Tax and Employee Incentives Law Update

WILMERHALE

Budget Update

On Wednesday, 22 March 2006, Gordon Brown delivered his tenth consecutive Budget. The Budget speech itself was a mix of finance-related reports and changes on the one hand and, on the other, a summary of the policies of a Prime Minister in waiting. As a result, there were few headline-grabbing tax changes. However, as always, the various Budget day notices contain a wealth of measures that will impact day-to-day business. This short Budget briefing highlights a few areas that may be of particular relevance to our clients.

Stamp Duty – Delaware Flips

Many of our UK clients have effected a "Delaware Flip" – a process whereby a new US holding company is created, with a view to achieving greater valuations and business opportunities in the United States. The most common method used to effect a Delaware Flip is a share-for-share exchange – shareholders simply sell their existing shares in return for shares in the new holding company. One downside of this route is that stamp duty is payable (broadly, 0.5% of the market value of the UK company at the time of the Delaware Flip). However, a court-sanctioned scheme of arrangement can also be used to effect a Delaware Flip, a method that does not give rise to a stamp duty charge.

The Chancellor has announced the removal of the stamp duty charge on a simple share-for-share exchange into a non-UK holding company. When this change comes into effect (probably in July or August), there will be no stamp duty saving to offset the complexities of a scheme of arrangement (although there may may be non-tax reasons for undertaking such a scheme).

EU Loss Relief Claims Following Marks and Spencer

As expected following the Government's defeat in the European Court of Justice in the Marks and Spencer group loss relief case, the Budget includes an extension to the group loss relief rules that will enable losses incurred in a subsidiary that is tax resident in another EU Member State to be set against profits of a UK parent company. The background to this issue was addressed in our May 2005 Tax and Employee Incentives Law Update.

It is disappointing, though entirely expected, that the revised loss relief rules have been very narrowly drawn. First, the loss-making subsidiary must be tax resident in another EU Member State (there had been vain hopes that the rules would be extended to cover subsidiaries tax resident in treaty jurisdictions such as the United States, as well as EU Member States). Second, in order to use the losses in the UK, it will be necessary for the UK parent company to show that it is no longer possible to use the losses in the country in which the EU subsidiary is tax resident. This would seem to require complete closure of the overseas operation. Third, it would appear from the Budget press release that there will be a requirement for the loss-making subsidiary to have a UK parent company. Thus, if, for example, a US parent company has two direct subsidiaries – one in the UK and one in France – the losses of the French subsidiary could not be set against profits of the UK subsidiary. An intermediate UK holding company may well be required in order to create a UK parent company to utilise the losses of the overseas subsidiary. However, the detail of the final legislation will be critical on this point.

No stamp duty on Delaware Flips

Narrowing of the EIS and VCT Schemes

Unfortunately, the Budget includes various restrictions on venture capital trust (VCT) and enterprise investment (EIS) schemes.

At present, investors in VCTs are able to obtain income tax relief at 40% on the amount of their investment and need only hold their shares in the VCT for three years to secure this income tax relief. For subscriptions on or after 6 April 2006, the income tax relief will be reduced to 30% and shareholders will need to hold their shares in the VCT for five years. The EIS relief, however, is being maintained at 20%, as is the EIS three-year holding period.

Tax saving schemes closed with retro-spective effect

Perhaps the most significant change is that relating to "qualifying companies". For EIS income tax relief to be granted, an EIS investor must invest in a qualifying company. For a VCT to retain its tax-approved status, the VCT must invest certain percentages of its funds in qualifying companies. There are numerous criteria that determine whether or not a company is a qualifying company for these purposes. One requirement, under the old rules, was that the gross assets of the company (or group, if the company is a holding company) are not more than £15m prior to the EIS (or VCT) investment and not more than £16m after the investment. These limits have now been reduced to £7m and £8m, respectively. This is a disappointing move by the government, since it will greatly reduce the number of companies that can attract EIS or VCT investment.

One small piece of good news concerning EIS is that the annual EIS investment limit (being the limit on the amount on which income tax relief will be granted) has been increased from £200,000 to £400,000.

R&D Tax Credit

The R&D tax credit scheme has the unusual consequence that a successful claim by a small- to-medium sized enterprise (SME) results in payments being made by the Revenue to the company concerned. Larger companies can obtain an enhanced deduction for R&D spending. An SME must meet a number of conditions to qualify for this tax credit. Currently, SMEs must employ less than 250 people. This limit is to be increased to 500 employees. However, this is subject to certain EU approvals and so it is not known when this change will come into force. The resulting delay is likely to enable the government to try to gain additional political credit by re-announcing this measure over the course of several Budgets and pre-Budget reports.

Disclosure Rules

In 2004, the Chancellor introduced rules requiring companies and their advisers to notify the Revenue of tax avoidance schemes concerning, in the main, employment arrangements or financial products. The idea was to ensure that the Revenue became aware of such schemes early on, so that measures could be taken to shut them down. Many arrangements have been disclosed since the 2004 rules were introduced. The Budget contains yet more examples of action being taken against tax avoidance schemes. An important addition is that the Budget widens the scope of these disclosure rules so that they now apply to **all** taxes.

One particularly interesting example is an arrangement under which bonuses are essentially paid in options to achieve, at the very least, a tax deferral. New legislation intended to stop this arrangement will be brought in with effect from 2 December 2004 – i.e., with considerable retrospective effect. 2 December 2004 marks the date of a broad statement by government that whenever they become aware of tax avoidance schemes, they would introduce legislation to close down those schemes, possibly from that date. However, at that stage, the schemes in mind were not identified. It is now clear that any existing or new tax avoidance schemes are in danger of being closed with **retrospective** effect.

FOR MORE INFORMATION ON THIS OR OTHER TAX EMPLOYEE BENEFITS MATTERS, CONTACT YOUR USUAL WILMERHALE LAWYER, OR:

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