.
- Taxation of intellectual property – research and development tax credits and the proposals from the Dyson Review.
- Taxation of non-domiciled individuals – to consider whether changes can be made to ensure a fair contribution is made to reducing the deficit.
- PAYE – to consider how the system could be made easier to operate for employers.

- Pensions – to consider the requirement to purchase an annuity at the age of 75 and to reform the existing tax allowances.
- Climate change levy.
- General anti-avoidance rule – an examination as to the need, long-debated, for an overarching rule to prevent avoidance of tax.
- IHT on trusts – should this area be brought within the 'disclosure of tax avoidance schemes' regime.
- Banking remuneration disclosure scheme.
- EU cost-sharing exemption – whether it should be implemented in the UK.

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