

UK 2010 Emergency Budget GES Newsflash

If it counts, it's covered

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Introduction

George Osborne's first Budget, an "Emergency Budget", in his words was "tough but also fair". Given the nature of the Budget, as expected there were no wholesale changes for employers, rather he has confirmed or in some cases simply re-confirmed that there will be a wide range of consultations on matters ranging from the pension changes, operation of PAYE, anti-avoidance rules for trusts and other vehicles, and a review of geared growth arrangements.

The 50% tax rate is still with us, as are most of the other changes from the March Budget. However the predicted £1,000 increase to personal allowances did materialise, although only benefitting basic rate taxpayers.

There are a number of clear positives for employers though:

- The National Insurance changes will reduce costs for many employers;
- The CGT changes were significantly better than the worst predictions;
- The complex pension rules removing higher rate relief for contributions are likely to be replaced with a simpler regime.

Balanced against this though there remains significant uncertainty in a number of key areas and it is hoped that these can be clarified in the near future.

Our view

Overall the Budget was nowhere near as bad as it could have been for employers.

The Chancellor noted that the capital gains tax changes would discourage employers from using arrangements to convert income into capital, but with a 28% CGT rate comparing very favourably with 52% (income tax and employee NIC) arrangements allowing employees to participate in capital growth will continue to be of interest. The coalition has clearly listened to businesses and the suggested simplification of the pension reforms will be very welcome. However, the continued extent of consultation on matters such as the non-domiciled rules and compensation arrangements simply extends the uncertainty that businesses have found frustrating over the last few years.

1. Income tax and NIC rates and thresholds

The income tax-free personal allowance will be increased by £1,000 to £7,475 for all taxpayers under 65 from 6 April 2011. The maximum level of age-related personal allowance those older than 65 will not be known until September 2010, but appears not to attract this £1,000 increase.

To ensure that this measure does not benefit higher rate taxpayers, the basic rate limit for income tax will be reduced by £2,500, so this will not be tax neutral for 40% taxpayers. It appears that the threshold for the 50% rate will remain at £150,000.

The 1% increase to primary, secondary and Class 4 self-employed national insurance contribution (NIC) rates announced by the previous Labour government will remain. In addition, the primary and secondary thresholds will be increased.

- The primary threshold will be increased by the amount planned by Labour, which was up to the original personal allowance (expected to be £6,475) plus a further £570.
- The secondary threshold will be raised by an extra £21 per week over and above the indexed threshold that would have applied under Labour.

- Class 2 self employed rates are unaffected by these measures, but are expected to rise as normal in line with inflation.

The NIC Upper Earnings/Profit Limit will be reduced to align with the higher rate income tax threshold, meaning that no employees should pay 40% tax and 12% NIC on the same income.

The exact level of the basic rate threshold for income tax and the primary and secondary thresholds for NIC will not be known until after publication of the Retail Price Index (RPI) in September 2010.

Our view

The increase to the personal allowance is in line with expectations, given the aim of the coalition government to increase the personal allowance to £10,000 over the course of this parliament. The reduction to the basic rate income tax threshold by a greater amount was a surprise given the announcement suggested only that higher rate taxpayers would not benefit from the increase in personal allowance; it was not obvious they would actually pay more tax.

The reduction in the basic rate threshold will also represent an increased tax burden compared to 2010/11 for those earning over £112,950, as the increased personal allowance is phased out.

It is clear that the Labour promise to increase the Class 1 NIC primary threshold to £570 above the income tax personal allowance will be honored, and in fact the threshold is increased further for secondary contributions. However, it is unclear whether the primary threshold will be increased by £570 above the newly-increased personal allowance of £7,475 or above the previous personal allowance. Sources at HMRC confirm that it is the latter, and as such the exact threshold will not be known until after the RPI publication in September.

It seems likely that the NIC savings for employers will be counter-balanced by the need to update their payroll systems to account for different primary and secondary NIC thresholds, and the costs associated with this.

2. Regional Employer NIC exemption

New businesses setting up in the UK outside of the Greater South East and East Anglia during a three year qualifying period will not have to pay the first £5,000 of employer's Class 1 NICs due in the first 12 months of employment for each of the first ten employees hired in the first year of business. The exact demarcation between qualifying and non qualifying areas has not yet been confirmed.

Personal Service Companies (those caught under HMRC's IR35 rules) or individuals employed through Managed Service Companies will be excluded, as will employees engaged by individuals for personal domestic services, such as nannies, chauffeurs etc. Businesses in the coal sector are excluded and certain restrictions will apply to the agriculture and fisheries sectors, but these are as yet undefined.

The NIC holiday will start as soon as is practicable, probably from 6 September 2010. Businesses which meet the criteria setting up between 22 June 2010 and commencement will be liable to pay employer's NIC in the period before the start of the scheme. However, they will receive an NIC holiday of equal duration once the scheme starts.

Our view

This scheme may prove to be an effective encouragement to set up a new business, but it will unfairly discriminate against existing businesses taking on further, or their first employees.

We look forward to information being released on how the boundaries will be drawn for qualifying areas and the full range of exclusions before understanding the ability of employers to satisfy all relevant criteria.

3. Pensions

3.1 Pensions Tax: restricting higher rate relief

The Government has indicated an intention to do away with the 'high income excess relief' charge before it comes into effect on 6 April 2011. In its place it is considering capping the annual allowance at between £30,000 and £45,000, subject to discussion with interested parties. The anti-forestalling measures for 2009/10 and 2010/11 will not be disturbed.

The annual allowance limits the pension savings that can be made by or on behalf of an individual, with tax relief at the individual's highest marginal rate. Pension savings in excess of this amount attract an annual allowance charge, currently of 40%.

A number of other details are also still to be discussed.

Our view

This is a sensible measure and one that we and others in the pensions industry called for. It will achieve the Government's objective of limiting the amount of higher rate tax relief available to high earners who make pension contributions, without the complexities of the high income excess relief charge.

Employers looking for alternative ways of providing pension benefits outside the registered pension regime will need to take note of proposed anti-avoidance legislation in relation to trusts, yet to be announced. The Government has today confirmed this will include Employer Financed Retirement Benefit Schemes when it comes into effect from 6 April 2011.

3.2 NEST Pension Schemes

The new Government appears set to go ahead with plans to introduce National Employment Savings Trust (NEST) pension schemes from 1 October 2012. The legislation is expected to be phased in, affecting the largest employers from 1 October 2012 and the smallest from 2016.

Employers will be required to auto-enrol their employees in a qualifying pension arrangement and start making contributions to these schemes. The minimum contributions will be phased in starting at 2% of earnings (including 1% from the employer), rising to 8% of earnings (including 3% from the employer) by October 2017.

Employers with existing pension arrangements will be able to either enrol their employees into their existing schemes (assuming they fulfil the minimum requirements) or set up a new NEST scheme.

Our view

Auto-enrolment is likely to be an effective way of encouraging pension scheme membership amongst employees. Employers not currently offering contributions to pension schemes or those with a low uptake to their employer schemes are likely to experience a significant increase to their employment costs.

4. Enterprise Management Incentive plans – more companies to qualify

Although previously announced, it was confirmed in the budget that the Enterprise Management Incentive (EMI) plan legislation will be amended so that EMI options can be granted if the company granting options has a permanent establishment in the UK. Currently, to qualify companies are required to operate wholly or mainly in the UK. The changes will apply once the legislation receives Royal Assent. This widening of scope to qualify will be welcome news.

Our view

Notwithstanding the higher rate of capital gains tax that will apply to higher earners, EMI options are still significantly more tax efficient than realising a gain that is liable to income tax, such as on the exercise of an unapproved share option. Moreover, if an EMI option holder qualifies for "Entrepreneurs' Relief" on disposal of the shares, EMI options could become even more attractive – with gains of up to £5m being charged to tax at a rate of 10% rather than 50%.

5. Capital Gains Tax changes and impact on share rewards etc

In recent years, companies have utilised incentive plans that seek to deliver gains within the (more favourable) capital gains tax rather than the income tax regime. There are two measures that may impact on such incentive arrangements.

1. The rate of capital gains tax that will apply will increase from 18% to 28%, where an individual's total income and gains less allowances exceeds the basic rate limit (currently £37,400).
2. Where shares qualify for "Entrepreneurs Relief" on disposal, the gain is liable to CGT at a rate of 10%. The lifetime limit on the quantum of gains that can qualify for the 10% rate is to be increased from £2m to £5m.

The March 2010 Budget announced an intention to review "geared growth" arrangements involving employment related securities. HMRC today confirmed that a consultation will go ahead later this year - the stated purpose is *"to develop proposals to ensure that employment income from employment related securities is subject to income tax and National Insurance Contributions."*

Our view

For a 50% taxpayer the increase in CGT simply restores the differential between income tax and CGT to 22% (50% - 28%) as it was previously (40% - 18%). Therefore, compared with income gains, capital gains remain attractive. Capital gains are also not liable to NIC. It is, however, unclear what impact the review of "geared growth" arrangements will have on such arrangements.

HMRC approved plans should not be impacted by the review of geared growth arrangements. Such plans will therefore continue to be of interest as they can deliver gains within the CGT regime while also potentially giving rise to a statutory corporation tax deduction for the employer.

Some groups will be disappointed that the definition of qualifying property under Entrepreneurs Relief has not been broadened – for example to cover employee shares more generally. However, this is perhaps mitigated by the fact that the rate of CGT has not been increased to 40% or possibly even 50% as had been suggested.

6. Seafarers' Earnings Deduction

The Seafarers' Earnings Deduction (SED) will be extended to European Union (EU) and European Economic Area (EEA) residents who pay UK tax on their earnings as a seafarer for 6 April 2011.

SED provides for 100% tax relief from earnings received for carrying out duties as a seafarer wholly or partly outside the UK during an eligible period.

One of the existing qualifying conditions is that a claimant must be ordinarily resident in the UK. The condition will be amended so that EU or EEA residents who are not ordinarily resident in the UK are eligible for 100% SED for eligible periods.

Our view

This measure had previously been announced at the Pre-Budget Report in December 2009 and aligns the UK provisions with the EU Treaty (equal treatment of workers within the EEA).

This is a welcome provision as it will avoid the current mismatch between non-UK residents who are resident in the EU/EEA and individuals ordinarily resident in the UK who can claim 100% relief from UK tax under the SED provisions.

Non EU/EEA residents working in UK territorial waters who are either non resident or resident but not ordinarily resident in the UK remain subject to UK tax and will still need to rely on double taxation agreements to mitigate any double charge to tax, where the SED is not available.

7. Further anti-avoidance changes

General

The Government has announced that as part of its plan to tackle tax avoidance, it is to examine whether the use of a 'General Anti-avoidance Rule' would be appropriate.

If implemented, this would impact all taxpayers (individual or corporate) who engage in transactions which helped mitigate their tax liabilities but have not been specifically approved by HMRC.

Currently there are no fixed plans to implement such a regime and the government has only announced a review.

Our view

Where implemented in other countries e.g. Canada, such rules have resulted in enormous uncertainty as to whether or not transactions are caught by such rules. We suspect that upon review the new Government will likely conclude, in line with prior Governments, that such a rule would not be advisable.

Use of trusts

The March 2010 Budget announced action to tackle arrangements which sought to avoid, defer or reduce income tax and national insurance by using trusts and other vehicles to reward employees. The Government has confirmed that it is to continue with such measures. It was also confirmed that employer financed retirement benefit schemes ('EFRBS', an unapproved pension arrangement) would fall within the scope of these rules.

Any new legislation introduced is proposed to be effective from April 2011.

Our view

Although the Government has confirmed its intention to take action to counter a specific area of perceived avoidance, it remains to be seen what form these changes will take and how extensive they will be. This will be an important area to keep under review.

8. PAYE review

The Government has stated its intention to consult this summer with employers and payroll providers on mechanisms to support more frequent or real time processing of PAYE data. The Government is looking for ways to reduce costs and make the system easier for employers and HMRC to administer.

Our view

In general, we support any reduction in the burden to business of administering the tax regime. However, it is difficult to see any material savings to business unless responsibility to calculate taxable amounts is transferred to a central processing system, rather than that system being responsible only for processing payments. However, this would be a huge change and would need to be very carefully thought through. With other initiatives currently being considered, such as the payrolling of benefits in kind, it could be some time before any proposals to emerge from this consultation come to fruition.

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