



Accountants &  
business advisers

# autumn statement

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## Not a Pre-Budget Report

The Chancellor's Autumn Statement was a much lower profile event than the Pre-Budget Reports of recent years with his speech lasting less than 20 minutes. Responding to the Office for Budget Responsibility's *Economic and Fiscal Outlook* report, George Osborne claimed that the coalition Government's plan for economic recovery was working and would be reinforced with a range of corporation tax reforms and a consultative growth planning process.

The corporate tax reforms suggested in the Emergency Budget in June 2010 are to be incorporated into a 'Corporate Tax Road Map' covering the rest of this parliament. The road map is designed to make the UK a more attractive home for international business. The Government's aim is to simplify UK corporation tax (without losing attractive elements such as the UK's debt interest relief regime) and reduce the main rate of corporation tax to 24% by 2014/15.

These changes will take some time to materialise as there is to be considerable consultation at each step. However, by setting out the general direction of the reforms the Government is clearly seeking to minimise corporate migration now with the promise of more beneficial rules in the future.

# Innovation and intellectual property

The Chancellor has confirmed plans to introduce a 'patent box' with effect from 1 April 2013, giving a 10% tax rate on profits falling within the regime. This will focus solely on patents rather than wider forms of intellectual property (IP).

The stage one consultation issued on 29 November also gives some details of the Government's thoughts on how such a regime will develop, including:

- entry to the regime will be optional, to avoid placing an unnecessary compliance burden on businesses that may only obtain marginal benefits
- the intention is that all patents first commercialised after 29 November 2010 will qualify for inclusion, subject to specific qualification and transitional rules
- the patent box will be available for both royalty

income and embedded income included in the price of patented products

- the intention is for the preferential rate to apply to net patent income after associated expenses (including pre-commercialisation expenses)
- the relief will not incentivise the purely passive holding of IP.

The Government is consulting on methods of preventing abuse, such as linking the amount of income which may be attributed to the patent box to the level of ongoing R&D or manufacturing activity, but does not intend any such rules to limit the benefit of the regime to any businesses genuinely engaged in patent development. It has indicated that it would welcome views from business on the form such rules might take. The stage one consultation is open until 22 February 2011, with the intention being to deal with the second and third stage consultations in time for the regime to be enacted in Finance Act 2012.

## Research & development tax credits

Despite concerns raised following the Dyson Review, the Government has indicated, in the consultation issued on 29 November 2010, that it does not intend to restrict qualification for R&D tax credits to specific sectors as the scheme is intended to remedy a market failure that exists for companies across the economy. This is good news for those companies that are not in the high-tech or small start-up categories, which will have been concerned that relief may be lost in future.

The Government's intention is to examine the extent to which the relief is appropriately targeted at those costs that are most closely linked to genuine innovative activity.

The consultation asks whether the relief could be made easier to access, or better focused. However the overriding requirement is that any changes do not cost more money. So, within the confines of the relief remaining available to all companies engaging in qualifying R&D, at or near the current levels, any refocusing (for instance in order to stimulate greater R&D activity by high-tech companies) will have to be

paid for by limiting relief in other areas. One suggestion for expenditure on which relief might be limited in future is software developed for internal use. The consultation also asks whether there are any further enhancements which would be effective in promoting additional R&D activity by the smallest companies, albeit recognising that any such move would introduce further complexity.

The stage one consultation on both the R&D tax credit and vaccine research relief (see below) is open until 22 February 2011. No definite timescale for reform has yet been announced however this may well continue to run in tandem with the planned patent box.

## Vaccine research relief

Take up of VRR has been very low with reportedly only ten claims a year made through the scheme. The Government has asked whether the VRR as currently operated is effective, or whether it would be more effective to deliver equivalent support via other mechanisms.

# Controlled foreign companies

The Government had previously proposed in a July 2010 consultation document that it would reform the controlled foreign companies (CFC) legislation in two stages:

- a set of interim improvements to be included in Finance Act 2011 and
- a more fundamental reform of the regime to be implemented in 2012.

The Government has announced further details regarding the proposals for both these stages of reform.

## Interim improvements

The two key aims of the interim improvements are to provide exemption from the rules for commercially justified activities that both business and HMRC agree do not erode the UK tax base and to help UK businesses to undertake overseas acquisitions and reorganisations.

To assist with the first key aim, two new exemptions have been proposed which will apply to intra-group trading activities and IP exploitation where there is minimal connection with the UK. The conditions applicable to these two exemptions are broadly similar. For the intra-group activities test to apply, the CFC must:

- have a genuine business establishment in its territory of residence
- carry out no, or only a small amount of, non-trading activities (a small amount will be defined as no more than 10% of the company's activities)
- not receive more than an incidental amount of finance and IP income (defined as no more than 5% of the CFC's total income) and
- not derive more than 10% of its business income or expenses from transactions with the UK (referred to as the company's 'connection with the UK').

If the CFC meets all of these tests in a particular period, it will be fully exempt for that period. If it fails one or more of these tests (and no other exemption is available) then a CFC charge may be applied, but can be reduced in certain circumstances. For example, if the CFC's combined finance and IP

income exceeds 5% of total income, then only the excess above 5% will be subject to the charge.

Similarly, if there is a connection with the UK of more than 10% but not more than 50%, full exemption will apply provided the overall level of profitability is sufficiently low to indicate a limited Exchequer risk. There will be an element of subjectivity involved in assessing this and it is anticipated that the UK parent will need to discuss the position with HMRC in such cases.

To assist with the second key aim, a 12 month extension has been proposed to the period during which a company is exempt from the CFC rules when it comes within the scope of the regime for the first time following a reorganisation or change to UK ownership. The exemption will apply for two years (previously one) after the end of the accounting period in which the relevant acquisition takes place both to companies acquired from third parties (and vehicles set up to make such acquisitions) and certain types of group reorganisations.

The exemption will also apply to groups migrating into the UK. The period of exemption, however, will cease if there is a relevant change of business of the CFC, which will be measured by reference to whether there is a reduction in UK tax as a result of that change.

Two other miscellaneous changes have also been announced. The first of these is an extension to the de minimis profits exemption. At present, a company is exempt where its chargeable profits (excluding chargeable gains and losses), as calculated under UK tax principles, do not exceed £50,000. It is proposed that, for any group which includes at least one large company, this limit will be increased to £200,000.

In addition, the £50,000/£200,000 limit will be calculated with reference to accounting profits, as adjusted in line with transfer pricing rules where such adjustments would amend profits for this purpose by at least £50,000. Anti-avoidance measures will be introduced to ensure that groups do not arrange their affairs purely to take advantage of this exemption.

The second miscellaneous change is to extend for 12 months the transitional rules for superior and non

local holding companies which could allow them to remain exempt from the CFC rules until July 2011 (now to be July 2012).

## Longer term reforms

The Government proposes to make fundamental changes to the CFC legislation in Finance Act 2012 so that it is more consistent with a territorial basis of taxation. Its key aims are to:

- target CFC charges only on artificially diverted UK profits
- exempt foreign profits where there is no erosion of the UK tax base and
- not tax profits from genuine economic activities undertaken offshore.

The corporate tax reform document issued alongside the Autumn Statement focuses on two of the most important and difficult issues in this regard: monetary assets and IP.

The Government plans to tackle the first of these issues through the introduction of a partial exemption for group finance companies. It believes that the proposed measures will allow it to reject any potential additional restrictions it might have instead imposed on the deductibility of interest, such as where that interest has been incurred on loans taken out to finance non-UK activities.

It is proposed that the finance company exemption will apply to any company which meets a specified debt:equity ratio. Broadly speaking, the higher the level of UK debt funding, the more of the profits will be exempt. The rationale is that, if the CFC is totally equity funded, the UK parent would not be subject to tax on its investment return (i.e. tax-exempt dividends) so ought, therefore, to be taxed under the CFC mechanism instead.

Similar rules are proposed to deal with excess cash held alongside the trading activities of CFCs. The Government proposes that, where only incidental amounts of interest are earned this will not give rise to a CFC exposure. Cash balances in excess of this will be treated as if held in a financing company, with

a debt:equity ratio applying to that part of the company.

As explained above, interim measures are proposed to exempt foreign IP from CFC charges where this has minimal connection to the UK. The Government wishes to take these reforms further in 2012 and focus the CFC rules on those activities which represent the highest risk to the UK tax base. Three key scenarios have been identified:

- where IP was developed in the UK and transferred to a low tax jurisdiction
- where IP is held offshore but is effectively managed in the UK
- where UK funds are used to invest in IP held offshore and the UK does not receive a return on that investment.

A two step process has been proposed in identifying the profits that should be subject to a CFC charge:

### Step 1

Identify high risk entities that hold IP with a substantial UK connection as defined using the principles set out above

### Step 2

Assess whether excessive profits have arisen and, if so, what proportion has been artificially diverted from the UK. It is suggested that this could be achieved by applying a safe-harbour test and then making an appropriate allocation of the excess between the UK and the overseas territory with reference to the contributions that the respective entities have made to the creation, funding and management of the IP concerned.

Where the IP is held as an offshore investment, the Government believes that this is more akin to a finance investment such as an interest-bearing loan. The proposed approach in this case is to apply the same debt:equity ratio test that applies to financing companies.

## Branch profits

The Government has announced that it will introduce an opt-in exemption regime for UK companies with foreign branches. The exemption will be available for accounting periods commencing on or after a date in 2011 yet to be announced.

Once a company has made the necessary irrevocable election, profits arising in all of its current and future overseas branches will be permanently exempt from UK corporation tax. Should any of the branches make losses, those losses will not be available to off-set against the company's profits. There will be a transitional measure to deal with those companies with branches that have realised losses in any of the six years prior to the exemption coming into force. Under this rule, a company's branch profits will become exempt as soon as the tax losses of those branches in the immediately preceding six years have been matched by profits. There will be special rules for very large losses (those over around £50m).

The exemption will apply to the trading profits, investment income and chargeable gains that are effectively connected to the branch concerned. Trading profits and chargeable gains will be defined with reference to the relevant double tax treaty. Investment income must be genuinely connected to the business to qualify for the exemption. In other words, the economic ownership of the assets that generate the income should lie with the branch. However, the exemption will not be available to a

company whose business is wholly or mainly investment business.

For branches in territories that have no tax treaty with the UK, the measure of exempt profits will be determined with reference to the OECD model treaty as released in July 2010. However, the exemption will not be available to non-treaty branches of small companies due to the perceived risk of loss of tax through diversion of personal income.

Anti-avoidance measures will be introduced, along similar lines to the CFC rules, to prevent the diversion of profits for tax avoidance purposes. There will be exclusions from the anti-avoidance rules including a motive, lower level of taxation and de minimis level of profit test. When the CFC rules are amended in Finance Act 2012, the anti-avoidance rules applicable to the branch exemption will be re-written so that the same broad rules continue to apply to both subsidiaries and branches of UK companies. Companies will also be expected to minimise the profits that are subject to tax in the overseas jurisdiction, for example by taking full advantage of the extent to which the treaty limits that territory's taxing rights and claiming all possible reliefs and exemptions.

The branch exemption will not extend to international air transport and shipping as these activities are generally not taxable in the foreign jurisdiction under the relevant treaty and the OECD model.

## The growth review

In place of the Government White or Green paper that had been expected on ways to encourage business growth, the Treasury and the Department for Business Innovation and Skills have jointly published a document entitled *The path to strong, sustainable and balanced growth*.

This document sets out plans for a rolling review of ways to encourage growth across a wide range of business sectors over the next few years. Each year, the review will focus on a number of business sectors and seek to engage businesses in those sectors in a detailed analysis of the specific barriers to growth for each sector (and how they could be removed) and

structural reforms that would improve the wider business environment.

The Government has already identified a number of general areas requiring priority action (many set out in the Coalition Agreement and the Emergency Budget in June 2010) which involve all areas of Government policy and fall under the following broad headings:

- planning
- trade and inward investment
- competition

- regulation
- access to finance
- corporate governance.

The first period of the Growth Review will run until Budget 2011 (23 March 2011) and will focus on the following business sectors:

- advanced manufacturing
- digital and creative industries
- business and professional services

- retail
- construction
- healthcare and life sciences.

Elements of the Corporate Tax Road Map are expected to address some of the potential barriers to growth that are identified but it remains to be seen if the various sector reviews will lead to further business tax simplification and reform or increase pressure on the Government to introduce sector specific investment incentives.

## Corporate tax road map

This road map is the Government's plan to make the UK a more attractive home for international business by creating a competitive and stable corporate tax system. Its key principles for the reforms include:

- lower tax rates but fewer tax reliefs
- avoiding unnecessary changes (for simplicity and stability)
- keeping pace with modern business practice
- a level playing field for businesses.

The reforms that are introduced as part of the road map will also be designed and implemented

according to the Government's new tax policy making procedures. Proposals for these procedures (set out in the *Tax Policy Making* consultation document published with the Emergency Budget in June 2010) envisage extensive consultation with affected businesses before changes are made.

The Government has provided a timetable - set out below - showing the planned reforms and has confirmed that it does not intend to make any further significant reforms in the first three years, other than those listed. It has, however, retained the option of introducing unplanned anti-avoidance legislation to prevent revenue losses if necessary.

2010	Reform action
Autumn	Published paper on reforming CFC rules Published paper covering IP, the patent box and R&D tax credits Published further details on the CFC interim improvements and on chosen option for foreign branch reform
<b>2011</b>	
Spring	Introduce rate cuts in small companies' rate and the main rate to 27%. Publish further details of new CFC rules for consultation. Publish further details of the patent box for consultation.
Finance Bill	Legislate for capital allowances reductions. Legislate CFC rules interim improvements and foreign branch reform.
Autumn	Publish draft legislation on new CFC rules and the patent box.
<b>2012</b>	
Spring	Introduce further cut in main rate to 26% and reductions to capital allowances.
Finance Bill	Legislate outcomes following consultation on new CFC rules and the patent box.
<b>2013</b>	
Spring	Introduce further cut in main rate to 25% and the patent box.
<b>2014</b>	
Spring	Introduce further cut in main rate to 24%.

For more information on any of the issues covered please get in touch with your usual PKF contact.

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