

Finding its way: a return to the competitive path for Britain?

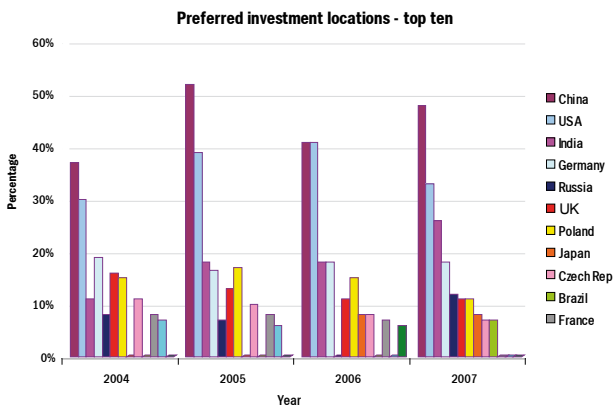
A common feature of the Budgets of the last Chancellor was the target of making the UK the best place to do business in and from. The new Chancellor, Alistair Darling, carried on this rhetoric in the Pre-Budget Report, wanting to “make and keep the UK as the best place for business”, whilst at the same time announcing measures that have created the largest amount of concern in business since the 2000 Budget changes on foreign profits.

At this now very delicate time, this paper looks at whether the Chancellor will be able to deliver on his aims of making the UK “a modern tax regime based on three clear principles: that our system is competitive, simple and fair”. To what extent does UK tax regime already provide a basis for the Chancellor’s goals and what does the Chancellor need to do to achieve his objectives?

Competitiveness

In his last Budget speech, Gordon Brown outlined his goal that the UK should have the most competitive business tax rate of the major economies, and, like a magician pulling a rabbit from a hat, announced a future cut in the mainstream corporation tax from 30% down to 28%. That cut will be confirmed in Alistair Darling's first Budget...so is that enough to make the UK competitive?

One way of answering this is to consider the results of Ernst & Young's 2007 European attractiveness survey which looks at the most preferred investment locations around the world. Since 2004, the UK has fallen from the fourth most preferred location to the sixth (which place it also held in 2005 and 2006) being overtaken by India and Russia and equalled by Poland. This is a worrying trend for an open economy.



Source: Ernst & Young's 2007 European Attractiveness Survey

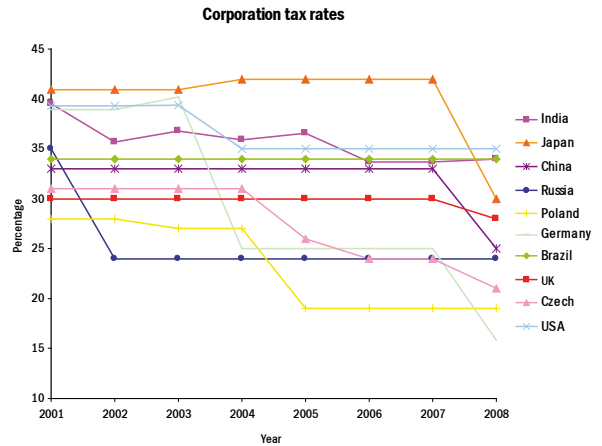
In tax terms, this leaves the Chancellor with an interesting dilemma. On one hand, our survey showed that to improve the attractiveness of Western Europe as an investment location, investors cite above all other factors the need for reforms providing greater flexibility, simpler admin procedures and support for innovation. This is reassuringly close to the Chancellor's objectives which is a good start. On the other hand, however, aside from basic infrastructure factors such as transport, telecoms and the potential for productivity increase, our survey shows that the three main factors influencing the choice of investment location are labour costs, the corporation tax rate and the transparency of the political, legal and regulatory environment. All of these elements, despite the proposed reduction in corporation tax, may give the Chancellor more cause for concern.

Corporation tax rate

So, has Gordon Brown's reduction in corporation tax rate done enough to improve the UK's position? Ernst & Young's Barometer of Tax Competitiveness provides tax and economic data from all of the OECD countries which allows us to compare how the UK ranks against the other countries in the top ten preferred investment locations list.

The following diagram shows that, of the countries still in the top ten of the attractiveness index, only the USA, Brazil, India and Japan have a higher rate than the UK. Of even more concern is that other key countries on the list such as China, the Czech Republic and Germany have reduced their corporation tax rates with effect from 2008 by

considerably more than the UK. Even the USA is far nearer the UK in corporation tax terms than they were in 2007. All in all, this means that, despite the forthcoming reduction, the UK is sitting in the middle of the scale once again.



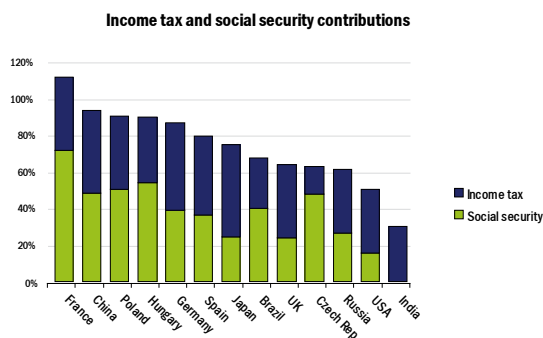
Source: Ernst & Young's Barometer of Tax Competitiveness

Of course, it's not all about the rate and the Barometer of Tax Competitiveness shows that the UK competes well in relation to the reliefs and incentives offered by competitor countries. In fact, one area where the UK does distinguish itself is in the area of venture capital incentives. Of the preferred investment locations, only France has a similar relief and this gives the UK a significant advantage in terms of its attitude towards enterprise and growth. This, coupled with the established success of London in terms of its open economy, time zone and wealth of indigenous talent put the UK in a strong position in perception terms. However, to rest on the laurels of a two percentage point reduction in the main corporation tax rate would be a mistake as our competitors are catching up in many areas.

Labour costs

In terms of labour costs, the UK is not in as poor a position as one might initially think. Of course, UK salaries are higher than many of the other preferred locations but the supply of cheap labour is not the only factor in investment location decisions. For example, China has some of the lowest labour costs in terms of salaries but it is still challenged by investors on the quality of its workforce and it is here that the UK compares well. A number of factors help to make the UK attractive for international investors most notably: easy access to markets, the availability of qualified staff and the number of languages spoken. These factors all help to offset the relatively high cost of labour and property.

In tax terms, the UK fares well, appearing very near the bottom of the chart in terms of compulsory social security contributions. Added to this, the UK (alongside France, Hungary, Germany and Japan) is one of the few countries to provide an exemption for low salaries. Once the higher rate of income tax is added into the equation, the UK is still towards the bottom half of the list. However, UK salaries are higher than many of our competitors so when these rates are actually applied, the resulting burden is significant so if the Chancellor is contemplating any short to long-term changes to the income tax or national insurance burden, a reduction would be the only competitive decision.



Source: Ernst & Young's Barometer of tax competitiveness

Transparency of the political, legal and regulatory environment

The news is arguably worse, however, in terms of the certainty of the UK tax regime. While the general legal and political environment is far more open than many of the other preferred locations, the tax regime has become increasingly complex in recent years.

This is partly attributable to inconsistent drafting of legislation which results in complex anti-avoidance measures to make it fit for purpose. Another factor is the issuance of policy proposals that seem to lack an appreciation of the environment in which they will operate. One good element is that these will generally be changed following consultations but this poor starting point leads to concern, mistrust and long drawn out consultations. We have seen repeated examples where the initial proposals have been unworkable (such as the taxation of foreign profits of companies) and this has led to significant uncertainty for the businesses affected. When this position is considered together with recent cases in which the Chancellor has been forced to backtrack on measures announced outside of the consultation process (eg capital gains tax), it is no surprise that businesses are thinking twice before investing here and some others are already publicly stating their intention to leave.

Perhaps the largest deterrent, however, is the recent experience of quasi-retrospective changes in tax law, which rewrite the future tax treatment of investments made in the past. Recent examples include:

- the abolition of industrial buildings allowances, which could result in an extra £11.5bn of tax over the life of existing assets

- the abolition of taper relief which, for those who do not want to or can't sell before 6 April 2008 will see their tax rates change to 18% together with the loss of indexation, and
- the potential retrospective impact on remittance for non-domiciles.

Whilst some might benefit from retrospection (such as those facing rates of between 40% and 24% on capital gains) the overall impact is clearly negative and this uncertainty will hinder our competitiveness.

It is this volatility in the tax regime that is a potential deterrent for investors and something that the Chancellor should address without delay and this leads us neatly into the issue of simplicity which is the next of the Chancellor's key objectives.

Simplicity

Ernst & Young has been calling for simplicity and clarity in the tax system for many years so the Chancellor's announcement that this is one of his key objectives was an extremely welcome development. However, early indications are that the path to simplicity is not an easy one for the Chancellor.

As outgoing Chancellor, Gordon Brown put in place a number of measures to effectively 'lock-down' the tax system for many years. Some of these measures were announced under the simplicity banner but appear to provide little, if any, simplification. Since then, Alistair Darling has continued on in the same vein although unfortunately with some of the same consequences.

Industrial buildings allowance

The reform of the capital allowances system (including the abolition of the industrial buildings allowance (IBAs)) has led to confusion and consternation among taxpayers not least because of the unexpected and retrospective nature of the IBAs change; and yet the IBAs changes in particular were attributed to simplification. IBAs require the identification and tracking of the assets individually, rather than in a pool, and the Government argued that, as a complex process, this is no longer appropriate and hence the relief should be removed.

There are two issues here. Firstly, the fact that the relief is complex should have encouraged consideration of simplification of the relief rather than outright removal. Furthermore, there is a clear distinction here between the existing stock of assets, for whom all the calculations

have been made, and new investments. The logical approach would have been to introduce a pool, in the tried and tested manner that has been used for plant and machinery. Instead, it would seem that the 'simplicity' argument has been used to remove a valuable relief for businesses.

Gordon Brown did not implement the changes in the Finance Bill 2007 so, failing a change in view, we can expect this to be included in Alistair Darling's first Finance Bill next year. It will, no doubt, be feted as a step towards simplicity but we disagree.

Capital gains tax

Moving on to Alistair Darling's inaugural Pre-Budget Report speech, the principal announcement was the reform of capital gains tax (CGT) with the Chancellor saying that it would "make the system more straightforward and sustainable" by setting "consistent incentives for investment and enterprise and ensuring it remains internationally competitive". Much has been said in the press on this issue but the Chancellor's main oversight in this respect was that a flat rate of tax will indeed be far simpler for some taxpayers but, for others, the impact will be a dramatic and one-off rate increase. The result of the Chancellor's sweeping away of business asset taper relief was a frantic rush to reorganise businesses before the 5 April 2008 deadline.

In order to appease his critics, the Chancellor then chose to implement 'Entrepreneurs' Relief'. This means that the first £1m of gains that qualify for relief will be charged to CGT at an effective rate of 10% (effectively retaining the business asset taper for gains of up to this amount). Gains in excess of £1m will be charged at the normal 18%. The introduction of the 'lifetime' nature of the £1m limit such that once an entrepreneur has breached this limit, the 18% rate will be effective for future gains undermines the simplification. Not only does this have the potential to confuse taxpayers, it will also be seen as a disincentive to continued serial entrepreneurship. The more successful you are as an entrepreneur, the less the incentive to carry on – this does not seem to be encouraging the right behaviour.

Principles-based approach to financial products avoidance

The trail of uncertainty initiated by Gordon Brown and perpetuated by Alastair Darling in the Pre-Budget Report seems to have continued unabated ever since. December 2007 saw the next stage of the 'simplification package' – the publication of a consultation document on a principles-based approach to financial products avoidance.

This approach starts with a principle of UK taxation which would be accompanied by a statement of how the legislation intends to operate by reference to that principle. In theory, this would be done in such a way it would be clear, on a first reading, what was being addressed and with what outcome in mind.

As a method of simplifying the legislation, this is a new direction and something that businesses and advisors alike have followed anxiously. Unfortunately, the first iteration of the 'principles-based legislation' has fallen far short of expectations. Three weeks before the end of the consultation period, substantial changes were released with no extension to the response deadline. These changes, as drafted, would tax unfairly many innocent and very common commercial transactions. However, this remains an interesting initiative and the Government should take time to consider the impact rather than rushing towards the Chancellor's first Budget.

Fairness

The Government uses the term 'fairness' in a variety of potentially contradictory ways. The average taxpayer would be forgiven for assuming it was a reference to measures to ensure that taxpayers are not overburdened with tax. Indeed, in changing the inheritance tax rules in the 2007 Pre-Budget Report, the Chancellor did talk about "what is fair in the future of inheritance tax". More often, 'fairness' is used refer to taxpayers 'paying their fair share' which is actually synonymous with anti-avoidance. Given that many anti-avoidance measures are aimed at what has traditionally been acceptable tax planning, the issue of fairness in this scenario is not clear.

Inheritance tax

It is very encouraging to be welcoming a measure introduced under the fairness banner. The inheritance tax (IHT) changes announced in the 2007 Pre-Budget Report allow a claim to be made to transfer any unused IHT nil-rate band on a person's death to the estate of their surviving spouse or civil partner. Coming, as they did, on the back of a series of complex measures to impose an income tax charge on individuals who continued to benefit from free or low cost enjoyment of assets they formerly owned (or provided funds to purchase), this announcement was warmly received.

A regime whereby spouses or civil partners are forced to give away joint assets on the death of the first of them in order to prevent a large

inheritance tax charge is extremely inequitable. For this reason, the changes go a long way towards meeting the Chancellor's fairness objective.

Income shifting

The proposals for income shifting are a good example of anti-avoidance being badged as fairness. These proposals, which are a response to the Arctic Systems case, were referred to in the Pre-Budget Report and were published shortly after. The justification given for the proposals is that "the Government believes it is unfair for one person to arrange their affairs so that their income is diverted to a second person, subject to a lower tax rate, to obtain a tax advantage".

While it is hard to argue with the objectives of the proposals, their practical impact is going to impose large administrative burdens which may undermine the arguments of fairness. Alongside an assumption of guilt where spouses work together, the proposals also impact unconnected individuals in situations that are arguably normal commercial working relationships. For example, if applied in accordance with the draft legislation, the proposed rules will mean that, in order for them to ensure that there is no tax advantage, the shareholders of a private company would need to divulge their personal income levels to each other.

Two wrongs don't make a right and while it may be unfair for some taxpayers to manipulate their tax affairs, to make the whole system inequitable for everyone is not a solution.

Residence and domicile review

Perhaps the most controversial of the Chancellor's attempts to bring fairness to the tax regime has been the introduction of proposals to change the tax rules for UK resident taxpayers who pay tax on the remittance basis and non-resident individuals who spend a significant amount of time in the UK. Non-domiciled taxpayers who have been resident in the UK for more than seven out of 10 years and who wish to continue to apply the remittance basis must pay an amount of £30,000 per year. This is, in effect, an extra tax and will be payable at the same time as the normal tax bill.

However, the other big concern here is the raft of detailed legislative amendments that followed the announcement changing all the rules, even if one were to pay the £30,000 'season ticket'.

The proposed rules for non-domiciliaries may well provide clarity for some, but many others will still face fundamental uncertainty over how their tax position will change. This uncertainty is compounded by the very short timescales associated with the changes. The associated ambiguity makes, for many, leaving the country the only option that really provides certainty. Added to this, the residence and domicile review is another situation where the initial consultation document was followed by draft legislation but without any extension of the response deadline.

At a more fundamental level though is the question of whether the current situation is actually 'unfair'. It is a common misconception that foreign domiciliaries do not pay tax. It is their overseas wealth (with little if any connection to the UK) that is not taxed. Like the rest of the UK, they will pay tax and national insurance on their UK income – often in significant amounts. This – coupled with the payroll taxes and NICs they generate as employers and other taxes such as VAT – means their overall contribution to the economy would be sorely missed.

Conclusion

As a first step towards competitiveness, simplicity and fairness, the Chancellor's initial actions have been less than successful. He has used the right words but the related actions have not measured up.

With the credit crunch having a significant impact on the global economy, the forthcoming Budget may be a difficult time to start implementing new measures to increase the competitiveness of the UK. That said, the Chancellor should never lose sight of the impact the steps that he takes in relation to the tax regime will have on our position in the global marketplace.

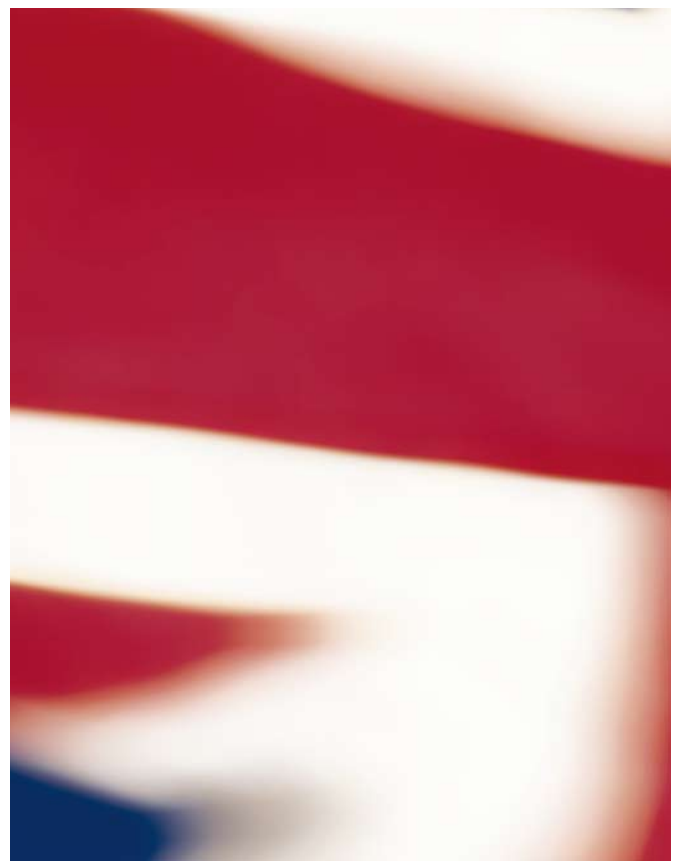
Simplicity and fairness are not impacted by the credit crunch and should, therefore, be a focus for the Chancellor this year. It is crucial that he looks back over the measures announced recently to review the impact that they have had on taxpayers.

In attempting to simplify the tax regime, the Chancellor must understand that any changes are a compromise between the rights of the individual and the needs of the State. Taking the middle ground may often be a better solution than headline grabbing measures that end up disadvantaging those that should be helped.

If the Chancellor does not take action to halt this recent chain of events, there is a very real danger that fairness will be sacrificed at the altar of simplicity.

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