



Autumn Statement 2011

On 29 November 2011 the Chancellor delivered his Autumn Statement to Parliament, alongside the publication of the Office for Budget Responsibility's (OBR) updated forecasts for growth and borrowing.

Although there were no major policy changes, the Chancellor managed to address some key issues in the UK economy with measures that are likely to promote growth. Cancelling this January's increase in fuel duty and lowering the increase in rail fares by 2 percentage points will ease pressure on households, and the Government's plans to increase capital spending will benefit the UK's potential output and facilitate growth in the long run. The Ernst & Young ITEM Club analysis of the economic impact of the Statement is provided later on in this alert.

Alongside the spending announcements were a number of announcements relating to tax. Most of these were re-confirmations of measures previously announced. Some, however, were new, though not completely out of the blue as most have either been mooted in the last few days or discussed as part of prior consultations.

The main new announcements were:

- ▶ An increase in Bank Levy
- ▶ A proposed new 'above the line' research and development (R&D) tax credit system
- ▶ Anti-avoidance legislation on asset-backed pension contributions
- ▶ Enhanced capital allowances for six enterprise zones
- ▶ New tax reliefs for investments in start-up companies
- ▶ A deferment of fuel duty increases
- ▶ Tax relief for gifts of 'pre-eminent objects'

More details in relation to a number of these announcements, together with details in relation to other measures announced prior to 29 November 2011, are expected when draft Finance Bill 2012 clauses are published on 6 December 2011. We also expect to see a number of HMRC responses to consultations published at the same time.

Taxation measures

Bank Levy

The Chancellor announced the headline Bank Levy rate which applies to short-term liabilities will increase from 0.078% to 0.088% with effect from 1 January 2012. The Chancellor's Statement made no specific reference to changes in the long term rate but we would expect this to be adjusted to 0.044% (being half of the new headline rate).

This is the third increase in Bank Levy rates in a row and confirms the Government's primary objective for the Bank Levy is to raise a minimum amount of £2.5bn per annum from the banking sector. This may reflect an intention that, even if the levy encourages a reduction in banks' reliance on short term funding, the rate may continue to be reviewed to achieve the target revenue figure.

The focus on raising a minimum level of revenue appears to be driving uncertainty in relation to the actual rates, which may cause concern amongst all major banks operating in the UK, particularly UK-parented banking groups who are likely to bear this uncertain and growing cost on their entire global balance sheets.

It is also worth noting that HMRC published an updated version of its Bank Levy manual on 18 November 2011. The revised manual tracks changes arising from revisions to the legislation over the last year but incorporates a number of other changes, including an expansion of guidance on the Financial Services Compensation Scheme, new examples reflecting the revised netting rules and updated commentary on the anti-avoidance provisions.

In his speech, the Chancellor specifically referred to the Government's determination to resist the imposition on the UK of an EU Financial Transaction Tax, which it sees as a 'tax on people's pensions', preferring instead to use the Bank Levy as a means of ensuring that 'the banks pay their fair share'

R&D tax credits

The Government will introduce an 'above the line' tax credit in 2013 to encourage R&D activity by larger companies. The Government will consult on the detail at Budget 2012.

Currently the R&D tax credit scheme in the UK is structured as an enhanced deduction. From a

financial statements perspective, the R&D tax benefit is recorded as part of the tax provision on financial statements and does not impact the earnings before interest and taxation (EBIT) figure. However, many larger companies measure their performance by reference to EBIT, and so the benefits of the R&D tax credit do not flow through to the performance measures or investment budgets.

In its R&D consultation document in June 2011, the Government announced that it was considering the possibility of introducing an 'above the line' tax credit system. The Chancellor has now confirmed the Government's intention to introduce such a system in 2013 'to encourage R&D activity by larger companies'.

The mechanism of an above the line credit system should benefit directly those departments undertaking the R&D work, which is of vital importance if the scheme is to affect behaviour and encourage R&D activity.

Smaller companies are likely to be less impacted by how the R&D credit is accounted for, but the Government has indicated that it intends to ensure that R&D incentives for small and medium sized enterprises (SMEs) are not reduced as a result of this change.

Asset-backed pension contributions

The Chancellor announced new legislation to be introduced as part of Finance Bill 2012 in relation to employer asset-backed pension contributions. These changes are effective from 29 November 2011.

The changes announced are intended to ensure that asset-backed pension contributions do not give rise to 'unintended' or 'excessive' relief. However, the validity of and rationale for asset-backed contributions is recognised and intended to be preserved.

The draft legislation published on 29 November refers to arrangements implemented either before, on or after 29 November 2011. In summary:

- ▶ Upfront relief for asset-backed contributions should continue to be available where the relevant arrangements are accounted for by the employer as a financial liability so that the structured finance arrangements (SFA) rules in Chapter 2 Part 16 CTA 2010 apply

- ▶ Where the SFA rules do apply, additional relief may also be available for the finance charge element only of any subsequent payments
- ▶ Where the SFA rules do not apply, upfront relief would no longer be available. However, relief for subsequent income payments to the pension scheme may be available
- ▶ Transitional provisions have been introduced in relation to arrangements entered into before 29 November 2011, which may in some situations may result in a clawback of part of the upfront tax relief previously allowed at the end of an arrangement
- ▶ Other adjustment mechanisms and anti-avoidance rules have also been included within the legislation.

The rules introduced are highly complex in nature and careful consideration should be given to establish whether arrangements entered into or being contemplated are potentially impacted by these rules. As the application of the rules depends to a large degree on the existence of a 'loan' and payments made to reduce this, the accounting adopted for particular arrangements may also be very important.

Enterprise zones

The Government will be approving proposals from the Lancashire and Humber Local Enterprise Partnerships to form Enterprise Zones in these areas, and will consider an Enterprise Zone in Battersea linked to the redevelopment of the power station. Subject to due diligence, the Government will also expand the existing Enterprise Zone in the North East to include land around the Port of Blyth.

In the case of six enterprise zones, tax depreciation of 100% of the expenditure on plant and machinery will be available rather than the normal rate of 18% (or 8% in some cases). This enhancement will apply for investment incurred between April 2012 and March 2017. The six enterprise zones are the Black Country, Humber, Liverpool, North Eastern, Sheffield and Tees Valley.

New venture capital rules

The Chancellor announced details of a new relief for investment into start-up companies. Very few details are currently available, though the idea was consulted on earlier this year.

The detail is expected to be announced on 6 December. In overview, a new Seed Enterprise Investment Scheme (SEIS) will be introduced that will attract 50% income tax relief for individuals who invest in shares in qualifying companies, regardless of their marginal rate. The scheme will be subject to an annual investment limit of £100,000 for individuals, with a cumulative investment limit for companies of £150,000.

There will also be a one year CGT exemption on gains realised in 2012/13 which are invested in SEIS in the same year.

The Government also announced its intention to simplify the Enterprise Investment Scheme (EIS) and Venture Capital Trust (VCT) rules. This will include a relaxation of the connected party rules as well as excluding companies 'set up for the purposes of accessing the relief.'

The relief will also exclude the acquisition of shares in another company (meaning it is likely that relief would no longer be available in a management buy-out situation) as well as investment in Feed-in-Tariffs.

In addition the statement confirms the intention to remove the £1m investment limit per company for VCTs.

To help pay for the new reliefs, the Chancellor has announced that the CGT annual exemption will be frozen at £10,600 for 2012/13.

Fuel duty

The Chancellor announced that the 3.02p per litre increase in the main fuel duty rate that was due to take effect on 1 January 2012 (as announced at Budget 2011) will now be deferred to 1 August 2012. In addition, the inflation increase planned for 1 August 2012 will now be cancelled.

On 1 August 2012, the duty rate for leaded petrol and compressed natural gas will change by the same monetary amount as main fuel duty. Duty on aviation gasoline and rebated oils will change in proportion to the main rate. The duty differential for liquefied petroleum gas will be maintained until

1 August 2012, when it will be reduced by 1p per litre.

In these days of high oil prices this is a welcome announcement.

Gifts of pre-eminent objects

The Government will bring forward legislation to introducing a relief to encourage the donation of 'pre-eminent objects', typically works of art or historical objects, to the nation. As a result of the relief, individuals will receive a reduction in their income tax or capital gains tax liabilities, and companies will receive a reduction in corporation tax. Trustees are not mentioned and it is not clear whether the relief will apply to them.

It is also not yet clear at what rate the reduction will apply, although the proposal at the time of the consultation was for a reduction of 25% of the value of the object.

Other tax announcements

Other measures that have previously been announced, but which were referred to in the statement, include the following:

- ▶ The reduction in the corporation tax rate to 25% which will be effective from 1 April 2012 (which has already been legislated in Finance Act 2011)
- ▶ Legislative changes in respect of the 'Corporate Tax Road Map', where details including the promised controlled foreign company Technical note and an update on the Patent Box are promised for 6 December
- ▶ The abolition of low value consignment relief for goods sent from the Channel Islands with effect from 1 April 2012
- ▶ An increase in air passenger duty (APD) rates from 1 April 2012, with the Government also confirming that it will proceed with the extension of APD to private and business jets, although this measure will now take effect from 1 April 2013
- ▶ A VAT exemption for services shared between VAT exempt bodies, including charities and universities
- ▶ The climate change levy discount on electricity for climate change agreement participants will be increased to 90% from 1 April 2013

- ▶ The provision of up to £100m over the Spending Review period, to mitigate from April 2013 the impacts of the carbon price floor on electricity costs to businesses that are electricity intensive and operate in internationally competitive markets (subject to relevant State Aid rules)
- ▶ The steps taken to simplify the tax code and, in particular, the integration of the operation of income tax and national insurance
- ▶ The extension of the current small business rate relief holiday for a further six months from 1 October 2012, and further business rate deferrals
- ▶ In addition, the detail of the Autumn Statement confirms that the Government will put the treatment of Manufactured Overseas Dividends 'beyond doubt'.

ITEM Club view

As feared, the Government announced all of the good news from this package before the Autumn Statement because it knew that this was likely to be overshadowed by bad news on the economy and government borrowing.

Indeed the news was arguably even worse than expected. The OBR expects the economy to grow by just 0.7% next year, well below other forecasts (with the exception of yesterday's forecast from the OECD). This seems a realistic assessment given the pressure on household budgets and the uncertainty gripping exports and investment at the moment, but could easily be overtaken by the fallout from the problems in the Eurozone. The OBR assume, like we do, that policymakers resolve these in an orderly way.

Upward revisions to government borrowing naturally follow growth downgrades but were significant in their scale, pushing the projection for 2013/14 up from £70bn at the time of the budget to £100bn. The cumulative overshoot of £112bn for the four years 2011/12 to 2014/15 has the effect of pushing the debt to GDP ratio up to 78% over this period. With debt ratios on that scale it becomes imperative to maintain confidence in the government debt market. We have seen what happens when confidence is lost. Interest rates increase and can reach levels that make the debt unsupportable, threatening default or recourse to the IMF.

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This has made the arithmetic very tight for the Chancellor, much tighter than we expected. It means that the initiatives on infrastructure, housing and credit easing that were announced before he spoke, together with the give-aways announced today, have to be financed by economies elsewhere. Moreover, the freeze in real public expenditure has to be extended into 2015/16 and 2016/17 to meet the fiscal targets. That means a reduction in spending of £15bn in 2016/17.

However, given the steady deterioration in UK's growth prospects, the need for policy intervention has intensified. Although there were no major policy changes, the Chancellor managed to address some key issues in the UK economy with measures that are likely to promote growth. In the main, these measures are encouraging and appropriate. The variety of sweeteners extended to the UK consumer are a step in the right direction. Cancelling this January's increase in fuel duty and lowering the increase in rail fares by 2 percentage points will help ease the pressure on households' squeezed incomes. The Government's plans to increase capital spending will benefit UK's potential output and facilitate growth in the long run. Moreover, the various measures announced to support youth employment are sensible and definitely needed.

One area, however, where the Chancellor fell short of expectations was making the housing market more accessible to first-time buyers. The stamp duty tax relief will end in March 2012 as planned and there were no further measures along the lines of guaranteeing bank loans to first-time buyers. We are also doubtful about the Government's concept of 'credit easing' of guaranteeing bank loans to small and medium sized businesses (thus lowering their borrowing costs). Although this makes sense in theory, we are not convinced that it will be enough to ease credit conditions in the SME market. The current climate is very risk-averse and banks are likely to need more than this to be persuaded to loosen their purse strings. So indeed will businesses.

The downside is that all of these measures have to be paid for within the budget constraint. So the tax handouts are balanced by higher taxes on banks and other businesses. Higher levels of capital spending mean lower levels of current spending. Public sector pay rises are to be capped at 1% in each of the two years following the current freeze. The OBR now expects government employment to decline by 710,000 by 2016/17 (as opposed to the earlier forecast of 400,000 by 2015/16). The second quarter of 2011 saw a 105,000 job losses in the public sector with data for Q3 expected to be as bad if not worse. All of these numbers exceed our expectations.

Further information

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