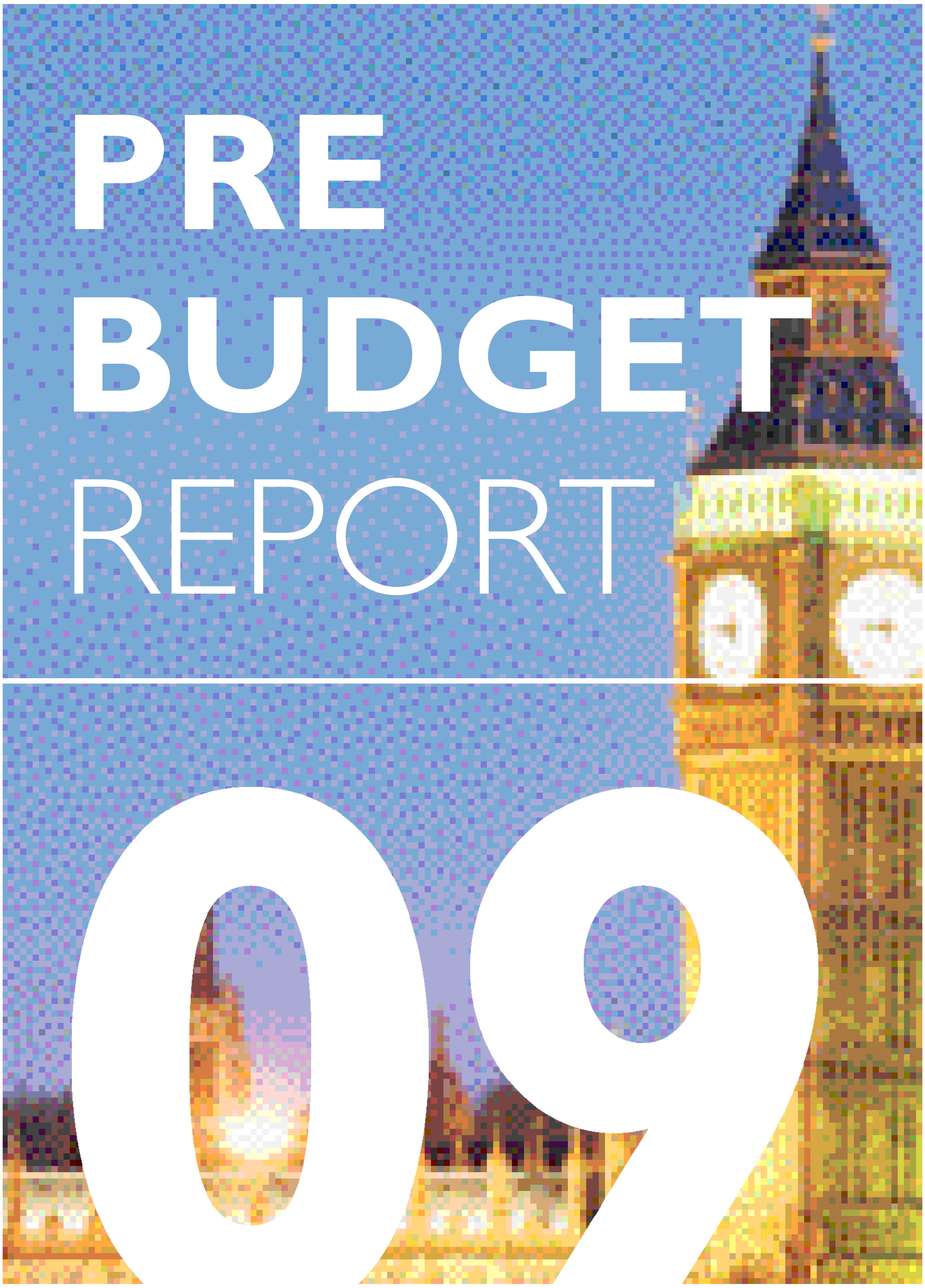
PRE BUDGET REPORT

2009



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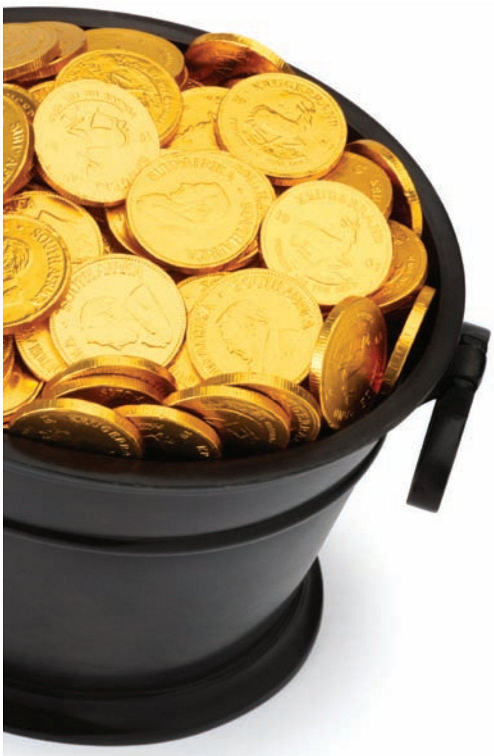


Looking for the pot of gold at the end of the recession

When you are in a hole, the saying goes, you should stop digging. For the Chancellor of the Exchequer, there is no choice – he has to make a Pre-Budget Report at the end of the year to outline what he intends to put in his Budget in the Spring. This year many people are predicting that the country's finances will not be Alistair Darling's responsibility for much longer, but he still has to tell us what he will do if we give his party another five years.

He had a very difficult balance to strike between the demands of politics – not wanting to scare the voters too much – and economics – trying to convince the world's markets that the UK's finances would be restored to health in the foreseeable future. He has announced a number of significant measures, but many people are still wondering whether there is enough here to fill the deficit: there is surely more pain to come, in higher tax or in cuts to public spending, which will have to be announced after the election by whichever party is in power by then.

The Shadow Chancellor, George Osborne, was quick to criticise the proposals, but it's not yet clear what he would do instead. Mr Darling tries to portray the Conservatives as more likely to send the country back into recession, while Mr Osborne says that Labour has failed to address the huge public sector debt, and will leave the country bankrupt.

Whoever is right – and it is possible that they both are – the Pre-Budget Report contains a number of detailed proposals behind the headlines. This document explains the main announcements so you can see how they might affect you.

Personal tax

Tax rates and allowances

The tax rates for 2010/11 have already been announced in the April 2009 Budget. The main points are:

- 50% tax rate on income above £150,000
- Tax-free personal allowances restricted if income is over £100,000, reduced to nil by income of £112,950
- Basic rate 20% up to taxable income of £37,400
- Higher rate 40% between £37,400 and £150,000
- Different rates (10%, 32.5% and 42.5%) still applicable to dividend income

Normally the tax-free allowances and the threshold for higher rate tax are increased by inflation. As the Retail Prices Index fell in the year to September 2009, these figures have all been frozen at their 2009/10 level. The freezing of the allowance is therefore officially "a real terms benefit", according to the Government.

The PBR included the long-term announcement that the threshold for higher rate tax will be frozen in 2012/13 at the same levels as in 2011/12. If average earnings increase in the meantime, more people will be caught by higher rate tax, and may be brought within self-assessment as a result.

Furnished holiday lettings

As announced in the April 2009 Budget, the favourable treatment of furnished holiday lettings (FHL) will cease from 6 April 2010. Property rental is normally treated for tax as an investment activity, which restricts the offset of losses against other income, the use of the earnings for pension contributions, and the availability of a number of capital gains tax reliefs. Lettings which met the conditions for FHL enjoyed a much more favourable treatment.

The law used to restrict these FHL advantages to UK properties only. When the Government realised that this was contrary to European law, it had to extend the good news to properties anywhere in the European Economic Area – but then decided to abolish the treatment altogether from 6 April 2010 (1 April for companies).

C O N T E N T S

It will still be permissible to set running expenses against the income from all UK rents, but it will not be possible to set a net loss from FHL against income from other sources.

Entrepreneurs' Relief reduces the effective rate of CGT on sales of business assets from 18% to 10% for the first £1m of gains. It has been available for disposals of FHL either on the cessation of the rental business or within 3 years after cessation. HM Revenue & Customs have confirmed that the change of the rules on 6 April 2010 will be treated as "ceasing the trade" for this purpose: this means that the FHL property can still be sold within the 3 years following 5 April 2010 at a CGT rate of 10%. After that, the normal rate of CGT will apply.

Pensions and Credits

State Pension

The basic State Pension will increase by 2.5% in April 2010 to £97.65 per week for a single person and £156.15 for couples. The Government promised to increase the rate by the higher of 2.5% and inflation: as inflation has currently gone into reverse, this increase represents a larger than normal benefit – even if it is still very small in real terms.

Rates of tax credit

Although most allowances have been frozen because of the recent falls in the RPI, there have been small increases in the level of Child Tax Credits and Working Tax Credits which will apply in April 2010. There is also a small increase in the level at which Child Tax Credit is withdrawn, but the overall amounts of awards are likely to be broadly similar in 2010/11 to 2009/10 levels on the same income.

National Insurance Contributions

Rates and limits: 2010/11

The rates of National Insurance Contributions, and the thresholds at which they apply, nearly all remain the same in 2010/11 as they are in 2009/10.

There is a £2 increase in the employees' Lower Earnings Limit (to £97 per week) above which entitlement to State Pension is earned, but no NIC are payable by either the employer or the employee until the Primary Threshold at £110 per week.

Rates and limits: 2011/12

Last year we were told that the main rates of NIC would rise by 0.5% in 2011/12. This has now been revised further upwards:

- Employees' Class 1 NIC will rise from 11% to 12% from the Primary Threshold up to the Upper Earnings Limit, and from 1% to 2% above that
- Employers' Class 1 NIC will rise from 12.8% to 13.8% on earnings above the Primary Threshold
- Employers' Class 1A NIC on benefits will also rise from 12.8% to 13.8%
- Self-employed Class 4 NIC will rise from 8% to 9% from the lower to upper profits limits, and from 1% to 2% above that

To offset the effect of this increase on lower-paid workers, the lower threshold will increase by £570 more than the rate of inflation in April 2011. This is supposed to mean that only those earning more than £20,000 will pay more in NICs as a result. Recent attempts to set the thresholds for income tax and NICs at the same levels have clearly been abandoned.

These increases mean that the marginal rates of tax on earned income will be 32% (20% income tax plus 12% NIC) on average earnings and 42% (40% plus 2%) at £50,000.

Employees

Bankers' bonuses

One of the expected headlines in the Pre-Budget Report was the attack on bankers' bonuses. The proposal makes it clear that there is no effect on the taxation of the banker at all: the bonus will suffer income tax and NIC according to the normal rules, and those tax charges will no doubt be subject to the normal attempts to avoid them using schemes dreamed up by tax lawyers. Instead, the PBR attack levies a tax on the bank paying the bonus (described under Business Tax).

Electric cars and vans

Cars which run on electricity do not emit carbon dioxide, so the normal rules for calculating a taxable benefit in kind on a company car cannot apply. Instead, a wholly electric car has been charged at 15% of the list price, and an electric van would be subject to the normal figure of £3,000 if private use is for more than home-to-work travel. The 15% figure was to be reduced to 9% for 2010/11, but instead both these benefit figures will be reduced to zero for 5 years from 6 April 2010: there will be no income tax for the employee, and no Class 1A NIC for the employer, on the provision of an electric car or van for an employee's private use.

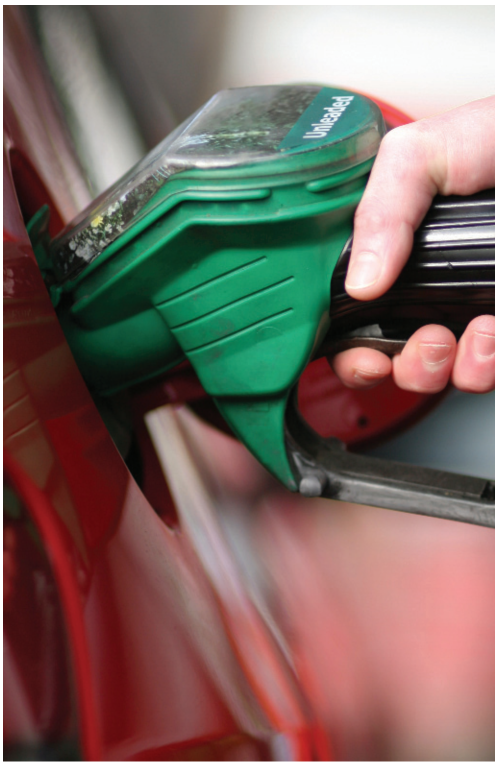
Cars up to 2012

The benefit of a company car has been charged for some years using a percentage of the car's list price. This is determined according to the CO_2 emissions rating of the car. In 2009/10, cars with a rating of up to 120g/km are taxed at 10% of the list price. Above that a 15% rate applies up to 139g/km; the percentage increases by 1% at 140g/km (i.e. 16%), 145g/km etc. to a maximum of 35%. Diesel cars suffer an addition of 3% to the figure for petrol cars, but are still subject to the same maximum.

We have already been told that the 1% increases will start at 135g/km (i.e. 16%) rather than 140g/km in 2010/11, and then at 130g/km in 2011/12, so most company car drivers will see an increase in the tax charge each year even if they are driving the same car.

Now we are told that the rules will change again on 6 April 2012 so that the 10% rate will apply up to 99g/km; at 100g/km, 105g/km, 110g/km and so on there will be a succession of 1% increases, rather than a jump straight to 15% at 121g/km. So from that date it will be harder to qualify for the lowest 10% charge, and the 16% level will be reached at 125g/km, representing a further 5g/km tightening of the rules.

As decisions taken on company cars may affect the employee's tax position for several years to come, it is important to take into account these tax increases coming over the next three years as well as the current position.



Car fuel

The taxable benefit of receiving free fuel for use in a company car is currently based on the same percentage that is applied to the list price for working out the car benefit itself – based on the CO_2 emissions rating of the car – times a fixed figure of £16,900. This figure increases to £18,000 with effect from 6 April 2010, a rise of 6.5%. The taxable benefit will lie between £1,800 (10%) and £6,300 (35%), chargeable to income tax on the employee and Class 1A NIC on the employer.

As the rate applicable to an electric car is zero, recharging such a car using the company's electricity appears not to result in a chargeable benefit for the employee.

The chargeable figure for fuel provided in a company van will also rise from £500 to £550.

Works canteen

There is no tax charge on the benefit to employees of providing free or subsidised meals in a works canteen, provided that the meals are "reasonable" and all employees have the same rights. HM Revenue & Customs have become aware of schemes which allow employees to give up some of their salary in exchange for canteen meals – in effect paying for their lunches out of pre-tax salary instead of net pay. The rules will be changed to prevent this scheme working, but they will only take effect in April 2011.

Savings

Pension contributions

In the April Budget we were told about the restriction on higher rate tax relief for pension contributions that would bite on people with incomes over £150,000 in 2011/12, and also measures to stop people keeping the benefit of that relief by paying extra contributions in advance of 6 April 2011 (so called "anti-forestalling rules"). If someone has had income of at least £150,000 in the current or the last two tax years, and makes a "special pension contribution" of more than £20,000, they may suffer a tax charge of the difference between the higher rate relief they would expect and the basic rate relief that they would be entitled to in 2011.

The PBR includes a measure to tighten up this rule. HMRC have realised that pension contributions paid by a self-employed person or by an employee are effectively part of their gross income and so count towards the £150,000; contributions paid directly by an employer are not. So someone with a salary of £200,000 who paid a contribution of £80,000 would be caught, but someone with a salary of £120,000 whose employer paid a contribution of £80,000 would not.

For contributions paid on or after 9 December 2009, employer contributions will count towards an employee's income limit when measuring it against £150,000. However, someone with an income of no more than £130,000, before the employer contribution is added, will not be subject to the supplementary charge.

These rules are complex, and anyone who has had total income approaching £150,000 in any of the last three years should take advice before paying a pension contribution totalling over £20,000 in a year. However, the rules for tax relief on pension contributions for people on lower incomes are not currently expected to change.

Capital Gains Tax

Annual exemption and rate

The annual exemption for CGT is not announced at the PBR. As it usually changes by the same amount as the personal allowances, it is likely to remain unchanged at £10,100 for 2010/11.

There was some speculation in advance of the PBR that the Chancellor might do something to address the large and increasing difference between the top rate of income tax (rising from 40% to 50%) and the CGT rate (18%). This is clearly an incentive to invest for capital rather than income returns, but no measures were announced to counter it. There are already plenty of anti-avoidance rules to stop artificial attempts to turn what is really an income profit into something that is taxable as a gain, and HMRC must believe that those existing rules are enough for the moment.

Inheritance Tax

Rates and threshold

Several years ago increases in the IHT threshold were announced for an extended period, ending with a jump from £325,000 to £350,000 on 6 April 2010. The Chancellor has now decided that this increase will not happen: the threshold will be held at £325,000 (effectively £650,000 for a married couple or registered civil partnership) for 2010/11.

Because of falls in property values, only 1 in 40 estates were liable for IHT in the last year. Freezing the allowance will bring more estates into charge when the economy begins to recover.

The rates of IHT remain 20% (lifetime) and 40% (chargeable on a death transfer).

Stamp Duty/Stamp Duty Land Tax

Extended holiday ends

No further extension of the Stamp Duty Land Tax "holiday" was announced, so properties costing over £125,000 (£150,000 in disadvantaged areas) will once again become chargeable to 1% SDLT on 1 January 2010. The threshold remains £175,000 until then.

Corporation Tax

Rate of tax

The small companies rate of corporation tax, which applies to corporate profits of up to £300,000 a year, was supposed to rise from 21% to 22% on 1 April 2009. This was deferred for a year to 1 April 2010, and has now been deferred again for a further year to 1 April 2011.

No change has been announced to the full rate, which is therefore expected to remain at 28%.

Business Tax

Bank payroll tax

As widely predicted, the Chancellor announced a special charge on bankers' bonuses. It appears likely to be a very complicated rule that will be hard to apply in practice, and perhaps the clearest thing about it is that it is charged on the employing bank or building society rather than on the individual employee. It is supposed to be levied at 50% on a bonus awarded from the moment the announcement was made on 9 December 2009 up to 5 April 2010, to the extent that the bonus exceeds £25,000. Unlike employer's NIC, the "bank payroll tax" will not be an allowable expense for the company's corporation tax.

The extra charge does not apply to basic salary or to bonuses which were a contractual entitlement before the announcement was made. At first sight, it would seem relatively easy for the bank to avoid the charge by delaying awarding the bonus until after 5 April, or by consolidating it with salary. It remains to be seen how effectively HMRC can police this headline-grabbing but controversial measure.

Capital allowances

Cars with an emissions rating below 110g/km already enjoy a 100% first year allowance for deduction against profits. From 6 April 2010 (1 April for companies) this will be extended to purchases of electric vans, provided European rules on State Aid are satisfied.

Research and development

Companies enjoy an additional tax relief if they spend money on qualifying research and development activities. "Small and medium enterprises" (up to 500 employees, turnover up to □100m and balance sheet total up to □86m) can deduct 175% of R&D expenditure in computing their corporation tax profits, which at the main CT rate of 28% represents a subsidy of 21p for £1 of expenditure.

Until now, it has been a condition that the company claiming the deduction has had to have legal ownership of any intellectual property arising from the R&D work. This condition is removed for expenditure incurred in an accounting period ending on or after 9 December 2009. This means that the benefit could be enjoyed retrospectively – it will apply to the whole of an accounting year to 31 December 2009, even though the rule change has only just been announced.

Time to pay

The Business Payment Support Service was introduced in the 2008 PBR a year ago to help businesses defer payments of tax, PAYE and VAT in order to keep them going through the recession. This year's PBR states that 160,000 businesses have been allowed to postpone payment of £4bn of tax, of which more than £3bn has been collected. This year's PBR confirms that the service will continue to be operated by HMRC until further notice.

It is important to contact the BPSS before the tax liability becomes due and to agree a realistic payment schedule that must be adhered to. The BPSS may ask to see the business accounts and may object to deferral of tax if it appears that the owners or directors of the business are taking large amounts out in salary or dividends.

Empty property rates relief

The Government will extend the temporary increase in the threshold for business rates empty property relief for a further year, and will increase the value to which the relief applies. For 2010/11 empty commercial properties with a rateable value of up to £18,000 (2009/10: £15,000) will be exempt from business rates.

Value Added Tax

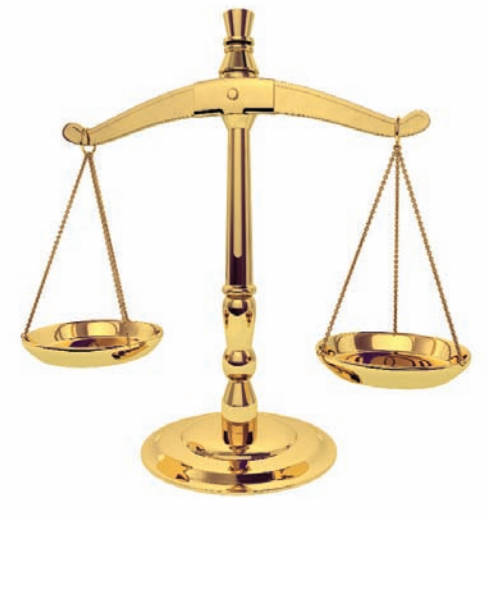
Standard rate

Before the PBR there were rumours that the Chancellor would look to an increase in the rate or scope of VAT to try to fill some of the hole in the public finances. If he has such a plan he chose not to tell anyone about it this side of a General Election. The standard rate goes back up from 15% to 17.5% on 1 January 2010, but there is no indication that it will go up again after that, or be applied to any of the categories that are currently VAT-free such as food, children's clothes, newspapers and new houses.

Flat rate

The flat rate scheme for small traders operates by disallowing input tax on expenses, but allowing the trader to keep some of the output tax charged to customers in order to compensate. Different flat rates are set to reflect the different circumstances of each of over 50 categories of business. It is up to the business to decide which rate to apply, but HMRC can object to the choice made if they carry out an inspection.

When the standard rate was cut from 17.5% to 15%, the flat rates were also reduced, but not by the same amount. On 1 January 2010, the flat rates change again, but they do not necessarily go back to where they were before. Some are higher, some are lower, some changes are 0.5% and some are up to 2.5%. Any FRS trader should consult the list on the HMRC website, or contact us, to make sure that they are applying the correct rate in 2010.



Other Measures

Equitable liability

If a taxpayer fails to file a tax return on time, they may be issued with a determination by HMRC based on an estimate of the liability. The only way to displace a determination is to file a tax return. If the taxpayer fails to do that within the time limit, the tax is legally due and cannot be appealed against. By concession, in the past HMRC have offered a relief called "equitable liability" – if it was clear that the determination was excessive, they would not collect the tax.

Recently a number of concessions – practices which HMRC operate to moderate the harshness of the law – have been withdrawn, and equitable liability was one of these. After a campaign by the tax profession, it will now be included in the law itself, so that HMRC will not collect tax where it is clear that a determination is excessive.

To qualify, a taxpayer must be able to show that the amount is too large, and must bring his tax affairs up to date by filing appropriate tax returns and paying outstanding tax, interest and penalties. It will still be better to do everything on time rather than relying on this new rule.

Offshore disclosure opportunity

The PBR includes measures to increase the penalties for "offshore tax evasion". People hiding their money from HMRC in offshore accounts will be subject to penalties of up to 100% of the tax evaded, and there will be separate penalties for failing to notify the opening of an account in certain foreign countries. This means that a total penalty of 200% could be levied, together with interest – if the tax rate is 40%, let alone 50%, the final liability is considerably more than the figure you started with.

At present, taxpayers have been invited to make a disclosure of any offshore assets that have been concealed from HMRC. It will be necessary to come forward by 4 January 2010 to qualify for a special reduced penalty regime. This is supposed to be "one last chance" before the higher penalties will apply in future. HMRC say that they have access to information from over 300 financial institutions which will identify UK taxpayers who have accounts abroad and have not disclosed them – so, once they have sifted through all that information, they will come looking for those who are still hiding.

Public sector pay and pensions

One of the biggest measures announced in the PBR is a cap of 1% on public sector pay settlements in 2011/12 and 2012/13, to deliver savings of £3.4bn a year, and reforms to public sector pensions from 2012/13, delivering another £1bn of savings. The Government has to cut spending, and its payroll is clearly one of the largest figures in the budget – but many public sector workers will feel that they are having to suffer for the rest of the country.

Tax avoidance

As usual, the Chancellor has used the PBR to close down a number of cunning tax-saving schemes across a range of taxes. These include schemes to exploit capital allowances, avoidance of stamp duty land tax, reduction of insurance premium tax, and ways of getting money into trust without paying inheritance tax. The Government's figures always include a saving from closing down these plans, but it is more likely that the planners will simply move their efforts elsewhere and hardly any extra tax will result.