Tax First

Keeping tax professionals up-to-date*

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Banking & capital markets | Finance & treasury | HR | Indirect tax | R&D tax incentives | Calendar

Welcome to the February issue of Tax First.

2010 is set to be a pivotal year for many businesses, as the UK economy finally moves in the direction of recovery.

As mentioned in our December issue, the Chancellors Pre-Budget Report (PBR) introduced the bank payroll tax, and in the banking and capital markets section of this issue we detail HM Revenue & Customs' (HMRC) clarification on the scope of the legislation and which financial services institutions will be effected. We also look at how HMRC's approach to dividends received by UK companies appears to be changing, as well as confirming that the Court of Appeal's *Vodafone 2* judgment is now final.

In finance and treasury news, we outline one important anomaly from Finance Act 2009 debt cap rules, governing UK deductions for intra-group interest expense, and also examine debt cap rule changes published for consultation with the PBR.

With bonuses still very much in the limelight, the HR section highlights the release of PricewaterhouseCoopers' *Executive Compensation - Review of the Year 2009,* which this year shows that FTSE executives' pay increases have been outstripped by UK average pay increases for the first time in a decade.

The indirect tax section focuses on HMRC's detailed guidance on dealing with 'Fleming' claims, including the current state of thinking within HMRC concerning the principal 'themes' of claims. We also highlight how the European Commission (EC) has challenged eight member states, including the UK, with regard to the application of VAT grouping.

To round up this issue, we examine the opportunities for R&D tax incentives – HMRC has recently changed its practice on which activities are eligible, so it may be advisable to claim whilst you can!

I hope you find this issue both interesting and informative; if you have any thoughts or comments on any of the topics covered, then please do contact me.

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Tax partner
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Potential change of HM Revenue & Customs' approach to dividends following capital reductions

HM Revenue & Customs' (HMRC) approach to dividends received by UK companies, where such dividends are paid out of reserves created as a result of a capital reduction, appears to be changing. If it seeks to treat such dividends as capital, this would have potentially significant implications not only for future transactions of this type, but also potentially in relation to transactions that have been undertaken historically. We understand that HMRC policy on this issue is still under review and is not yet final. HMRC is aware that this issue is causing considerable concern and is dealing with it as a matter of urgency.

The First-Tier Tribunal case, *First Nationwide v The Commissioners for HMRC,* has recently found that a dividend was not capital in nature merely because it was paid by a Cayman Islands company out of its share premium account. Use of the share premium account in this way is not permissible under UK company law, but the Tribunal judgment provides encouragement for our view that if HMRC were to pursue the argument above on amounts paid out of reserves created by a capital reduction it would be unsuccessful.

PricewaterhouseCoopers (PwC) is continuing to press HMRC at all levels for early resolution of its views. In the meantime, companies wishing to pay such dividends need to consider the potential downside if HMRC decides to pursue this policy and is ultimately successful in its arguments.

Vodafone 2: Court of Appeal's May 2009 judgment for HMRC on the UK controlled foreign company rules is now final

On 22 May 2009, the Court of Appeal found for HMRC in the *Vodafone 2* case on the compatibility of the UK controlled foreign company (CFC) regime with the European Community (EC) Treaty. The Supreme Court registry has now said that Vodafone has been refused leave to appeal that judgment – which accordingly is now final. The Court of Appeal's decision was that the UK CFC regime is capable of being interpreted in a way which conforms to the EC Treaty – now the Treaty on the Functioning of the European Union (TFEU) – and cannot, therefore, be disapplied. However, even based on this conforming interpretation (or 'reading down'), CFCs which are established in an European Union (EU) or European Economic Area (EEA) state and carry on genuine economic activities there should still be able to rely on the TFEU freedom of establishment to avoid a CFC charge.

The consequences of the Court of Appeal judgment are that treaty protection from the historic (pre-Finance Act 2007) UK CFC regime for EEA subsidiaries will have to be sought on a case-by-case basis, demonstrating that each EEA subsidiary is genuinely economically established and not a wholly artificial arrangement.

Court of Appeal to hear *Prudential* case on legal professional privilege for accountants

As expected, the Court of Appeal has agreed to hear Prudential's appeal against the High Court's October 2009 judgment (for HMRC) that legal professional privilege does not apply to advice given by accountants on tax law. The question of whether legal advice given by accountants is subject to legal professional privilege is a fundamental one. This latest development means that clients can continue to withhold tax advice documents on the basis that the issue is ongoing before the Courts and has not been finally determined. The Court of Appeal hearing is likely to take place in the autumn. For further information, please see the Legal section of the December 2009 issue of Tax First.

Bank payroll tax amendments to clarify scope proposed by HMRC

HMRC has issued clarification of the new bank payroll tax which was announced in the Chancellor's 9 December 2009 Pre-Budget Report. HMRC accepts that the scope of the tax as originally defined caught too wide a range of financial activities. It has, therefore, now proposed some amendments to the draft legislation with a view to specifically excluding certain activities and making it clear exactly which activities are included. HMRC believes that these changes address most of the representations made concerning the definition of banks and banking groups. In addition, HMRC is working with representative bodies and individual groups to address further representations to clarify the scope and effect of the proposed legislation.

Entities which have the following characteristics will be treated as banks and will be within the scope of the bank payroll tax:

- Deposit takers.
- Any full scope BIPRU (Prudential sourcebook for Banks, Building Societies and Investment Firms) 730k investment firm whose activities consist wholly or mainly of relevant regulated activities.
- A foreign entity which would be a full scope BIPRU 730k investment firm if it were resident in the UK.

Companies who are not part of a banking group and are not a BIPRU 730k firm (and not a deposit taker) will be excluded from the tax. In addition, entities with the following characteristics will be excluded:

- Prime brokers who are full scope BIPRU 730k firms.
- A non-deposit taker that only carries on regulated business on behalf of an insurance company in the same group.
- A manager of a pension scheme who does not carry on any other relevant regulated activities.
- A company which wholly or mainly operates collective investment schemes.

Exempt BIPRU commodities firms.

In respect of the activities of a banking group, HMRC have clarified the meaning of 'banking employment'. As such, non-propriety activity will be excluded from the meaning of 'banking employment' if it is neither directly nor indirectly concerned with relevant regulated activities or the lending of money. For example, HMRC considers that the following do not amount to 'banking employment':

- Providing non-financial insurance services to external policyholders.
- Operating a collective investment scheme for external investors.
- Dealing and arranging deals as agent, rather than for own account, as part of the discretionary management of the assets of external clients, or of insurance companies which are members of the same banking group.

In addition, it is also proposed to exclude non-banking financial services groups where a group company carries on banking activities, but these activities are minor compared with the group as a whole. In this case the company carrying on the banking activities would be in the scope of the new tax but the rest of the group would not be. No details have been given as to what would be regarded as 'minor'.

For more information on any of the above, please contact:

Justin Woodhouse on 020 7804 6750

Debt cap 'de minimis' trap highlighted

Finance Act 2009 makes significant changes to the rules governing UK deductions for intra-group interest expense – the debt cap. One important anomaly – which is damaging to taxpayers – arises from the 'de minimis' thresholds of £500,000 in each company for 'net financing deductions' and 'net financing income'. This trap can affect normal commercial arrangements such as:

- concentrating operating subsidiaries' cash surpluses in one company;
- 'conduit' financing companies with large gross income/expense but small net income; and
- intercompany balances outstanding from 'hive up' or 'hive across' transfers.

Click here for further information

Debt cap amendments published for consultation with Pre-Budget Report leave further work to do

Draft legislation amending the debt cap rules was published as part of the Pre-Budget Report (PBR). This legislation is intended to be included in Finance Bill 2010 but will take effect retrospectively from 1 January 2010, when the rules as a whole took effect to restrict relief for UK interest by reference to the financing costs of the worldwide group. The amendments made by this proposed legislation are largely as previously advised by HM Treasury; however, some matters on which we have asked for clarification or change have still not been addressed. The draft legislation also gives HM Revenue & Customs (HMRC) powers to address mismatches between tax and accounting treatment of certain amounts. HMRC invited taxpayers to make representations on this draft legislation, with the consultation having closed on 29 January 2010.

Click here for more information

IFRIC 19 clarifies IFRS accounting for debt to equity swaps with unconnected parties

The International Financial Reporting Interpretations Committee (IFRIC) has issued IFRIC 19, which clarifies the accounting – under International Financial Reporting Standards (IFRS) only – for debt to equity swaps. IFRIC 19 provides that the borrower must recognise (in profit and loss account) the difference between the carrying value of the loan liability and the fair value of the equity instruments (shares) issued. It generally only applies to debt to equity swaps between unconnected parties. It comes into force for annual periods beginning on or after 1 July 2010, although early adoption is permitted.

Click here for further information

For further information, please contact:

Neil Edwards on 020 7213 2201
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FTSE executives' pay increases outstripped by UK average pay increases for first time in a decade

Executive Compensation - Review of the Year 2009

On 21 January 2010, the PricewaterhouseCoopers annual report on executive compensation was released. The main findings of the report are as follows:

- 2009 national average earnings increases (2.5%) outstripped FTSE 100 (1%) and FTSE 250 (0%) executive base pay increases for the first time in a decade.
- Around one-in-six FTSE 100 executive directors did not receive a bonus in 2009, with median bonus payments falling 20%.
- Shareholder opposition to remuneration proposals grew - 20% of FTSE 100 companies had more than one in five of their shareholders withhold support for the remuneration report, up from 3% in 2008.
- There is a need to move beyond the narrow constraints of current practice to prove pay for performance can be a force for good.
- Governance models need to adapt with greater recognition of risk in performance measurement in all sectors, not just financial services.
- Non-executive director fees likely to rise with increasing responsibilities and time commitment.

To read the report in full, please click here

Moderation in executive pay, but is it enough?

PwC's annual report of FTSE remuneration, *Executive Compensation - Review of the Year 2009,* was released on 21 January 2010 and shows that FTSE 100 companies have exercised pay moderation in response to the recession. Median increases in base salary for FTSE 100 and FTSE 250 executives fell to 1% and 0%, respectively, in 2009 and were outstripped by the national average earnings base pay increase (2.5%) for the first time in a decade. In 2008, increases were 6% for both the FTSE 100 and FTSE 250 while the national earnings pay increase was also higher at 3.7%.

Our research also found that median maximum bonus potential for chief executive officers (CEOs) remained stable at 150% of salary in the FTSE 100, equivalent to around £1.2m, and 100% in the FTSE 250, which would equate to around £425,000 if paid out in full. But, actual bonus payments decreased by 20% in 2009 reflecting business performance and the economic climate. The median bonus payout for CEOs in the FTSE 100 and FTSE 250, respectively, were £525,000 and £217,000.

The number of executives receiving nil bonuses doubled in the FTSE 100 last year and increased by 40% in the FTSE 250. In practice, this means one in six executive directors in the FTSE 100 and FTSE 250 did not receive a bonus in 2009. This statistic is significantly influenced by banks, which in many cases did not pay bonuses in 2009.

Median total long-term incentive grants values fell slightly at CEO level with the median economic value of awards now at 140% of salary – roughly equivalent to just over £1m. This compares with 150% in 2008. Companies experiencing significant falls in share price have scaled back award levels by anything between 20% and 40% in response to shareholder pressure. The most common plans remain performance share plans, deferred bonus plans and share options.

Notwithstanding this moderation, shareholder opposition to remuneration proposals grew, with 20% of FTSE 100 companies having more than one in five of their shareholders withhold support for the remuneration report, up from 3% in 2008. The majority of contentious AGMs arose outside the banking sector.

Spill-over from banking into wider sectors

While the stated focus of the Financial Services Authority (FSA) Code of Practice and the one-off 50% payroll tax levy on bankers' bonuses is to change behaviour in the banks, the repercussions of this and other prescriptions for remodelling the way executives in the broader financial services sector are remunerated will be felt by FTSE-listed companies.

There is already wide-spread use of deferred bonuses in the FTSE 100, which is consistent with the prescriptions set out for the banking sector by the FSA. Some 72% of FTSE 100 companies (46% in FTSE 250) operate a deferred bonus plan, in which executives defer some of their annual cash bonus into shares. Around three quarters (two thirds in FTSE 250) of these have a compulsory element to deferral.

The need for a new remuneration model

PwC research over several years has shown that current long-term incentive plan designs frequently fail in their objectives of motivating executives and aligning reward with performance.

Non-executive director (NED) fees

Median FTSE 100 chairman fees stand at £300,000 and director fees at £62,000. Median additional fees for an audit committee chair are £18,000 while typical membership fees in the FTSE 100 remain between £5,000 and £10,000. Senior independent director fees are now £12,500.

PwC executive remuneration perspectives

The report contains trend data for the FTSE 100 and FTSE 250, including: base salary; annual bonus; deferred bonus plans; long-term incentives; performance measures; pensions; total compensation; and non-executive director fees, together with a collection of points of view on compensation design, governance and required action.

For more information, please contact:

Tom Gosling on 020 7213 3973

European Commission challenge on VAT Grouping

The European Commission (EC) has announced that it has formally requested eight member states, including the UK, to amend their legislation with regard to the application of VAT grouping. As regards the UK, the proceedings are concerned with the inclusion of 'non-taxable persons' within a VAT group. For these purposes, a 'non-taxable person' broadly equates to a company which is not in business and will therefore include both passive holding companies and dormant companies.

However, there is a concern that the definition of 'non-taxable person' may also extend to companies that make supplies on an infrequent basis. In the Commission's view, the opportunity to join a VAT group should be available only to those that are 'taxable persons' in their own right. It is for the UK to either accept the Commission's view (and alter UK VAT law accordingly), or contest it – which is likely to result in a case being brought before the European Court of Justice (ECJ). If the Commission's argument ultimately prevails, the UK will be required to change its rules and restrict the entitlement of certain companies to be registered as part of a VAT group.

In light of these developments, clients should review their VAT Group and determine the potential implications and whether any restructuring is necessary.

PwC recently held a webcast covering the EC challenge on VAT Grouping. To watch a recording of the webcast, please click here.

For further details please contact your usual PwC VAT adviser or Michael Bailey on 020 7804 3254

HM Revenue & Customs publishes detailed guidance on dealing with 'Fleming' claims

Businesses with 'Fleming' claims that remain unresolved may be interested to see how their claims are regarded by HM Revenue & Customs (HMRC) in principle.

The new guidance lists the principal types, or 'themes' of claims which have been submitted, the types of evidence which HMRC officers should request to support the claims, HMRC policy regarding the issues underlying the claims and instructions to officers as to how, or if, the claims should be progressed. Please click here for details of guidance and 'themes'.

The guidance is a useful summary for businesses and advisers as to the current state of thinking and policy within HMRC concerning the principal 'themes' of 'Fleming' claims, albeit with the caveat that some aspects already need updating to recognise recent developments.

It may be possible to determine, for any given claim which falls within one of the 'themes', how HMRC is likely to act based on the guidance, but there are clearly many variations on a 'theme' and each claim will have to be dealt with on its own merits. Undoubtedly, there are differences of opinion between HMRC, claimants and their advisers and those will have to be resolved in due course, but it is to be hoped that, with the creation of its 'Fleming' teams and this new guidance, HMRC will now be able to progress claims that have been lodged for some considerable time.

If your business has submitted a claim which falls within one of these 'themes', you may wish to speak to your PwC VAT adviser to discuss the claim in the light of HMRC's guidance.

PwC are running a 'Fleming Forum' event on 1 March 2010. For details, please click here.

Alternatively please contact Michael Bailey on 020 7804 3254

R&D tax incentives – claim them while you can?

HM Revenue & Customs (HMRC) has recently changed its practice on activities that are not ‘hands-on’ research & development (R&D) but support the R&D undertaken by others. These ‘qualifying indirect activities’ include maintenance, security, administration and clerical activities. – and this has resulted in an increase in claims of between 10-25% or more.

Most importantly, the change applies immediately and amended claims have to be made by the second anniversary of the period end. For example, a company with a 31 March year end must amend its claim for the period to 31 March 2008 by 31 March 2010 or forego the increased relief. This follows increases in the cash value of R&D incentives: for small to medium enterprises (SMEs), rising from £15 for every £100 of R&D spend to £21 from 1 August 2008, while for larger companies the incentive rose at 1 April 2008 from £7.5 to £8.4 for every £100 of R&D.

Some companies’ claims have increased even more significantly. Originally, a company could only be classed as an SME if staff numbers were less than 250 and either its turnover was not more than €50m or balance sheet gross assets were not more than €43m (all measured on a group basis). From 1 August 2008 these thresholds doubled. Consequently, companies which were over the old thresholds but under the new doubled ones have become entitled to the SME relief with their R&D claims increasing nearly threefold from £7.5 to £21 per £100 of R&D.

Finally, for SMEs to be entitled to their more generous relief, they had to own any intellectual property (IP) resulting from their R&D, but this ownership requirement was abolished in the Pre-Budget Report for periods ending on or after 9 December 2009.

In view of the above, everything might appear perfect in the world of R&D incentives. However, this is not the case.

Of most concern is the possibility that the R&D incentive will be withdrawn completely, or at least for large companies. Government borrowing is at an all time high and incentives that are not achieving policy objectives could be withdrawn, particularly if they are seen to be being ‘abused’. There has been much press coverage in recent months, nearly all directed against HMRC, suggesting the R&D incentive is being mishandled. However, the coverage generally does not show how this has come about.

Some companies, perhaps encouraged by advisers, have pushed the limits of what qualifies as R&D. Substantial claims have been made where HMRC see little evidence of technological uncertainty being overcome. For example, manufacture of products in circumstances very similar to ordinary production and after extensive pilot scale testing is being claimed. HMRC’s response has been to rely on an exclusion in the definition of R&D which disqualifies ‘production’ of goods and services. The exclusion allows HMRC to reject these claims without the harder task of evidencing that they did not involve R&D. Claimants are arguing that this was never the intention of the disqualification for production.

Application of the production exclusion may restrict some entirely innocent claims. For example, a company aiming to deliver a small number of working prototypes to a customer for testing might find that its unsuccessful early attempts at making working prototypes are disqualified, not just the prototypes ultimately delivered.

Whatever the merits of each party’s position, the way this has been communicated means there is a danger that the overall perception is that the incentive is being abused by claimants, mishandled by HMRC, or both, and this increases the possibility of the withdrawal of the incentive – a leading think-tank paper has recently advised that the incentive should be retained for SMEs but abolished for large companies.

In summary, companies should claim the extra tax reliefs on qualifying indirect activities while they can. Those concerned that tax reliefs may be withdrawn should campaign through industry organisations for the preservation of the incentive and a fair resolution of the production issue, recognising production has so far been disqualified but could be allowed in the future.

This article originally appeared in the January issue of UK Science Park Association magazine – *Innovation Into Success*

For more information on R&D tax incentives, please contact

Diarmuid Macdougall on 01895 522112

February

1 The future of UK GAAP: Accounting Standards Board consultation period ends

The new European Commission will take office with a five year mandate

Department for Business Innovation and Skills (BIS) consultation on the default retirement age ends

10 ICTA seminar: *CFC reform* Millennium Gloucester Hotel, London

11 Indirect tax forum, PricewaterhouseCoopers. Edinburgh

14 Double taxation agreements and double contribution agreements negotiating priorities 2010/11 – HMRC consultation period ends

19 Disclosure of tax avoidance schemes (DOTAS/TAD) – HMRC consultation period ends

24 ICTA seminar: *The end of UK GAAP and what you can do now,* Charing Cross Hotel, London

26 HMRC expects to have sent letters to businesses affected by online filing and electronic payment of VAT requirements applicable from 1 April 2010

March

1 *Fleming Forum* event, Institute of Directors, London

Department for Work and Pensions (DWP) Pension schemes: disclosure of information requirements – consultation period ends

Pensions Regulator draft revised guidance on pension scheme internal controls – consultation period ends

3 ICTA seminar: *The future of the UK tax system,* Holborn Bars, London

Pre-Budget Report: consultations on proposed pensions legislative changes – consultations end

9 *IBC International Transfer Pricing Summit 2010,* Hilton London Paddington Hotel

18 ICTA Seminar, *Senior Accounting Officer,* Holborn Bars, London

31 Last chance to make common law EC Treaty claims for repayment of direct tax

International transfer pricing event

PricewaterhouseCoopers (PwC) is sponsoring the IBC *International Transfer Pricing Summit 2010*. The event will be chaired by Ian Dykes from the PwC transfer pricing network and will feature presentations from more than 25 corporate heads of transfer pricing from leading multinational enterprises and FTSE 100 and Fortune 100 companies. The keynote speech will be delivered by Caroline Silberztein from the Organisation for Economic Cooperation and Development (OECD) and other speakers include PwC transfer pricing specialists and representatives from HM Revenue & Customs.

Location: Hilton London Paddington Hotel
Dates: 9 and 10 March 2010
A 50% discount is available by quoting VIP code TT12 when registering.

To register contact IBC directly on:

Tel: + 44 (0) 20 7017 7312
Email: kpatel@iir-conferences.com
Please visit the event website for more information

For full details of the ICTA seminars, Indirect tax forums and the Fleming Forum event, please follow the link below:

ICTA seminars, click here

Indirect tax forum, click here

Fleming Forum, click here.

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