

Business Predictions

Chancellor's Pre-Budget Report 2009 Predictions

What might feature in the Pre-Budget Report 2009 - Business

We know that when Mr Darling, rises to deliver the final Pre-Budget Report (PBR) of this parliament, many businesses will be looking closely for any measures that could help them through these turbulent times, and for any changes that will mean higher tax bills. So what should directors, employers and shareholders expect to see? KPMG in the UK considers some possibilities below.

Taxation of Intellectual Property (IP)

The Government announced at Budget 2009 that it would consider evidence for changes to the way the tax system encourages innovative activity and the relative attractiveness of the UK to global firms as they make decisions on where to locate their R&D and other innovation activities. Since then officials from HM Treasury have met with many interested parties including advisers and companies in various industry sectors.

The HM Treasury website states that "*The Government will set out its assessment and proposed approach before the Pre-Budget Report 2009*" so we may well see an announcement of some sort in the next few weeks. If this does not materialise then it is highly likely there will be some detail in the PBR itself.

There are many different options for a change in the UK corporation tax rules around IP but perhaps the most likely is the introduction of a so called "patent box", modelled on an overseas regime, for example the Dutch scheme which has been in place since 2007. A patent box works by separating out all income and expenditure related to IP owned by a company that is legally protected by a patent. The net income or expense is then subject to a lower tax rate, for example 10 percent in the Netherlands. Such a regime can prove attractive to multi-national groups considering where to locate IP but it is interesting to note that the Dutch government has recently announced significant enhancements (effective from 1 January 2010) to their regime to deal with perceived shortcomings. For example the effective tax rate will reduce to 5 percent, it will apply to profits from many more types of intangible assets for which no patent has been granted and any losses incurred within what is now being referred to as the "innovation box" will be deductible against other profits at the

normal rate.

Hopefully the HM Treasury team performing the UK review will be looking closely at these Dutch proposals; something similar here would give a great boost to the competitiveness of the UK tax system.

Restriction on losses carried forward

At the moment UK tax legislation does not impose time limits on the use by companies of trading losses carried forward against future profits of the same trade. Given the potential value of trading losses incurred during the recession, especially in the financial sector, it is possible that the government may seek to change that in order to raise tax revenues in future years. A time limit, of say five years, within which losses must be used before they expire would be relatively easy to introduce, features in many overseas regimes and is not an immediate cash cost to companies still struggling to return to profits so it could prove very attractive to a government looking to replenish depleted coffers. However the absolute cost to British businesses could be extremely high and its application would be very indiscriminate as it would hit hardest those that have suffered the most and taken the longest to recover.

Alternatively a restriction could be introduced to the amount of losses brought forward that can be used each year so that, for example, only 50 percent of taxable profits in any year can be sheltered by losses brought forward. This would not be as penal as an outright time limit but for some taxpayers the cost in cash flow terms could be much greater. It should also be noted that a number of countries, including the US and Germany, have recently announced changes to ease restrictions on the use of tax losses so any announcement in the PBR that has the opposite effect in the UK is likely to prove very unpopular with British taxpayers.

A fairer approach, that would also have the benefit of helping struggling businesses now, would be a “sale of tax losses” for value to HM Revenue & Customs (HMRC). Companies in desperate need of cash may be happy to give up tax losses that currently have little value to them even for a heavily discounted price. Getting that price right would be key to ensuring it is worthwhile for both the Exchequer and British business, and European Union (EU) State Aid rules would need consideration.

Taxation of foreign profits

It is looking unlikely that there will be any major announcement in the PBR on progress on the ongoing review of the UK Controlled Foreign Company (CFC) regime. At a recent stakeholder event HM Treasury announced that the next steps will involve publication, around the end of 2009, of a discussion document on the shape of the new CFC regime. There may be an update on progress published at the PBR but this is unlikely to contain anything new of significance as that will be appearing at the end of the year.

We do know, however, that draft legislation amending certain aspects of the Worldwide Debt Cap rules in the light of representations from business and advisors will be published at the PBR. HMRC have recently published a technical note explaining what will be included in this amending legislation. The changes will be included in Finance Bill 2010 and will have

effect for periods of account of the worldwide group beginning on or after 1 January 2010, when the debt cap rules come into force. Many groups are currently preparing themselves for the introduction of these rules in the new year and will be looking at this draft legislation with interest. Based upon the technical note already published these changes are generally very positive as they remove some of the uncertainties and potential mismatches that are possible under the current legislation. However, the proposed changes will, in some cases, result in additional complexity in calculating whether groups meet the gateway test and in doing the detailed calculations.

Taxation of financial services

There has been significant media interest and speculation on the possibility of some form of “windfall tax” being imposed on banks and other financial institutions. We know from the announcements made in the Queen’s Speech that the PBR will include new legislation on financial services businesses, including on remuneration, but it is unclear whether such a tax will be introduced.

Anti-avoidance measures

HMRC have announced a number of anti-avoidance measures that will be confirmed in the PBR. It is always possible that further anti-avoidance rules will be introduced to deal with perceived abuses; there continues to be a steady flow of disclosures to HMRC of tax avoidance arrangements under the Disclosure of Tax Avoidance Schemes rules introduced in 2004.

VAT and Duty Rates

Following last years PBR announcement of the temporary VAT rate decrease, this PBR is expected to be a much quieter affair. Despite calls for a delay to the reversion to 17.5 percent beyond 1 January, all legislation, anti-forestalling measures and HMRC documentation point to the 1 January. Whilst a further future increase is likely, this would not be until after the next election. Given Labour’s purpose of the decrease was to boost the economy, an increase over and above the previous rate would, by the same logic, put the brakes on an economy still struggling to come out of recession.

Elsewhere European moves to allow Member States the option to reverse charge certain goods and services liable to fraud have begun. The UK has already implemented measures for mobile phones and emissions allowances. Therefore the UK’s reaction is not certain and as European legislation is still at the proposal stage any imminent announcements are unlikely. Less controversial is the UK’s request to Europe to extend the threshold for the cash accounting scheme from £1.35 million to £1.5 million. This scheme allows businesses to account for VAT when payment for sales is received and purchases paid. This is beneficial as it protects businesses from having to account for VAT on bad debts.

Whilst the much publicised widening of optional reduced rates for labour intensive services has actually been agreed in Europe, these are still optional and there has been no evidence that the UK is keen to extend our reduced rates. The latest lobbying for reduced rates has been for the tourism and catering sector with a recent Early Day Motion calling for a

discussion on the matter. Perhaps more likely is the potential introduction of exempt cost sharing groups for charities. Such cost sharing groups have always been permitted in EU law but the UK has not yet taken the option to introduce the concept. Subject to certain conditions this would allow supplies to members of the cost sharing group to be exempted from VAT and therefore reducing VAT costs of (e.g.) shared service centres.

Finally, if this to be a green budget there may be some minor rate changes to encourage green behaviour or punish wasteful profligacy, however the Chancellors options are limited with any EU agreement on reduced rates for most green products still years away. We may also see some amendments about the next stage of the campaign to simplify partial exemption.

As well as avoiding any major tinkering with VAT the Chancellor is unlikely to announce any new increases in Excise Duty. Unusually the PBR last year announced increases in excise duties on cigarettes and alcohol to offset the VAT rate decrease. With those excise rates not going back down as the VAT rate goes back up, businesses in the sector will effectively see a tax increase come 1 January. This is on top of already announced 'duty accelerator' increases of 2 percent above inflation on alcohol duty in future years and a 0.5 pence per litre above inflation increase in April 2010 on fuel duty.

Employers

An unexpected development in the employee benefits arena was announced at the recent Labour Party conference. At the moment KPMG do not see any need for undue concern, but it is certainly an issue that employers and employees alike need to be aware of.

In essence it has been proposed that the exemptions from income tax and national insurance contributions (NIC) in respect of employer-provided childcare vouchers are to be phased out (however, an announcement from No.10 on 15 November 2009 now suggests the relief will only be withdrawn in respect of higher rate tax payers – those earning more than £43,875 a year). The exact details are yet to be confirmed but it is expected that they will be announced in the forthcoming PBR.

Following the announcement, the Department for Children, Schools and Families have indicated that:

- No income tax or NIC relief will be available to employees who take up childcare vouchers for the first time from April 2011;
- For employees who have been in receipt of childcare vouchers prior to April 2011, tax and NIC relief will continue to be available until April 2015;
- After April 2015, childcare vouchers will continue to be available but will no longer benefit from tax or NIC relief; and
- The long-standing exemption from income tax and NIC in respect of the provision of workplace nurseries will not be affected by this announcement.

Where employers have historically provided childcare vouchers to employees in conjunction with a salary sacrifice arrangement this is likely to create an increase in costs as there is unlikely to be widespread interest from employees in continuing to sacrifice salary in respect of a benefit which attracts both tax and NIC (the additional costs arising from the Employer's Class I NIC liable on the salary no longer being sacrificed). It is unlikely these costs will be material but, at a time when employers are reviewing all areas of expenditure, this is a further economic burden to bear.

For employees, this will also mean an increase in costs as they will either be subject to tax and NIC on vouchers where they continue to be provided by their employer, or they will need to meet the costs associated with childcare from net salary.

It should be noted that this development comes at a time when HMRC are considering a number of employee benefits and remuneration strategies that utilise salary sacrifice arrangements to create reductions in tax/NIC liabilities for employees and employers. Whether there is any connection between the two initiatives is not clear at present but hopefully the PBR will shed some more light on the matter.

Share schemes

There has been some press speculation that tax planning designed to circumvent the 50 percent tax rate will be scrutinised. We may see legislation aimed at some of the more aggressive or artificial schemes, such as plans that purport to deliver cash taxed at capital gains tax (CGT) rates on the basis that this is derived from contracts for differences. However, we expect the more mainstream tax efficient employee share plans to survive (not least because, although these plans can allow the growth in value of shares to be taxed at CGT rates, there is a 'quid pro quo' for the tax man as there is usually a lower corporation tax deduction and some income tax and NIC may be paid at an earlier date). Common tax efficient plans are the joint share plan (where an employee and the trustee of an employee benefit trust co-own shares with the employee having an 'upside only' interest), deferred share plans (where shares are sold for market value but the obligation to pay the purchase price is deferred) and growth share plans (which use a special class of share with upside only rights).

Business rates

The Government could announce measures to help small and medium sized businesses via business rates reliefs or exemptions.

The Pre Budget Report proposals and other tax changes are summarised on these pages. The Pre-Budget Report proposals may, however, be amended significantly before enactment. The content of this communication is intended to provide a general guide to the subject matter and should not be regarded as a basis for ascertaining liability to tax or determining investment strategy in specific circumstances. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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