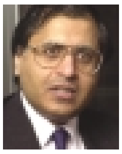
BROWN'S WARTIME BUDGET



AGAINST A BACKDROP OF A WAR WITH IRAQ, THIS YEAR'S BUDGET APPEARED LOW KEY. BUT **MOHAMMED AMIN** OF PRICEWATERHOUSECOOPERS DISCOVERS MUCH CHANGE FOR TREASURY.

The Budget on 9 April was widely reported as the first British budget delivered in wartime since 1945. Presumably the 'teenage scribblers' writing this never covered the Korean war at school. While the Budget sounded relatively quiet, there is still much change for treasurers.

TREASURY SHARES. UK companies have long envied the freedom of their US counterparts to purchase shares in the market, hold them as 'treasury shares', and resell them in the market when appropriate. This allows the equity component of the balance sheet to be managed as flexibly as the liability components of bonds or commercial paper (CP) (see Treasury Essentials, March 2003, p27).

Company law is being revised to allow public companies listed on the London Stock Exchange or AIM (or their equivalent in the European Economic Area) to purchase shares into treasury, up to a limit of 10% of the nominal value of that class of share. If the 10% is exceeded, any excess shares must be cancelled and cannot be resold.

The Budget announced the tax treatment of treasury share transactions. The initial purchase of the shares will be treated as if the shares had been cancelled. Shares held in treasury will be treated as though they did not exist and those sold out of treasury will be treated as if they are newly issued. While the tax treatment announced looks straightforward, without certainty regarding the tax treatment, companies could not have taken advantage of the company law change, which will take effect from an appointed day not yet designated.

REPO AGREEMENTS. There have been a number of widely marketed structured products involving the sale and repurchase (repo) of securities. The details varied. For example, one structure allowed the income earned by the security on a reverse repo (that is, purchase of securities and sell back at a higher price) to be tax free. Another structure gave rise to a deduction for a deemed manufactured interest payment, without any equivalent economic cost. The possibilities arose from flaws in the tax legislation governing repos. In particular, the rules did not cater well for situations when the second part of the transaction, the repurchase, took place at market value, rather than at a predetermined price as one would normally expect in a repo. That led to some of the repo tax rules applying but not others.

'THE ENTIRE TAX LAW REGARDING DERIVATIVES WAS REWRITTEN LAST YEAR AND SIGNIFICANT CHANGES WERE MADE TO THE LOAN RELATIONSHIPS REGIME'

These schemes will be blocked from Budget day. In future, a sale and repurchase will only be treated as a repo for tax purposes if all of the tax provisions regarding repo apply. It will not be possible to structure a transaction under which only some of the tax consequences of a repo rise. The changes will also counter schemes where the purchaser keeps the dividend paid on shares sold in a repo, with the dividend being tax free franked investment income, while the seller gets an income deduction. The foreign exchange treatment of repo transactions will also be clarified.

DERIVATIVES AND LOAN RELATIONSHIPS. The entire tax law regarding derivatives was rewritten last year and significant changes were made to the loan relationships regime. Accordingly, it is no surprise that the government is back to tidy up anomalies.

Ever since 1996, the loan relationship rules have contained special provisions giving 'continuity of treatment' where loan assets or liabilities are transferred between UK group members. Following the Finance Act (FA) 2002, similar provisions apply to derivatives. Some lawyers have argued that the continuity rules do not apply where a liability is transferred between group members by novation, which is the most common way to transfer a liability. The Inland Revenue has been adamant that the continuity legislation does cover novation, but just to be safe it is amending the law to put the matter beyond doubt.

During the consultation process last year, the profession pointed out to the Inland Revenue that the group continuity provisions could lead to profits or losses falling out of charge where the transferee was a company using mark-to-market accounting. The problem was that the rules did not cater properly for such transfers taking place part way through an accounting period. The legislation is to be tidied up. Despite the way the flaw was pointed out, this is billed as anti-avoidance legislation.

The changes will also clarify how foreign exchange differences are treated if a loan or derivative is transferred between UK group companies part way through an accounting period. There was some concern that the foreign exchange differences could fall out of charge to tax, if the transferee prepared its account in the currency of the loan or derivative. Instead, any foreign exchange gain or loss shown in the accounts of the transferor and transferee will be taxed/deducted.

The FA 2002 changes appear to have allowed tax avoidance by accruing (but not paying) interest expense owed to another company that was not taxed on it and which was economically part of the group without being connected for tax purposes. Legislation is promised to change the connected party rules to block this loophole from Budget day.

STAMP DUTY. From 1 December 2003, stamp duty will only apply to transactions in land, shares and interests in partnerships. This should be welcomed by treasurers undertaking securitisations where a common issue is whether the transfer of debts or other rights to the special purpose vehicle (SPV) will give rise to stamp duty. It should also facilitate purchases of businesses (as opposed to companies) which are more attractive following the extra relief for intellectual property introduced in 2002.

The stamp duty charge on leases will be completely rewritten from 1 December. At present, leases attract stamp duty based upon the average rent and the life of the lease. For example, a lease with a life of more than seven but not more than 35 years attracts duty at 2%, so if the rent on a 25-year lease is a flat £100,000 per year, the stamp duty is £2,000. Under the new rules, the stamp duty will be 1% of the net present value (NPV) of the total rent payable under the lease. The discount rate used will be 3.5%, which looks unreasonably low. (Not even the government can borrow for 25 years at that interest rate). The NPV of £100,000 per year for 25 years discounted at 3.5% is £1,648,000, with stamp duty at 1% of £16,480. This represents an eightfold increase in stamp duty, despite cutting the headline rate from 2% to 1%.

For some time, the Inland Revenue has been concerned that many large property groups own each property through a separate subsidiary. When a sale comes along, the subsidiary is sold with stamp duty at 0.5%, rather than selling the property with stamp duty at 4%. Consultations will continue regarding reforms which would charge higher rates of duty than 0.5% if the company sold was a property owning SPV. Meanwhile, for those groups that don't already have them, setting up such SPVs has been made more difficult. At present, if property is transferred by a group into a subsidiary company, the stamp duty group transfer exemption is disqualified if the subsidiary is sold within two years. That is being extended to three years.

SHARE SCHEMES. Treasurers will be gearing themselves up to calculate the value of employee options when granted using models such as Black & Scholes, in order to comply with proposed accounting standards on share-based remuneration. Perhaps as compensation, late last year the Inland Revenue published new legislation giving companies a statutory tax deduction for the profit employees make from share schemes.

As the profit and loss account will only suffer the initial value of options, while tax relief will be given on the entire employee profit, there should be a small benefit to the effective tax charge. For instance, if the employee is granted an option for ten years to acquire shares at £1, the initial value of the option may be, say, 40p. That will be the profit and loss account expense. If the option is exercised when the share price is £4, the employee's profit will be £3, and the company will get tax relief for that, saving 90p tax at 30%.

The Budget announced further anti-avoidance measures to prevent share option gains avoiding income tax or national insurance contributions. The changes are long and detailed but relatively unimportant compared with the implementation of the previously announced changes mentioned above.

'ANY TREASURER WHO MANAGES TO STAY 20 YEARS WITH THE SAME EMPLOYER CAN NOW RECEIVE A MUCH LARGER TAX-FREE LONG SERVICE AWARD. THE LIMIT OF £20 FOR EACH YEAR OF SERVICE IS INCREASED TO £50'

RESEARCH AND DEVELOPMENT. The research and development (R&D) tax credit is only a year old, but the government is already modifying it. The basic principle, that a large company spending £100 on R&D gets a tax deduction of £125 remains unchanged. (For small to medium enterprises (SMEs) the deduction is £150, or they can waive the tax deduction for a government cash refund of £24). However, several key details are changing.

At present, if an employee spends less than 20% of his time on R&D, the company cannot claim his costs for this scheme. Conversely, if the employee spends more than 80% of his time on R&D, all of his costs are eligible. In between, the costs are apportioned. In future, apportionment will apply to all staff costs. This may significantly increase the scope for claims, as many employees in the company may be involved in R&D for a small part of their time. In the US, where the R&D tax credit has been around for many years, companies frequently engage special studies to help them maximise their R&D claims.

The boundaries of what qualifies as R&D for tax purposes are presently very narrow. Consultation will take place regarding extensions to the definition covering areas such as development, design innovation and software development. However, it seems that to minimise Exchequer costs the government may limit most of any extensions to SMEs.

Finally, any treasurer who manages to stay 20 years with the same employer can now receive a much larger tax-free long service award. The limit of £20 for each year of service is increased to £50.

The big issue for the next year will be the reform of corporation tax. The government is looking at replacing capital allowances with relief for accounts depreciation, eliminating the differences between trading and investment companies, and abolishing the system of dividing income into specific schedules for tax purposes. These changes could create big winners and losers. At the same time, 'the government is determined to protect the corporation tax system against legal challenges under European law', since these risk decimating its corporation tax take. Watch this space.

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