The fiscal emergency

NEIL EDWARDS AND **GRAHAM ROBINSON** EXAMINE GEORGE OSBORNE'S FIRST BUDGET, AND ASSESS WHAT IT MEANS FOR TREASURERS.

If you type "emergency" into Google, the first thing it comes up with is suggested phrases you may be trying to search for. The most popular of these – before "doctor", "dentist" or any of the other usual suspects – is "Budget 2010". This fact in itself gives some indication of the size and importance of the changes which are taking place in the UK tax system.

So what does the Budget mean for the world of corporate treasury and taxation? There are various changes ahead, many of which will impact on a corporate treasury. In the short term, there are detailed changes to rates, allowances, calculations and specific anti-avoidance rules. In the medium term it appears that many aspects of the UK tax system are to be the subject of radical reform. Anyone looking at medium and long-term projections for their business should take note.

THE SHORT-TERM PICTURE

■ **Corporation tax and capital allowances** Looking specifically at corporation tax, the chancellor's first headline is something of an apparent gift to the corporate sector as a whole: a reduction in the headline rate from 28% to 24%. To mitigate the impact on the Exchequer's tax receipts, the fall is staggered at the rate of 1% per year over the next four years, commencing on 1 April 2011, so that the rate of 24% is reached in the year beginning on 1 April 2014. Clearly this is good news for companies generally, although the added complexity of rate calculations is a slight fly in the ointment.

A larger concern is the proposal to pay for this reduction in the rate of corporation tax by lower capital allowances for all but the smallest businesses. The main rate for plant and machinery falls from 20% to 18%; and the "special rate" for long-life plant, and fittings in buildings, falls from 10% to 8%. These rates drive the timeframe over which the cost is written off for tax purposes, so decreasing the allowance increases the payback time for investment in plant, equipment and similar infrastructure. The impact of a falling capital allowance rate is that the cost of financing such investments is increased.

While the impact of the reduction in corporation tax rate is welcome across the business community, the impact of the change to capital allowances is not evenly spread. It will be felt most severely in plant-intensive sectors such as heavy industry and manufacturing, and have a correspondingly lighter impact in the service sector.

■ **VAT** Perhaps the most widely trailed and noted change in the Budget was the increase in the VAT rate from 17.5% to 20%, to take effect from January 2011. The impact on businesses, of course, depends on their position. For a business making fully taxable supplies, and which is therefore able to recover all input VAT, there may be a small transitional change to cashflows. For a business making exempt supplies, where VAT is a real cost, there will be a correspondingly bigger effect. One way or another, most businesses will have to decide whether to pass on or absorb the increased cost.

If the VAT rate falls again in future, the effect would, of course, be reversed; although this may be of little comfort to businesses affected now.

■ **Anti-avoidance** The Budget made only one specific change to the taxation of financial instruments, and this was to block a tax planning arrangement involving derecognition.

Since the taxation of loans and derivatives is largely driven by the amounts recognised in a company's accounts, some companies have sought to arrange transactions so that financial assets fail the tests for accounting recognition. This used to be achieved by transactions where a company with a receivable, or a valuable derivative, undertook to remit all cash received to another group company, under the terms of a note or preference share issued.

A number of changes were made in the law over the past few years to prevent this. However, these changes did not affect companies that achieved the same effect (i.e. non-recognition of a financial asset) by contracting to subscribe amounts received to a subsidiary company or partnership. The latest change prevents these transactions from being effective after Budget day.

At the same time, the government announced that derecognition transactions would be blocked generically by a targeted anti-avoidance rule. This rule is to be structured to ensure that no future variants of the technique can be developed that side-step the specific anti-avoidance rules.

Treasurers may wish to keep an eye on developments in this area, as it will be important that the new targeted anti-avoidance rule does not apply in situations where financial instruments are derecognised, or held off balance-sheet for ordinary commercial reasons (for example, where an interest rate swap is treated as part of the debt it hedges, under old UK GAAP).

■ **Debt cap** Many people will be aware of the various issues and glitches that have arisen as the previous government tried to cap the level of borrowing for which a UK group could obtain tax relief on interest payments. The rules aim to limit interest relief available in the UK to the total interest charge suffered by the consolidated group on a worldwide basis.

The Budget announcement focused on consolidating into legislation various repairs to problems which had already been trailed.

IN THE MEDIUM TERM IT APPEARS THAT MANY ASPECTS OF THE UK TAX SYSTEM ARE TO BE THE SUBJECT OF RADICAL REFORM.

Unfortunately, many issues remain, and these will doubtless be debated with HMRC over the coming months. Many groups are now more than halfway through the first year to which debt cap applies, and the fact that a number of material issues remain unresolved by HMRC is likely to cause anomalies for a number of taxpayers.

A particular issue remains for companies that have raised fixed rate debt in the UK and swapped it to floating rate. The fair value movements recorded against the debt give rise to anomalous results in applying the debt cap rules. HMRC has been granted powers to deal with these matters by statutory instrument, but no such instrument has yet been published.

■ **Capital reductions and distributions** Treasurers may have encountered an anomaly which arose following the changes to the taxation of dividends effective from 1 July 2009. Prior to that date, UK dividends were always tax-exempt in the hands of a corporate shareholder, while dividends from overseas were taxable unless double-tax relief was available. However, since 1 July 2009, all dividends have been potentially taxable, although there is a series of wide-ranging exemptions to cover most types of dividends.

The rewrite of the rules gave rise to a significant headache for many taxpayers. It was argued by HMRC that a dividend paid out of reserves created by capital reduction could not qualify for the dividend exemption. Moreover, it was argued by some that this tax treatment should properly have been applied before July 2009, so that such dividends would be taxable as capital gains disposals in the hands of a shareholder.

The recent Budget and Finance Bill contained a very welcome clause to rectify this. The legislation ensures that a dividend paid out of reserves created by capital reduction is eligible for the dividend exemption, and is not a capital gains disposal. However, the clarification applies only to companies which use the UK company law procedure, or an analogous overseas procedure, to reduce capital. Where a dividend is received from a company which does not reduce capital in the same way (e.g. a UK unlimited company), or from a company resident in a territory which does not have a similar procedure (the Netherlands is one obvious example), a taxpayer will have to fall back on general principles and case law for determining whether the receipt is capital or revenue in nature.

THE LONG-TERM PICTURE

Excepting the various detailed matters set out above, the most striking feature of the Budget was the chancellor's commitment to wholesale reform of the corporation tax system. Given the overall level of complexity which has accumulated in the system, this stance is to be welcomed.

It has been announced that the process of reforming the UK's controlled foreign company (CFC) rules will continue, and is likely to include some re-examination of the rules governing interest deductibility. While simplification and modernisation of the CFC rules will be welcomed by many, companies will need to keep a close eye on changes to interest deductibility rules, and be prepared to adapt their capital structures to any new environment.

It should also be assumed that where specific rules are simplified, some wider scope for anti-avoidance law might be expected. The chancellor undertook to consider a general anti-avoidance rule, though experience in other countries and a similar debate in 1998 suggest that such rules are complex to operate in practice.

Whatever the outcome of the reforms, it is likely to be a number of years before they take effect, as the chancellor also committed to full consultation to changes in tax law. Treasurers can hope therefore that they have time to prepare for whatever lies ahead.

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