

Budget 2009



Darling's Budget – a retrospective

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Like the dog that did not bark, there are almost as many omissions from the Chancellor's Budget as announcements. The measures announced only make a small inroad into the tax increases which will be needed after the next General Election as a contribution, alongside public spending reductions, to reduce the UK's frightening public sector deficit.

Even in a year when tax cuts were unfortunately not on the agenda, the Chancellor could have instigated more tax reforms and tax simplifications to improve the UK's creaking personal and business tax foundations. Unfortunately, he has shown no such determination to grapple with these issues.

Budget impact on the Government's fiscal projections – a first instalment only?

In percentage terms, the cumulative public sector net debt, as a percentage of GDP, is projected to rise from 36.5 per cent in 2007/08 to 79.0 per cent in 2013/14. Many commentators fear that even this deterioration is unduly optimistic in the light of the Chancellor's aggressive assumptions for future growth.

Percentages can often obscure the extent of a problem. In absolute terms, the annual budget deficit is projected to increase from £34.6bn in 2007/08 to £175bn in 2009/10 and only falls to £97bn in 2013/14.

The policy measures announced by Mr Darling look very small beer in comparison to these numbers. In total, his measures cut taxation by £5.1bn in 2009/10 and only increase tax revenues by £5.2bn in 2011/12. Some will be surprised by the reduction in 2009/10.

This principally comprises the effect of the one-off increase in first year capital allowance to 40 per cent (costing approximately £1.6bn), the deferral of business rate payments (costing approximately £0.7bn), car scrappage allowances (costing

approximately £0.3 billion) and a series of spending measures affecting business and families. Despite this Chancellor's rhetoric concerning combating perceived tax avoidance, the measures he has introduced only bring in less than £0.3bn in 2009/10 and less than £0.6bn in 2011/12.

The Chancellor's forecast of current tax receipts, perhaps wisely, only extends to 2009/10. Between 2007/08 and 2009/10, he expects to lose £50bn in annual tax receipts (collections falling from £515bn to £465bn), such is the impact of the credit crunch and the recession.

The principal tax revenues forecast to fall include a £12bn loss of corporation tax (£47bn to £35bn), an £116bn fall in income tax (£151bn to £140bn), not surprisingly, a collapse in stamp duty revenues of £9bn (from £14bn to £5bn) and a £17bn fall in VAT (from £81bn to £64bn). Interestingly, there is only a fall of £3bn (from £100bn to £97bn) in national insurance contributions which demonstrates the effect of the Chancellor's previous policy decisions such as the significant increase in the upper earnings limit. Tax advisers spend a significant amount of time advising clients on capital gains tax and inheritance tax but, in terms of Government tax revenues, these taxes are almost inconsequential – the receipts from both these taxes are forecast to fall by £3.1bn and £1.6bn respectively to £2.2bn and £2.3bn.

It is feared that post election Budgets will target the largest tax raisers for significant increases to assist in closing the then Chancellor's fiscal deficit. The



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principal targets are likely to include VAT, national insurance contributions (both employees' and employers') and income tax. There is probably less scope to increase corporation tax as Chancellors must be mindful of the UK's competitive position as a location for global business inward investment.

Taxation of business – lack of strategy and simplification

Perhaps the most disappointing aspect from a business perspective was the lack of any indication of a further - and overdue - reduction in corporate tax rates to bring the UK's headline rate more in line with that of continental Europe. The only move on corporate tax rates was confirmation of the announcement in the 2008 Pre-Budget Report of a deferral in the increase in the rate for small companies, from 21 per cent to 22 per cent, from 1 April 2009 until 1 April 2010, with the 28 per cent main rate of corporation tax continuing for large companies. It is difficult to discern a particular strategy on corporate tax rates but with many competitor European jurisdictions at or below 25 per cent there will continue to be pressure upon the Chancellor to lower the rate to support his desire for a strong recovery in 2011.

One clearly bizarre matter was the Chancellor's decision to reintroduce a temporary 40 per cent first year allowance for all businesses that incur capital expenditure on certain qualifying types of plant and machinery in the 2009/10 fiscal year. This follows hot on the heels of a relatively recent decision to reduce the annual rate of writing down allowances for this type of capital expenditure from 25 per cent down to 20 per cent which only came into effect in April 2008.

Business planners may be somewhat flummoxed as they try to decide to what extent they should be influenced by the wildly fluctuating rate of tax relief when planning capital expenditure. Of course, for many businesses, plans will already have been made so the Chancellor may be disappointed if he expects the temporary capital allowance increase will provide a significant stimulus to the UK economy.

The Treasury have stated that the Chancellor was introducing a package of measures to "support the adjustment towards renewed economic growth and improve the UK's competitiveness". A principal headline measure that was announced, in addition to the first year allowance, was a £750m Strategic Investment Fund to support "advanced industrial projects of strategic importance". Such initiatives have a very mixed track record of success. The Chancellor confirmed implementation of a package of reforms to the taxation of foreign profits, including an exemption for foreign dividends, with the pending introduction of additional restrictions to interest deductions.

The changes to the taxation of foreign profits, made imperative by the increasing trend for UK listed global businesses to consider relocating overseas, are likely to prove to be one of the most important changes in the UK's approach to the taxation of international

groups in the last thirty years. Accordingly, it is important that the final rules are practical and have no unfortunate unplanned consequences. I am at this stage sceptical that these twin objectives can be achieved but it is to be hoped that the progress of the Finance Bill debates will help to remove the uncertainty that has been hanging over many international groups and that the measures will indeed improve the UK's tax competitiveness for global businesses.

Simplification is regularly something that our clients rightly would like to see as a major focus for the Chancellor but, as each year passes, there are more examples of special rules being introduced. Budget 2009 is no exception and by way of illustration there were changes to the definition of what constitutes a group for tax purposes. This change was confirmed in the Budget and seeks to alleviate a consequence of the banking crisis.

A number of banks were unable to make payments on their fixed rate preference shares and, as a result the preference shares would effectively have been regarded as ordinary shares leading to the reliefs available for tax groups no longer applying eg a subsidiary would no longer be able to surrender its tax losses to another group member. As this could have wider implications, the tax definition of preference shares is being broadened to introduce a new definition of relevant preference shares for group relief purposes. In short, business taxation simplification, without real commitment from the Chancellor, is likely to remain a hope rather than a reality. In the meantime, the tax compliance burden on UK businesses, both small and large, will continue to rise.

Budgets are often about unintended consequences rather than the effects which the Chancellor may have anticipated. Many owner-managed, entrepreneurial companies will note that surplus funds kept within a family company will be held within a 22/28 per cent tax environment but, if these are distributed to the shareholders by way of management remuneration or dividends, they will attract income tax from 2010/11 at rates up to 50 per cent (or 51.5 per cent from 2011/12 if national insurance contributions are considered). Hopefully, this aspect will not lead the Chancellor to reintroduce measures repealed decades ago which forced family companies to pay dividends in excess of what they considered to be commercially prudent.

Taxation of individuals – breakdown of consensus and heat on top earners

We have long argued for a simpler, flatter system of personal taxation with lower rates of income tax across the board at the expense of fewer, complex tax reliefs. The Chancellor has, regrettably, substantially increased the top rate of income tax from 40 per cent to 50 per cent (applied to income over £150,000 per annum) and has removed the personal allowance for individuals with income in excess of £100,000 per year so that they lose £1 of personal allowance for each £2 of income above this threshold. Both measures are with effect from 2010/11.

There are consequential effects arising from these changes, none of which are good news. Firstly, an effective tax rate of 60 per cent applies to the band of income between £100,000 and, approximately, £113,000. These “kinks” in tax legislation should be avoided as they cascade confusion for taxpayers. Secondly, the tax paid by higher rate taxpayers on dividends received, up to 2009/10, a simple and universal fixed rate of 25 per cent of the net dividend, becomes either 25 per cent or 36.1 per cent for those with over £150,000 taxable income. Again, introducing an added complexity in the tax system.

It is also necessary to consider the relief for pension contributions which individuals earning in excess of £150,000 per annum receive. A perfectly workable and sound system of tax relief for pensions savings has been in place in recent years which incentivised individuals to save for their retirement but capped the size of the fund which they could build up (at £1.65m for 2008/09). This system was, indeed, introduced by Gordon Brown himself. It should be pointed out that an indexed linked annuity bought with a fund this size might only amount to, perhaps, £60,000 per annum which, whilst generous in comparison to most pension funds, is comparable to many top level civil servants’ and government ministers’ pensions.

The Budget introduced a severe restriction on tax relief obtained for pension contributions by executives, professionals and entrepreneurs earning more than £150,000 per annum by restricting the tax relief to the 20 per cent basic rate. This applies from 2011/12 but there are manifestly unfair so-called “forestalling” provisions which effectively restrict tax relief to 20 per cent immediately (ie from 2009/10) for pension contributions made by the individuals or their employer in excess of £20,000 per annum in 2009/10 and 2010/11. This amounts to retroactive taxation as these individuals could reasonably have expected the existing regime to apply until 2011/12.

Those approaching retirement may have planned to use savings or surplus income to supplement their pensions in these years and the dangerous precedent set by the Chancellor for the taxation of savings generally will create distortions in the savings market and penalise those who had been planning to make additional provision for their retirement. The so-called mischief which the Chancellor is seeking to prevent ie accelerating pension contributions to 2009/10 and 2010/11 hardly seems to be unacceptable financial and taxation planning and is, anyway, controlled by the existing fixed pension cap and the availability of funds to make the contributions. Hopefully, the House of Commons will vigorously argue against these forestalling provisions, even if they feel they must accept that the Chancellor should get his way on pension relief from 2011/12.

The Chancellor, like all Chancellors, states that he is determined to counter tax avoidance but his personal taxation changes in the 2008 and 2009 Budgets combine to encourage tax avoidance, some of which will be successful, despite HMRC’s best endeavours to

prevent it. This is because Mr Darling has significantly increased the difference between the top rate of income tax and the top rate of capital gains tax. Indeed, these were both 40 per cent prior to the 2008 Budget. We now have the position where there is an 18 per cent capital gains tax rate (2008 Budget) and a 50 per cent income tax rate (2009 Budget). This difference of 32 per cent will, inevitably, be a focus for financial institutions and tax advisors seeking to convert income returns to capital. Indeed, Nigel Lawson, when Chancellor, focussed upon this aspect as a reason to equalise these tax rates!

Summary

No one can accurately determine the adverse effects of the 2009 Budget changes upon the competitiveness of the UK as a location for business investment by both multi-national companies and entrepreneurs. The Budget will be welcomed by countries such as Switzerland and Monaco which have traditionally focussed upon attracting high net worth individuals and entrepreneurs and also by countries which will now have much lower personal tax rates including the USA, Germany and France. There may well be a psychological impact arising from the Government taking the same level of reward as the entrepreneur for each pound earned over £150,000.

These changes, principally affecting the top end of the income distribution, are unfortunately likely to be woefully insufficient to meet the government’s likely need for additional tax revenues to assist in reducing the fiscal deficit. The Chancellor must not resort to corporation tax increases as he will need to be mindful of the much lower corporation tax rates in countries such as Ireland, Germany and much of central Europe.

Expect any incoming government after the general election to look to much more widely based tax increases affecting the broader middle income groups such as an increase in VAT to perhaps 20 per cent, an increase in both employers’ and employees’ national insurance contributions to perhaps 15 per cent and a restriction in all personal reliefs to the basic rate only. Needless to state, none of these measures would be welcomed by either business or individual taxpayers!

A key message

Both business and individual taxpayers would be ill advised to take any existing tax reliefs for granted and should, therefore, carefully consider how they can maximise their benefit from, for example, pension tax relief over the next few years either in the form of individual contributions or salary sacrifice arrangements. In particular, higher rate taxpayers on incomes below £150,000 would be well advised to consider maximising their pension contributions while full higher rate relief is still available. The message is clear; consider making use of tax reliefs while you can because in a rapidly changing fiscal environment, there can be no certainty they will continue to be available as financial markets force the Treasury to take steps to curb the scale of the Government’s unsustainable fiscal deficit.

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