DORSEY

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UPDATE

BUDGET 2004

EDITORIAL

Welcome to our summary which is intended to focus on the issues we know are front and central to Dorsey clients and is intended to get us all thinking on the way home and during the evening. We have supplemented this with Budget Alerts throughout the afternoon on reliefs for filmmakers, consultation on REITs, and the new transfer pricing and thin capitalisation rules.

So Gordon does it again! Practically every Budget since the 2001 election has seen commentators predicting that the Chancellor will have to come clean that he has run out of money to fund his overly-ambitious spending plans. But each time Gordon Brown bullishly reports that all is well with the public finances and he can afford to decide whether to cut borrowing, lower taxes or increase spending.

It was only at the end of his speech that he admitted that the revenue effect of the Budget would be broadly neutral. A cynic might say that the cheques he's writing today will be cashed after the next election. And the usual shedload of Press Releases need careful unpicking.

The targeted moves on tax avoidance, whether VAT, Section 222 leasing or partnership losses came as no surprise. Given the recent Press coverage, nor did the requirement for promoters of schemes to register them with the Revenue. As you will see, we have severe doubts as to the propriety of this last measure, and wonder if it was a consolation prize for the enforced merger of Revenue & Customs, with the associated job losses and moves out of London.

We welcome the consultation on Real Estate Investment Trusts and the relief for filmmakers. We also welcome the micro-measure on relief for management expenses, and the new relaxations on the UK to UK transfer pricing/thin capitalisation rules. But our general impression is that this is a transitional Budget ("freezing the rates" became a mid-speech mantra), with more dramatic measures postponed until the first post-Election Budget (Chancellor Alistair Darling, anyone?) when some of the EU issues have become clearer – hopefully for the benefit of you, our clients.

The main Budget proposals and other tax changes highlighted on the following pages may be amended significantly before enactment.

The main points announced by the Chancellor of the Exchequer in his Budget Statement earlier today are highlighted below.

BUSINESS TAXATION

Corporation Tax Rates

No change in the headline corporation tax rates.

Reform of Corporation Tax

Other than the measures on Transfer Pricing/Thin Capitalisation and Management Expenses discussed below, the Reform of Corporation Tax Project seems to have momentarily stalled. We are promised "further detailed legislative proposals" later in the year. To the delight of business, capital allowances are to be retained and modernised but we await details.

The Treasury Press Release promises a continuation of "the wider-ranging dialogue on international issues". This is code for debates between the Revenue and Business on how to make the UK corporation tax code ECJ-compliant. This means that, for the moment, no further action is to be taken to try and restrict EU-based litigation.

Given the requirement for most EU-listed companies to adopt International Financial Reporting Standards ("IFRS") for their published accounts in 2005, the Revenue has acted to ensure that IFRS accounts are valid for UK tax purposes.

Transfer Pricing and Thin Capitalisation

As prefigured in the Pre-Budget Report, the exemption for UK to UK transfer pricing is removed with effect from 1 April 2004. Furthermore, the thin capitalisation rules are abolished and will now fall under the revised transfer pricing regime. Small and medium companies are largely excluded, and there is a welcome revision to the rules to exempt companies dormant at the start date and thereafter. Also welcome is the ability for adjustments arising in a securitisation structure to be settled by companies outside the structure.

This new rules are intended to make the UK corporation tax code in this area "EU compliant", but we have our doubts. The move is certain to increase administration and compliance costs for UK Plc.

Films

As expected, today the Government announced a new relief for the British Film industry replacing Section 48 which is due to expire next year. This development is hot on the heels of various Revenue actions to tighten exploitation of the current film

schemes. The Pre-Budget Report announced restrictions on built-in exits followed by the Black Tuesday announcement restricting partnership losses.

The new relief is a tax credit system (similar to the tax credit system operating in Luxembourg since 1988) for production expenditure incurred that can be offset against profits or can be surrendered to the Treasury for a cash payment. The Government anticipates this new system to provide filmmakers with 20% of their budget. The full details of this new tax credit system and the scope of its application to distribution will be published in the Summer.

The Government will also be reviewing the treatment of co-productions and the definition for British Qualifying Films.

Amendments to Loan Relationships and Derivative Contracts

The loan relationship rules and the derivative contracts legislation set out in the Finance Act ("FA") 1996 and FA 2002 respectively will be amended to remedy certain defects in the existing legislation.

Increase in the Rate of First Year Capital Allowances for Small Businesses

The rate of first year capital allowances for small businesses spending on plant and machinery will be increased from 40% to 50% for a period of one year, to provide an increased cash flow benefit for the small businesses. The rate of allowances for medium sized enterprises remains unchanged at 40%.

Venture Capital Trust and Enterprise Investment Scheme

The Government is introducing various measures to encourage investment in VCTs, and the EIS, such as:

- the rate of income tax relief is to be increased from 20% to 40% for VCTs in tax years 2004/2005 and 2005/2006; and

- the annual investment limits for EIS and VCTs are to be increased from £150,000 to £200,000 and £100,000 to £200,000 respectively for shares issued on or after 6 April 2004.

Tax Clampdown on Small Companies

The Chancellor announced that a minimum corporation tax rate of 19% is to be charged when a company makes a distribution to non-company shareholders. This anti-avoidance measure seeks to prohibit the small incorporated businesses who have been using the current "zero" corporation tax rate in order to avoid tax and NICs by showing their income as dividends. The minimum rate will apply to distributions made on or after 1 April 2004.

Management Expenses

From 1 April 2004 management expenses can now be deducted in a greater range of entities than the old "investment company". But the definition of management expenses now excludes capital items (overturning the High Court decision in *Camas plc v Atkinson*). We are also aware of Inspectors challenging the general scope of management expenses even within investment companies.

Finance Leasing

The proposal that lessees should receive capital allowances in a finance lease has (for the moment) been averted, although Treasury Press Note 4 refers to consideration of "possible changes to the way leasing transactions are taxed". Lobbying needs to be kept up to resist this or at least make the allowances transferable.

Recent publicity given to big ticket so-called "Section 222 Sale & Leaseback" transactions (where anti-avoidance legislation is exploited) has led to targeted measures to limit the fiscal benefit to the lessee. The element of deductible lease rental will be limited to the finance charge element. Quite unusually, existing leases are not grandfathered, so the new rules apply to lease rentals payable from today (17 March), and arrangements to unwind existing structures will trigger an exit charge.

European Company

The "European Company" will enable groups to operate throughout the EU using a single corporate entity with effect from 8 August 2004. The Revenue has announced that relatively minor changes will be required to existing law to tax such entities established in the UK. This will be introduced in the 2005 Finance Bill following consultation late in 2004.

Improvements to Research and Development Tax Credits

Representing a Government investment of £35 million per year, widening the support given to innovative companies, and reducing the real cost of Research and Development, the categories of expenditure qualifying for Research and Development Tax Credits and vaccines research relief are being expanded to include expenditure on software, power, fuel and water. In a change to the definition of consumable stores, expenditure on consumable or transformable materials will also qualify for relief.

These changes also apply to various investment reliefs and Research and Development allowances. New DTI guidelines on the definition of Research and Development were published on 5 March 2004 for company accounting periods ending on or after 1 April 2004. The above changes take effect from 1 April 2004 for large companies and, for small and medium-sized enterprises, once State Aid approval is received.

Child Care

From 6 April 2005 employees will be able to receive up to £50 a week of childcare tax and National Insurance free where their employers contract with an approved childcarer or provide childcare vouchers for the purpose of paying an approved childcarer.

Pensions Simplification

The existing eight different tax regimes governing pensions are to be replaced with a single lifetime allowance on the amount of pension savings that can benefit from tax relief. The limit is to be set at £1.5m rising to £1.8m in 2010. There will also be an annual allowance initially of £215,000. The implementation date of the new regime ("A-Day") is 6 April 2006.

Offshore Funds

New rules will be introduced to reform the tests for distributor status of offshore funds. The intention is that more investments will be within the scope of being "distributing" so that UK investors in offshore funds will be taxed on the same basis as if they had invested in an equivalent UK fund. The changes will apply to the first accounting period of an offshore fund ending on or after Royal Assent.

Anti-avoidance

The Chancellor confirmed that no General Anti-Avoidance Rule ("GAAR") will be introduced, however, as heavily trailed in the press, steps will be taken against so-called "tax avoidance" by requiring professional advisers to inform the Revenue of any proprietary scheme which they intend to market.

We believe that such a step possibly may have human rights implications but is also unnecessary, in that officials have exaggerated the extent of the avoidance "problem" in an attempt to obtain powers Parliament never intended.

Strips of Government Bonds

In relation to strips of Government bonds disposed of on or after 15 January 2004, and where schemes or arrangements have been entered into to secure tax advantages, acquisition costs and disposal proceeds will be substituted for "market value", defined by reference to publicly available pricing information and disregarding any effect a scheme or arrangement may have on the value of the strip. This new definition also applies to year-end deemed disposals and re-acquisitions. Capital losses arising from such schemes or arrangements will be disallowed.

In relation to strips disposed of on or after 17 March 2004, losses arising on any actual or deemed disposal will be disallowed to the extent that the disposal proceeds fall below the acquisition cost.

Companies in Partnership

The Government has announced anti-avoidance provisions that will impose a Corporation tax charge on a company that realises capital from a partnership, with effect from today. This charge will effect companies where the realised capital represents profits ordinarily taxable on the UK company if the profits had been allocated in proportion to shares of partnership capital.

PROPERTY TAXATION

UK Real Estate Investment Trust

The Treasury has published a consultation document *'Promoting more flexibility in investment in property'* which considers the establishment of a property investment fund which would be similar to a US Real Estate Investment Trust and should align after-tax returns from holding property indirectly more closely with those obtained from holding property directly. This will be welcomed by the real estate industry which has been lobbying hard for the introduction of such a vehicle. Responses to the consultation must be made by 16 July 2004.

New Regime for Property Derivatives

Draft regulations (which will be subject to consultation) will soon be published to adapt the current derivative contracts legislation to include property derivatives. This would mean property-based derivatives being taxed like any other derivative (i.e. profits and losses would be taxed/relieved according to the accounting treatment, whether accruals or mark to market).

Stamp Duty Land Tax

Rates

Stamp Duty Land Tax ("SDLT") rates and thresholds have been frozen as have rates of stamp duty and Stamp Duty Reserve Tax.

Partnership Transactions

Following on from the introduction of SDLT on 1 December 2003, the Chancellor has brought in new measures which will apply SDLT to certain partnership transactions which involve an interest in land and which are currently excluded from the SDLT regime. SDLT will now be charged on the following transactions:

The SDLT charge will only be for the proportion of the property being transferred into the partnership. The SDLT charge to partnership transactions will have retrospective effect and apply from the date of Royal Assent, 10 July 2003.

Technical Clarification

The Chancellor introduced new measures to clarify changes, counter avoidance and extend some reliefs made since the introduction of SDLT. Broadly, the measures affect purchasers and lessees/tenants of land, especially those entering into complex commercial transactions. Residential purchasers and tenants are unlikely to be affected. The anti-avoidance measures include changes to the relief for Private Finance Initiative (PFI) projects to ensure that such transactions are always notifiable. The majority of the measures apply from today, except for those which extend some reliefs and reduce the compliance burden on purchasers, they apply from the date of Royal Assent. There will be no charge to SDLT when a property passes to a beneficiary under a will or on intestacy, this measure applies to the transmissions of property since 1 December 2003.

Jointly Owned Property

With effect from 6 April 2004, income distributions from shares in close companies jointly owned by married couples will now be taxed in proportion to the ownership of, and income entitlement to, the shares. Currently such shares are deemed owned in equal proportion (and taxed accordingly) unless an election is made.

VALUE ADDED TAX

Anti-avoidance

As has become usual for this Chancellor, tax avoidance formed the centrepiece of the VAT changes in this budget. Together with three specific and targeted measures, it is clearly the hope that the disclosure requirement, and Customs and Excise's aggressive stance in litigating against perceived tax avoidance (and good track record in the VAT Tribunal), will strike a major blow against the tax planning industry.

Disclosure of VAT Avoidance Schemes

Businesses with a turnover of more than £600,000 pa will have to disclose to Customs and Excise the use of any avoidance schemes featured on a list to be published by them (or face a penalty of 15% of the tax avoided). Businesses with a turnover of more than £10 million pa will have to disclose any scheme with "the hallmarks of avoidance" (or face a flat rate penalty of £5,000) unless the professional advisor marketing the scheme has voluntarily registered it with Customs and Excise.

These measures contrast with the treatment for direct tax where the primary liability to register the scheme lies with the promoter and not the taxpayer using it. It is not clear why the Chancellor has opted for different treatment in the different taxes but it may be that there was concern that the direct tax model would fall foul of the EU Sixth VAT Directive.

VAT Grouping

Following on from the consultation paper launched in the pre-Budget review, the rules on eligibility to join VAT groups will be changed with effect from 1st August 2004 to prevent certain companies from joining VAT groups and thereby being able to avoid charging VAT to partly exempt companies. Where a company is owned in whole or part by a separate entity and makes taxable supplies to a partly exempt group, that company will only be eligible to join its customer's VAT group if the majority of the economic benefits from that company go to a company associated with the VAT group and the entity's accounts are, or would be, consolidated with those of the person controlling the VAT group. A similar test will be imposed for limited partnerships.

The type of structure that is attacked by this measure has been used to enable outsourced services to be provided to the financial sector without increasing the VAT burden. Customs and Excise has seen such structures as unacceptable avoidance and is challenging several of them through the courts. This measure is an attempt to secure victory whatever the outcome of the legal process.

Option to Tax on Commercial Buildings

This is a measure to block a planning scheme used by partly exempt businesses on the purchase of land or buildings. A third party developer would purchase the land or buildings, exercise the option to tax, enter into a lease to the partly exempt end user and thereby recover input tax on the costs of construction. If the property subject to the lease is transferred as a going concern to a special purpose vehicle ("SPV") of the end user and the SPV has opted to tax, the irrecoverable VAT would be spread over the term of the lease (or possibly avoided in whole or part if the lease was terminated early). The new measure will cause the transfer of the property to be subject to VAT and disapply the SPV's option so leaving it with irrecoverable VAT. If the property is transferred through a sale of shares of the third party's SPV, it is that SPV's option which will be disapplied. This measure will take effect on 18 March 2004.

Demonstrator Cars

The recovery of VAT on the purchase of cars is blocked. However, this is not the case for stock-in-trade of motor traders, including demonstrator cars. Where personal use of such cars is allowed to employees, there is an obligation to account for VAT on the value of such use. Customs has agreed standard figures for such values with trade bodies. However, some businesses were avoiding paying VAT at the agreed rates by charging nominal sums to their employees for the use (the example is a charge of £1 for two years' use). Under the new measure, Customs and Excise will be able to direct that businesses account for VAT on such private use on the basis of the agreed amounts rather than the actual amounts charged to employees. This measure will require a derogation from the European Commission.

Change to the Place of Supply of Natural Gas and Electricity

This measure provides that VAT on wholesale supplies of natural gas and electricity will be accounted for in the place where the customer receiving the supply is established, otherwise the place of supply will be where the natural gas and electricity is consumed. The measure will also relieve natural gas and electricity from VAT when imported from outside the EEC but VAT will have to be accounted for by any VAT registered customer where a supplier is in a different country.

Similar measures will be introduced for place of supply rules for services related to providing access to, and use of, natural gas and electricity distribution systems.
This is going to effect all suppliers, importers and VAT registered recipients of natural gas and electricity. One of the most interesting parts of this is there will be a new reverse charge mechanism for gas and electricity.

EXCISE DUTY

Stamps for Spirits

In a measure designed to combat the £600 million lost in tax through spirits fraud, a new measure is being implemented so that retail containers of spirits will, subject to certain exceptions, be required to bear a duty stamp indicating that UK duty has been paid.

A number of new offences and penalties for dealing in unstamped products which are required to bear a stamp, will be introduced but as yet no details have been set out.

ENVIRONMENTAL LEGISLATION

In the Budget a number of environmental changes have been made in line with the Government's previous policy of encouraging/rewarding environmentally friendly activities and raising the amount of tax on non-environmentally friendly matters. These primarily include:

Landfill Tax

The standard rate of landfill tax increased from £14 to £15 per tonne and the Government has confirmed it will fulfil its commitment to raise the standard rate of landfill tax in subsequent years by £3 per tonne and by at least that amount in the years thereafter on the way to a medium to long term rate of £35 per tonne.

Climate Change Levy: Climate Change Agreements

Eligibility to businesses to enter climate change agreements which provides an entitlement to an 80% reduction in the rates of climate change levy in return for agreeing to reduce their omissions and/or energy use is being extended. Full criteria

is not yet set out as this measure requires clearance from the European Commission.

Climate Change Levy: Leviable Energy Products used to Create Excisable Energy Products

It has been recognised that the creation of new bio fuels has meant that the scope of the exemption of certain products from climate change levy has fallen behind the speed of change in this area. This measure will extend the exemption so as to stop potential double taxation of bio fuels and will also allow future changes to be made by statutory instrument enabling the Government to introduce measures far more quickly.

Hydrocarbon Oils: Introduction of a Reduced Rate of Duty for Sulphur Free Oils

This assists oil industry with the introduction of new more environmentally friendly fuels, and the mixing of duty paid road fuels will no longer be prohibited. The new rate for sulphur free petrol and diesel will be 48.52 pence per litre. This is 0.5 pence per litre less than the duty rate for ultra low sulphur petrol and diesel.

Hydrocarbon Oils: Introduction of a Reduced Rate of Duty on Bioethanol

Bioethanol is defined as petrol quality liquid fuel consisting of ethanol produced from biomass (biomass is vegetable or animal substances consisting of biodegradable fraction products, wastes and residues from agriculture, forestry and related activities, or industrial and municipal waste).

The rate for this fuel will be 28.52 pence per litre, 20 pence per litre less than the rate for sulphur free petrol. Further, the blending of hydrocarbon oil and bioethanol will be permitted in a tax warehouse where sufficient records are kept to show the proportion of each ingredient in the resultant mixture. The bioethanol duty rate will apply only to the bioethanol part of the blend.

Hydrocarbon Oil: Change to Provisions for Mixing Dutiable Products

In a further measure to assist the oil industry in the smooth introduction of new more environmentally friendly fuels, it is now permitted to mix two duty paid road fuels of different duty rates.

PERSONAL TAXATION

Tax Treatment of Pre-owned Assets

The Chancellor announced that from 6 April 2005 a free-standing income tax will apply to the benefit people receive from arrangements to dispose of valuable assets whilst retaining the use of them free of charge or at a low cost. Following

consultation this charge has been introduced in answer to various schemes which have been designed to avoid inheritance tax and in particular exploit existing rules regarding gifts with reservation. The charge will apply to both tangible and intangible assets. There will be a threshold of £2,500 per year, below which the cash value of the benefit will be disregarded.

Rate Applicable to Trusts

Tax rate applicable to trusts will increase from 34% to 40% from 6 April 2004. This specifically applies to:

- income of discretionary and accumulation trusts other than dividend income;
- capital gains of all trusts and estates of deceased persons in administration; and
- certain amounts received by all trusts, eg offshore funds.

The dividend trust rate will increase from 25% to 32.5% from 6 April 2004.

Section 677 of the Income Corporation Tax Act 1998 has been amended to ensure that the settler is not given credit for more tax than the trustees have actually been paid.

Anti-avoidance

UK Equity Repo or Stock Loans

This anti-avoidance measure extends the provisions announced in November 2003 preventing individuals from avoiding tax by entering repo or stock lending transactions over UK equities, with effect from today. The new measures now apply to trustees and include the development of the original scheme. They also ensure that the dividend is taxed at the same rate as relief is given making the repo or stock transaction tax neutral.

AND FINALLY… INLAND REVENUE AND CUSTOMS MERGER

The O'Donnell Review has concluded that the two departments should be merged into one "customer-focused tax services". This should facilitate "joined-up working", but it remains to be seen which culture dominates, given the differences between transaction-based taxes and taxes on gains and income.

FURTHER INFORMATION

If you wish to discuss any aspect of the Budget or any other tax matter, please telephone your usual Dorsey contact or any of the tax team listed at the end of this summary.

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