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Business and capital taxes

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Outline

- Corporation tax changes (cost £2.2bn)
- Bank tax (raises £2.4bn)
- Employer NICs relief for start-up businesses (costs one-off £0.9bn)
- Capital gains tax (raises £0.9bn)
- Pension tax relief (revenue-neutral)
- Other small measures

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Corporation tax

- Cut headline rate from 28% to 24% over four years
  - Costs £3.6bn
- Cut small companies' rate from 21% to 20% from April 2011
  - Had been due to rise to 22%
  - Costs £1.4bn
- Cut allowance for plant & machinery investment from 20% to 18% from 2012
  - From 10% to 8% for certain long-life assets etc.
  - Raises £1.8bn
- Cut annual investment allowance from £100,000 to £25,000 from 2012
  - Raises £1.0bn
- Consultations on difficult issues
  - Foreign profits, R&D tax credits, intellectual property, small business taxation

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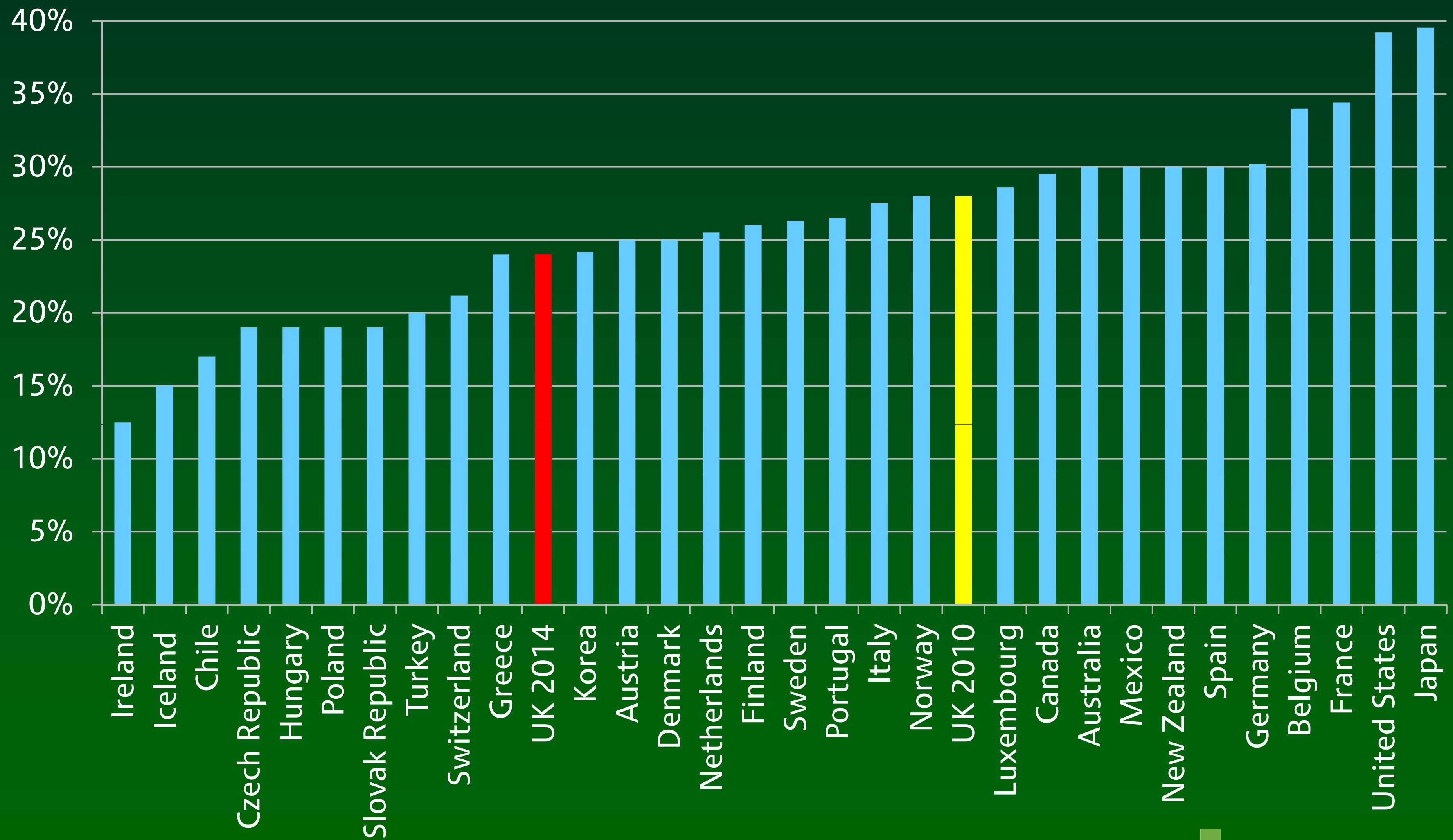
Headline corporation tax rates in 2010



Source: OECD

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Rate cutting, base broadening

- Very much in keeping with historical and international trends
- Biggest benefits go to low-investment, high-profit firms
  - Banks and supermarkets rather than manufacturers
- Cut in main rate is welcome
  - HMT estimate greater competitiveness reduces cost by 23%
- But cut in small companies' rate is less welcome
  - No clear reason to favour companies with low profits
  - Worsens avoidance problem – HMT estimate extra incorporations increase cost by £0.2bn
- And cutting capital allowances is not a good way to raise money
  - Capital allowances are an efficient way to promote investment
- Reform is not a simplification

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Bank tax(es)

- Tax on banks' liabilities (if they exceed £20bn)
  - Excludes tier 1 capital, insured deposits, and half of 1yr+ wholesale funding
  - Final details subject to consultation
  - Tax rate 0.04% from 1 January 2011, 0.07% from 2012
  - Forecast to raise £2.4bn

- Very similar to IMF's proposal for a 'Financial Stability Contribution'
  - And similar to US and Swedish reforms

- Also want to 'explore…a Financial Activities Tax'
  - IMF's second proposal
  - Tax on remuneration + profits
  - Could substitute for missing VAT on financial services

A tax on banks' liabilities

- Cost likely to be passed on in large part to customers
- Two stated objectives…

1. Raise revenue
   - '…a rebalancing of the burden of taxation between banking and other sectors'
   - Pay for past and future bail-outs?
   - But why tax their liabilities specifically…?
2. Reduce risk
   - '…intended to encourage banks to move to less risky funding profiles'
   - But HMT also say they expect little behavioural response!
   - What role for tax vs regulation?

- International issues to resolve

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NICs break for start-ups

- Exemption from…
  - One year's employer NICs in respect of…
  - The first 10 employees hired…
  - In the first year of trading…
  - By businesses set up in the next 3 years…
  - Outside London, the South-East and Eastern England…
  - Up to a maximum of £5,000 per employee

- One-off cost of £0.9bn, spread over the period

NICs break for start-ups

- Complicated!
  - What happened to ‘a simpler, flatter tax system’?

- Obvious potential for avoidance

- Why favour start-ups over existing companies?
- Why only certain regions?
- Why only temporary?

Capital gains tax

- Rate increased from 18% to 28% for higher-rate taxpayers
  - And entrepreneurs' relief lifetime limit increased from £2m to £5m
  - Raises £0.9bn
- Winners: owner-managers making gains >£2m on their business
- Losers: higher-rate taxpayers making gains on ordinary shares, 2nd homes, etc
  - But note widespread exemptions: main homes, ISAs, pensions, SIPs,…
  - And the £10,100 annual allowance is being kept
  - Assets can be transferred to a spouse or civil partner to use both annual allowances and basic rate bands

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Capital gains tax

- Move towards alignment with income tax rates is welcome
  - Reduces scope for avoidance
  - No reason to favour capital gains over ordinary income
  - No reason CGT alone should have no higher rate
- Discouragement to saving and investment is unwelcome
  - There are better ways to encourage saving and investment
  - But this Budget cut capital allowances instead
- Overall, probably a step in the right direction. But…

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Capital gains tax: a missed opportunity

- No discernible vision of how savings should be taxed and where CGT fits in
  - Lack of strategic thought does not bode well for stability
- Still some way from alignment
  - Is 28% 'similar or close to' 50% (or even 40%)?
  - Should also take account of NICs and corporation tax
  - Keeping entrepreneurs' relief forgoes much of the benefit of alignment
- Indexing for inflation would probably be worth the complexity
- Thankfully, also missed an opportunity to reintroduce taper relief

Tax relief on pension contributions

- Current system:
  - Pension contributions excluded from taxable income
  - So tax relief is at marginal rate
  - Subject to an annual limit of 100% of earnings or £255,000
  - And a lifetime limit (maximum pension pot) of £1.8m
- Labour proposal:
  - Reduce tax relief for very high earners, to 20% above £180k
  - To raise £4.6bn
- Coalition proposal:
  - Reduce annual limit to about £30-45,000
  - To raise the same as Labour's proposal

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Tax relief on pension contributions

- Winners: People on very high incomes making moderate pension contributions
- Losers: Less-high-income people making large annual contributions
- Revised proposal is a big improvement
  - Labour's proposal was complex, unfair and inefficient
  - Simply reducing the amount that can be saved in pensions makes much more sense
  - Some complexity remains – still need to value employer contributions to defined-benefit pensions
- Better: unlimited contributions, but less generous treatment?
  - Put a cap on the 25% tax-free lump sum? (Currently £437,500)
  - Charge NICs on employer contributions?

Other measures

- End of compulsory annuitisation at age 75
  - Gives savers more flexibility
  - But there are good reasons to force annuitisation of pension pots
  - Notably adverse selection

- Cancel or defer some of the previous government's plans
  - Tax relief for video games industry
  - Backdated business rate rises for ports
  - Changes to rules for furnished holiday lettings
  - Introduction of Managed Payment Plans

- Consider the case for a General Anti-Avoidance Rule

Summary: winners and losers

- Winners:
  - Most companies (most likely their employees or customers)
  - Those setting up businesses in certain areas, and their employees
  - Some well off business owner-managers
  - Some well-off pension savers

- Losers:
  - Bank customers
  - Investors making little profit
  - Higher-rate taxpayers making large gains on unprotected assets
  - Other well-off pension savers

Conclusions

- Very welcome change of direction on pensions tax relief
- Corporation tax and CGT rates moved in the right directions
- Decisions on tax bases less welcome
  - Action on capital allowances and inaction on CGT base unfortunate
  - Rationale for bank levy not clear
  - NICs break for start-ups looks complicated and prone to avoidance, and odd targeting creates distortions and unfairness
  - ➢ Little sign (yet) of long-term strategic thinking

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