

Bottom-line thinking

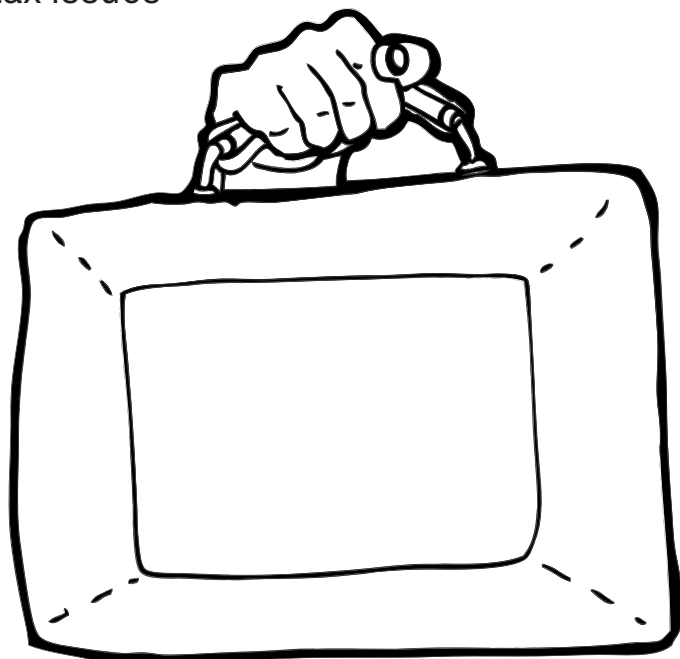
A closer look at the 2011 Budget

Now that the dust has settled, details not contained or obvious in the Chancellor's original announcement are beginning to emerge and opinions are forming. Accordingly, the Banking Tax & Finance team has taken a closer look at possible changes and their findings and conclusions are outlined below.

This is a follow-up to our earlier commentary headed "2011: A Budget for enterprise," which provided an overview of the key issues announced in the Budget on 23 March 2011. In this "Budget Tax Special," we look in more depth at some of the main tax issues that were introduced and suggest what they could mean for various types of business, as well as the implications for the consumer.

There are five sections:

- Carbon taxes, Green Investment Bank, tariffs and other disincentives
- Capital allowances — main changes
- REITs — possible significant relaxations to the regime
- Land remediation relief — is it being phased out?
- Summary



Carbon taxes, Green Investment Bank, tariffs and other disincentives

Green fingered

With HM Treasury playing a major role in the U.K.'s drive towards carbon reduction and sustainability, it was inevitable that the various policies now enjoyed their own unique grouping in the supporting document for the first time. Closer inspection of the carbon taxes section on pages 63 and 64 of HM Treasury's Budget 2011 may only show eight separate announcements, but the detail and additional implications are within the small print of the document.

A Budget focussing on fairness and creating the most competitive tax system in the G20 was labelled as "neutral" and should, therefore, have demonstrated a fiscally sustainable application of Newton's third law, i.e. for every action there is an equal and opposite reaction. A quick review of the fiscal impacts of Budget policy decisions, however, shows the additional revenue obtained far outweighs the immediate tax breaks provided.

The largest slice of tax revenue is undoubtedly the carbon reduction commitment (CRC) efficiency scheme. Until last October's spending review, this was intended to be revenue recycling, but will now inject £4.58 billion of much needed cash into the Treasury's coffers. Once you add in the £3.22 billion from the introduction of a carbon price floor from 2013-14 and the £355 million raised through efficiency savings within the renewable heat incentives (RHI) scheme, there was plenty for Chancellor Osborne to play with.

Carbon taxes

The use of feed-in tariffs (FiT) and RHI are designed to stimulate investment in the renewable energy sector. The capital cost and funding risks involved in developing and installing new technologies make the supply price uncompetitive when compared with fossil fuels. Both FiT and RHI

provide a subsidy to power providers in given circumstances until such time as the cost of generating green energy is the same as traditional means, this is known as grid parity.

The Department of Energy and Climate Change (DECC), however, recently announced a review, proposing to reduce FiT for solar photovoltaic (PV) installations ranging from 50 kW to 250kW. This potential disincentive to invest in PV has been tempered by the Budget announcement that a carbon price floor will be introduced from 1 April 2013; the floor starts at £16 per tonne CO₂ (tCO₂), rising to £30/tCO₂ by 2020. The target tax rate is expected to drive between £30 billion to £40 billion of capital expenditure in green energy generation, providing an additional 1.8GW of power by 2030, equivalent to 5,000 wind turbines or five new nuclear power stations.

This tax on fossil fuels used in electrical generation will hit the traditional power sector, particularly as the cost will be passed on to business, at an increase of up to 6% per annum on energy bills by 2016. Anti-avoidance provisions will be introduced to prevent forestalling with immediate effect. Relief will be provided for carbon capture and storage and combined heat and power (CHP) plant registered under the CHP quality assurance programme, although this is subject to EU State aid approval. This quality assurance certification is also an essential part of the process in claiming 100% enhanced capital allowances and it will now be even more important to ensure that these installations are tackled proactively from design stage to ensure the tax efficiency of capital expenditure.

The proposed reform of climate change agreements extends the regime to 2023, although the increased discount for participants

from 65% to 80% from April 2013 will only cost the Treasury £140 million over the parliamentary term.

With the CRC now effectively a carbon tax on certain building owners and occupiers, the initial rate of £12/tCO₂ will raise £715 million of income this year alone. Draft regulations will be published later this year around the implementation of allowances sales and it will be interesting to see whether the market apathy that greeted the scheme when it was revenue recycling will change once these proposals are published.

Green Investment Bank

Despite an increasing requirement for low energy solutions to built assets, either new build or retrofitted, the capital cost of plant and equipment is still often considered the driver for procurement strategies. The cost of cutting edge green assets is often perceived as being more expensive than alternatives, primarily because the technology has high fixed costs to get to market. Whilst the taxation system does recognise this through measures such as ECAs and research and development credits, there is still a requirement to spend the money upfront before any relief applies. Banks are still being very cautious around lending, a position that is exaggerated within the renewable energy generation sector, where there are inherent funding risks around new and unproven technologies, feedstock and end-user requirements.

The Budget announcement to bring forward the operation of the Green Investment Bank (GIB) to 2012-13, 12 months ahead of schedule, is welcoming news — along with the initial £3 billion capitalisation. The cost of this will not all be funded from current tax revenues, with £2 billion of cash to be met from sales of existing assets, less the £775 million realised from the sale of High Speed I. Assuming the national debt

is on track (as a percentage of GDP), the GIB will only have borrowing powers from 2015-16, prompting the Guardian's Damian Carrington to label it a "green bank that can't borrow."

With the Treasury understandably nervous about taking on this commitment, the Chancellor's announcement followed the publication of the Environmental Audit Committee's (EAC) on 11 March 2011, effectively giving him no option around a smaller scale fund if the U.K. is to meet the required investment levels to reduce carbon emissions by 2050.

A lot of work is still required here and no doubt speculation as to the role and effectiveness of the GIB will continue until further detail, including the preferred banking model, is announced in May.

Future consultation

In addition to the perceived hesitation around FIT for solar PV, the government has announced its intention to consult around the appropriate capital allowances treatment of plant and machinery assets attracting tariffs through FIT or RHI, with a view to implementation within the 2012 Budget.

At present, allowances are given on eligible plant and machinery assets, based upon the capital expenditure incurred by the taxpayer. Where there is a third party subsidy towards the cost, a reduction is made where the payment is also capital in nature. Given that FIT and RHI are treated as income in nature, they would not ordinarily be considered to mitigate the capital cost for capital allowances purposes, mixing the treatment of capital and revenue expenditure to suit the Treasury's purposes would be a worrying trend moving forward.

Whether the tariffs will impact solely on first-year allowances (FYAs) or the

overall ability to claim will become clearer in time, but either way it would seem that the government is keen to restrict allowances, either in cash flow or absolute terms.

The good news is that because of the consultation period, there is no immediate withdrawal of benefit and therefore, for the time being, the incentive remains for investors. As ever, professional advice should be sought to assess potential risks prior to closing any deal.

It is also worth noting that the government is intending to add businesses benefiting from tariffs to the excluded activities list for Enterprise Investment Scheme and Venture Capital Trust purposes, thereby further reducing potential equity investment. This too is subject to EU State aid clearance and is expected to hit the statute books in 2012.

Same carrot, bigger stick?

These changes follow the recent announcement on proposals to significantly discount tariffs for solar PV. The pressure for U.K. plc to go green is intense and therefore, the restriction of fiscal incentives ahead of market maturity achieving close to grid parity would not seem to be helpful in the short term. Many projects within the renewable energy sector are hamstrung by issues, including funding, preventing them from progressing. There is a real risk that private equity, which is a key accelerant in getting green energy to grid parity with traditional generation, could be put off this fledgling sector through the lack of credible incentives within the taxation system.

Despite the welcome news around the GIB, there will still be a substantial time lag before the funds become available, assuming the lending criteria are favourable and practical. Even then, the availability of funding will be critical, as the

initial capitalisation is conditional on other factors in a continuing difficult market.

The CRC has been on the agenda for a number of years, but there is a real sense that to date, most businesses are, at best, paying lip service, but most likely are unaware of the impact, particularly as it is now an effective tax on carbon. Only once the cost of this has hit the ledger, will we really expect people to sit up and take notice. Business will need to revisit previous assumptions around early inactivity giving rise to future revenue as a result of recycling and performance against peers, there will be no payback. The Confederation of British Industry has described the current scheme as untenable and lacking credibility.

The difference between green energy and fossil fuels is at present partially adjusted by FIT and RHI. With proposed adjustments to the tariff and future reviews likely, the government has sought to level costs by increasing the duties paid on fossil fuels through the carbon floor. The carbon price floor represents a potential opportunity to piggyback on rising oil prices by adjusting the current fuel duty that can be reclaimed on oil used in electricity generation.

With HM Treasury's supporting data showing tax received exceeding incentives given, for the Budget changes, as far as the green agenda goes Newton's third law has not been met.

Capital allowances

Main changes

The effect of the accelerated reduction to the main corporate tax rate

The reductions to writing down allowances and the annual investment allowance, which were introduced in the Emergency Budget on 22 June 2010, were reconfirmed in the 2011 Budget and they will take effect from April 2012, as previously announced. The reduction, however, to the main rate of corporation tax from 28% to 26% (instead of 27%) from 1 April 2011 and the eventual reduction to 23% (instead of 24%) for the tax year 2014/15 can be viewed as further compensation for the reduced rates of capital allowances.

With the further reductions to the main corporate tax rate, it is highly probable that large companies will benefit over a five-year period, despite the reductions to capital allowances. A property company paying the main corporate tax rate would need to have annual capital allowances of over 90% of taxable profits, before the deduction of capital allowances, in order to be worse off from the combination of the lower tax rate and lower capital allowances.

For a large retailer, its capital allowances would need to represent over 95% of its taxable profits, before the deduction of capital allowances, for the company to be worse off from the changes. This conclusion can be reached before factoring in the effect of the change to short life asset rules (see page 5), which can only increase the value of capital allowances to businesses such as retailers.

Extended cutoff period for short life asset treatment

This Budget initiative came as a surprise, but on reflection it is consistent with the government's stated aim that capital allowances should be closely aligned to economic depreciation.

Businesses can elect to have certain items of plant and machinery treated as short life assets (SLA), which means that the expenditure incurred on each of these assets is pooled separately. This enables the taxpayer to write off the expenditure over a short period (via a balancing allowance), rather than the expenditure being left in a pool when the asset is scrapped. It is unlikely that a balancing charge would arise on disposal (but not impossible), because normally a taxpayer would only go to the trouble of making the SLA election for an asset that was likely to be scrapped within a relatively short period.

For expenditure incurred before April 2011 (the pre-budget regime), the asset had to be disposed of within four years from the end of the year of expenditure (whether by sale or by being scrapped), otherwise the tax written down value of the asset is added to the main pool and writing-down allowances continue to be claimed on a year-by-year basis in the normal manner. SLA treatment is, therefore, only beneficial if the asset is disposed of within the four-year cutoff period.

For new expenditure incurred from April 2011 (1 April for corporate taxpayers and 6 April for income taxpayers) the cutoff point for SLA treatment is extended to eight-years. This increases the range of assets for which an election for SLA treatment may be beneficial. The Capital Allowances Act (CAA) 2001, Section 84, however, rules out SLA treatment for certain categories of expenditure and the main exclusions as far as plant and machinery in buildings is concerned are as follows:

- Special rate expenditure.
- Plant and machinery provided for leasing.

Special rate expenditure includes thermal insulation added to a commercial building, long life assets (with a useful economic life of at least 25 years) and integral features of a building. This expenditure attracts a current writing-down allowance of 10% per annum (on a reducing balance basis), reducing to 8% from April 2012. It is the last of these categories that will be the main exclusion as far as special rate expenditure is concerned. This is because the classification of integral features covers a large part of the plant and machinery in most buildings, including heating, ventilation and air-conditioning installations, electrical systems (including lighting), hot and cold water systems, lifts and escalators.

The exclusion for plant and machinery provided for leasing means that property investment companies cannot make SLA elections, irrespective of the type of plant and machinery concerned.

A SLA election must be made for corporation tax within two years of the end of the relevant chargeable period in which the expenditure is incurred. For income tax, the time limit is normally the anniversary of the 31 January following the tax year in which the end of the relevant chargeable period occurs.

The extension of the cutoff period from four years to eight years is likely to benefit those businesses that incur substantial annual expenditure on plant and machinery over the limit of the annual investment allowance (currently £100,000, but reducing to £25,000 from April 2012). In addition, these businesses will be property occupiers rather than property landlords.

Apart from plant and machinery chattels (such as required by manufacturing businesses), expenditure suitable for SLA

treatment could form part of the additions to operational property. This could arise through the fitting out of new space or the refurbishment of existing space, where the nature of the business demands constant updating of the business environment. Businesses in the food and drink, hospitality and leisure sectors could, therefore, gain most from this Budget change.

The cost to the Exchequer of the extended cutoff period for SLA treatment is expected to rise from only £10 million in the tax year 2011/12 to £170 million by the tax year 2015/16. It seems sensible to assume that this cost will continue

rising after five years as more and more assets are scrapped within the eight-year cutoff period. The downside for businesses is the increased administration burden from making a greater number of SLA elections and tracking the expenditure in separate pools. As alluded to above, it will be necessary to make separate balancing adjustment calculations when an item is disposed of within the eight-year period, as well as reallocating unrelieved expenditure to the main capital allowances pool if the asset is not disposed of within that cutoff period. In addition, there would also be a deferred tax benefit from the remaining pool that will further

reduce the absolute advantage to be derived from the extended cutoff period for SLA treatment.

However, as the following example illustrates, the benefit from electing for SLA treatment in the appropriate circumstances should far outweigh the increased cost of administration.

Example of the benefit of the extended SLA cutoff period

A successful mid-tier family restaurant company incurs £700,000 on the fit-out of one of its outlets in the financial year ending 31 March 2012. Of this amount, £20,000 qualifies for enhanced capital allowances (ECAs), £110,000 is special

TABLE A — SLA cut off period four-years from end of expenditure year

Year	ECAs	Main pool	SR pool	SLA	Total CA	Tax rate	Tax saving
1	20,000	56,000	11,000	24,000	111,000	26%	28,860
2	0	40,320	7,920	17,280	65,520	25%	16,380
3	0	33,062	7,286	14,170	54,518	24%	13,084
4	0	27,111	6,704	11,619	45,434	23%	10,450
5	0	30,171	6,167	8,822	45,160	23%	10,387
6	0	24,740	5,674	0	30,414	23%	6,995
7	0	20,287	5,220	0	25,507	23%	5,867
8	0	16,635	4,802	0	21,437	23%	4,931
TOTALS	20,000	248,326	54,773	75,891	398,990		£96,954

TABLE B — SLA cut off period eight-years from end of expenditure year

Year	ECAs	Main pool	SR pool	SLA	Total CA	Tax rate	Tax saving
1	20,000	20,000	11,000	60,000	111,000	26%	28,860
2	0	14,400	7,920	43,200	65,520	25%	16,380
3	0	11,808	7,286	35,424	54,518	24%	13,084
4	0	9,683	6,704	29,048	45,435	23%	10,450
5	0	7,940	6,167	31,053	45,160	23%	10,387
6	0	6,510	5,674	18,230	30,414	23%	6,995
7	0	5,339	5,220	14,948	25,507	23%	5,867
8	0	4,378	4,802	68,097	77,277	23%	17,774
TOTALS	20,000	80,058	54,773	300,000	454,831		£109,797

rate (SR) expenditure and £400,000 is main pool expenditure. It is the policy of the company to refurbish its restaurants every seven years. The company elects to treat £120,000 of the expenditure that would have entered the main pool as SLA, but the largest asset costing £100,000 (catering equipment) is not disposed of within the four-year cutoff period. The tax written-down value of the asset is, therefore, transferred to the main pool at the end of the fifth-year. Table A below shows how the capital allowances will flow on a year-by-year basis, assuming that no extension of the SLA cutoff period had taken place.

In practice, each and every asset that is subject to SLA treatment is accounted for separately in its own pool. However, for the purpose of this example, both Tables A and B show all the SLA pools lumped together.

In this second scenario, the SLA cutoff period has been extended to eight-years and the company now elects to treat £300,000 of its expenditure as SLA. In addition to the £120,000 that it would have treated as SLA under the old four-year cutoff period, it now decides to also elect for its music systems (£10,000), furniture and fittings (£130,000) and decorative assets (£40,000). The restaurant is refurbished within the eighth-year and all the items subject to SLA treatment are scrapped. Table B (see page 5) shows the cash flows for this scenario.

As can be seen from a comparison of Table A with Table B, the company is able to claim additional capital allowances of £55,841 over the eight-year refurbishment cycle due to the extended SLA cutoff period. (No account is taken of the refurbishment expenditure in year eight in order to make a meaningful comparison.) The additional tax saving of £12,843 should make the administrative burden of more elections and the greater number of pools worthwhile.

The cash flows in Table B are based on most of the elected items being scrapped in the penultimate year of the eight-year cutoff period, which would actually run for another year beyond the refurbishment year to 31 March 2020 (year nine). If the disposal date of the SLA is brought forward (but still outside the previous four-year period), then the benefit of this Budget measure will be even greater.

Fixtures mandatory pooling

The government will be issuing a consultation document at the end of May 2011 covering the proposal that businesses must pool their expenditure on fixtures in a building within a short period of acquiring the building in order to qualify for capital allowances. This was another surprise announcement but, in this case, the drivers are unclear. It has been mentioned by some commentators that this proposal may simply be yet another measure aimed at restricting allowances on second hand property. This may prove to be correct, but may not extend to the suggestion that the time limit for pooling the expenditure will impact on fixtures claims for development projects. Tax advisers may be concerned, however, that a client who misses out on capital allowances due to not being advised of the time limit for making a claim, could become a professional indemnity issue.

Whilst it is unknown how the government's proposal will be influenced, if at all, by the consultation process, based on the wording of the Budget announcement, the proposal does seem to be restricted to expenditure incurred on existing fixtures as a result of acquiring a building. It is also worth noting that this proposal came under the heading of "anti-avoidance measures" and may, therefore, be intended to apply to situations where there is danger of tax leakage, rather than being simply a restriction and/or a simplification.

Still, there could be other knock on effects, such as the need for the buyer of a company to carry out additional due diligence. For example, the stamp duty land tax (SDLT) saving from acquiring a property via a corporate acquisition may be partially reduced by unavailable capital allowances.

Assuming that mandatory pooling of fixtures expenditure only applies in the case of property acquisitions, why is the government introducing this measure? It may bring forward capital allowances claims on fixtures that might not otherwise have been made due to insufficiency of profits. We would suggest, however, that the insufficiency of profits is not the main reason for why such claims are not made soon after the acquisition of a building. In our experience, a far more common reason is that the property owner is simply not aware of the possibility of making such a claim. If that is the case, then mandatory pooling may not achieve anything beyond prompting an increase in the marketing activity of property tax advisers.

If a property owner fails to claim capital allowances within the mandatory period, presumably the new rules would not prevent a subsequent owner of the property from making such a claim. Any rule to the contrary would appear to be unworkable in view of the fact that not all property owners will be in a position to make a claim, such as pension funds and property traders.

As for the likely time limit for making a claim, a common sense approach would be to restrict the taxpayer to the time limit for amending a return. Any shorter period would be inconsistent with other capital allowances time limits.

In addition, the requirement is to add the expenditure to a pool. There should be no need for the taxpayer to actually claim writing down

allowances, as these can be reduced to nil under CAA 2001, Section 56 (5). The pooling of expenditure will be enough to restrict any future purchaser of the property to the level of expenditure incurred by the previous owner, but this restriction already exists at CAA 2001, Section 185. It is very unclear, therefore, at present what the government hopes to achieve with the mandatory pooling of fixtures expenditure and we will need to wait until the end of May 2011 for some clarification as to the intended effect.

Changes to the capital allowances anti-avoidance legislation

The government announced that it intends to make the anti-avoidance legislation within CAA 2001, Chapter 17, more effective and “in line with effective anti-avoidance tests elsewhere in the Taxes Acts.” What might this mean?

Currently, the general anti-avoidance provisions within Chapter 17 deny plant and machinery allowances where the “sole or main benefit” of a transaction is obtaining a writing down allowance, first-year allowance or annual investment allowance, which would not otherwise have been available.

If we look at the anti-avoidance legislation dealing with loss relief at Section 74ZA of the Income Tax Act 2007 as an example of what the government considers the “effective anti-avoidance tests,” then the words “sole” or “main benefit” might be replaced by “the main purpose or one of the main purposes.” This would significantly widen the scope of the capital allowances anti-avoidance legislation, but could also add a level of uncertainty that doesn’t currently exist.

For example, would the new anti-avoidance legislation prevent a buyer and seller of a property from agreeing how the disposal value of the fixtures should be split between the main pool and the special rate pool in cases where the seller incurred the expenditure prior to April 2008? Also, will tax arbitrage agreements still be possible, where agreements between buyers and sellers are reached on the basis of where the maximum value is available?

Furthermore, it will be interesting to see how the new anti-avoidance rules interact with the provisions for the mandatory pooling of fixtures. Again, we will have to wait until the consultation document is issued in May 2011 before any conclusions can be reached as to the likely effects of this proposal.

The REIT stuff

Possible significant relaxations to the REIT regime rules announced in the Chancellor's Budget

Introduction

In his Budget speech, Chancellor Osborne said that REITs were to be simplified to encourage home building. The subsequently released, detailed Budget papers included the welcome announcement of informal consultations with the property industry and representative bodies, which could result in significant relaxations to the Real Estate Investment Trust (REIT) legislative regime. Any such legislative changes are to be included in the Finance Bill 2012.

REITs, which are tax-exempt, listed, property investment companies or groups which must distribute at least 90% of their annual rental income profits to shareholders, were first introduced into the U.K. with effect from 1 January 2007.

Any taxpaying company converting to REIT status must pay a conversion charge equal to 2% of the market value of their investment properties becoming part of the REIT. Shareholders in REITs pay tax on the distributions received in accordance with their particular tax profiles. Most major quoted commercial property investment groups, including Land Securities, British Land, Hammerson, Liberty and SEGRO, converted to REIT status in 2007 to take advantage of tax-exempt status. However the REIT sector, now with over 20 members, has grown slowly since those early days, partly because of the subsequent severe credit crunch, but also because, with the exception of a few subsequent relaxations to the legislative regime, not much was done by the last government to encourage a wider take up of REIT status.

There has been little progress against the original policy objective to encourage the creation of residential property REITs. However, the possible significant and ambitious changes announced in the Budget for informal

consultation, offer the prospect of a much more relaxed legislative regime, which if enacted, could see the creation of many new REITs and could well result in the first residential REITs being formed in the U.K.

Most of the possible changes announced in the Budget for consultation have been sought by industry representative bodies over the course of the years since the original REIT-enabling legislation was included in the Finance Act 2006, which paved the way for the U.K.'s first REITs in 2007.

In 2009, the House of Lords' Select Committee on Economic Affairs criticised the Treasury for being "complacent and unduly cautious" in framing the REIT legislation, resulting in the failure to create residential REITs. It described this as a "policy failure," as an original objective of the REIT legislation was to "attract more capital into house building." In addition, the Select Committee noted that there had been little attempt to respond flexibly or significantly to the design of REITs given the difficult economic conditions.

The Office of Tax Simplification (OTS), set up by the present government, reporting last month, commented on the complexity of the REIT legislation and the resulting compliance costs and administrative burden.

The OTS referred to the restriction disallowing close company REITs, the listing requirement and the burdens of demonstrating that the conditions of the regime are met and recommended simplification of the regime. In particular the OTS recommended the widening of the scope of REITs beyond listed companies and modification of the close company restriction. These recommendations have been accepted by the government and reflected in the significant proposals for informal consultation.

Possible changes announced in the Chancellor's Budget

In brief, the possible significant changes announced in the Budget were as follows:

- Abolition of the 2% conversion charge.
- Relaxation of the requirement that a REIT must be listed on a recognised stock exchange.
- Relaxation of the non close company condition by introducing a diverse ownership rule for institutional investors.
- A redefinition of "financing costs" for the gearing test.
- Allowing cash to be a "good asset" for the test that requires 75% of a REITs total assets to be property investment business assets.
- Extension of the time limit for payment of profit distributions to shareholders where stock dividends are involved.

Abolition of the 2% conversion charge would be a major change

It goes beyond the expectations of the industry who have been lobbying for some of the other possible changes announced, but not for this. Indeed the British Property Federation's response to the Budget noted that it "went further than even the most optimistic in the industry could have predicted." The removal of the 2% conversion charge would create a strong stimulus for conversion to REIT status and could result in U.K. property owned offshore being brought back into onshore ownership. The abolition would remove a major barrier to REIT entry.

However those companies that converted to REIT status in 2007, and who, in some cases had to pay hundreds of millions of pounds in conversion charges to do so, as well as companies who converted more recently and who also had to pay the charge, may feel aggrieved that new entrants may not be required to do so. Also, some have questioned why abolition is to be delayed for a year, rather than introduced now.

Nevertheless the abolition, if it does indeed ultimately take place, will generally be very much welcomed. The government will then obviously not receive any tax from those who convert, which could include institutional owners of major residential portfolios. They will, however, receive tax from REIT shareholders who are liable to tax on profit distributions received from new REITs.

Relaxation of the stock exchange listing requirement will open up the REIT regime

The present requirement for REITs to be listed on a recognised stock exchange is an impediment to the formation of more REITs. A number of overseas countries' REIT legislation

has been relaxed successfully in this way. There has long been criticism that companies listed on the Alternative Investment Market (AIM) have not been able to convert to REIT status, which would become possible. The costs of a full stock exchange listing are much greater than for an AIM listing. Such a relaxation may also open the way for private property companies to become REITs. Thus the relaxation of the current listing requirement would remove another major barrier to REIT entry and further encourage new entrants.

At present to become a REIT, a company must not be a close company, that is a company controlled by five or fewer participators.

It is proposed that this restriction be removed by introducing a diverse ownership rule for institutional investors. This will enable diversely owned institutions, such as life companies and pension funds, to join together to form REITs. This proposal, together with a budget measure reducing SDLT payable on the bulk purchase of residential properties, as explained below, could result in significant institutional investment through residential REITs. This would help rectify the "policy failure" that has seen the creation of commercial property REITs, but no residential property REITs.

A redefinition of "financing costs" for the gearing test could help REITs meet the requirements of that test

In order to prevent a REIT over-gearing and thus having low profits leading to a small tax take for the Treasury from distributions received by shareholders, the REIT legislation requires "financing costs" to be at least 1.25 times covered by gross profits. At present "financing costs" include items other than interest, including movements on derivatives,

hedging transactions and debt breakage costs which, under the test, must therefore also be covered at least 1.25 times by profits. Thus, some relaxations in what constitutes "financing costs" would enable REITs to more easily pass this gearing test.

Similarly, allowing cash to be a "good asset" for the test that requires at least 75% of a REITs total assets to be property investment assets, would help REITs pass that test

At present, cash is a "bad asset" unless it derives from the disposal of property investments sold within the past two years pending reinvestment. This puts pressure on REITs to reinvest such cash in property to ensure that it does not become a "bad asset." A relaxation of this rule, such as allowing a longer reinvestment time limit, would help REITs make decisions on how to spend such cash on purely commercial grounds and in the REITs best interests. Subject to the consultations, it is also possible that the relaxation might allow REITs to, for example, treat cash derived from investors as a "good asset."

Extending the time limit within which REITs can pay stock dividends would aid some REITs

A REIT must distribute at least 90% of its annual profits to shareholders, normally within one year of the end of each of the REITs accounting periods. A welcome previous relaxation to the REIT legislation permitted REITs to pay distributions using shares, as well as in cash. This was designed to help REITs retain valuable cash resources, particularly during the credit crunch. Some REITs that pay dividends every six months have found it difficult to administer the payment of stock dividends within the time limit. Accordingly, an extension to the time limit to pay such stock dividends would be of assistance to the REITs concerned.

As mentioned on the previous page, a measure announced in the Budget and to be included in the Finance Bill 2011, is SDLT relief on bulk purchase of residential properties that could result in significant SDLT savings.

At present, if a portfolio of residential properties is purchased, SDLT is payable based on the aggregate consideration paid. This would normally result in liability at the highest rate of SDLT. Under the proposed change, where a number of residential properties are bought in a single, linked transaction, SDLT will be based on the mean amount paid for the properties. This will be arrived at by dividing the aggregate consideration by the number of properties acquired.

The SDLT payable will then be based on the mean price paid for each property, which, depending on the value concerned, could result in lower SDLT rates being payable, but always subject to a minimum rate of 1%. This makes buying a portfolio of residential properties more akin to buying individual properties separately. It should, therefore, encourage institutions to buy residential property portfolios, which can be put into REITs.

Conclusion

The possible changes announced in the Budget for informal consultation on relaxations to the REIT regime are significant and ambitious. If enacted, they should lead to a major relaxation and simplification of U.K.'s REIT regime. They are likely to make the regime much more attractive to new entrants and make the regime work better for existing REITs.

This could result in significant growth in the REIT sector, particularly in the residential property area, and bring in major institutional investment. The government is to be congratulated for accepting and putting forward the recommendations of the OTS, as well as responding to past lobbying by the industry and its representative bodies. The possible abolition of the 2% conversion charge goes even further than the industry could have expected.

It remains to be seen what changes will ultimately emerge from the informal consultations, but it is to be hoped that the prospect of a bright new future for REITs will not be hampered by unnecessary and unwelcome restrictions and caveats.

Land remediation relief

Is it being phased out?

Possible withdrawal

The proposed withdrawal of land remediation tax relief will be a blow to developers of brownfield land, if it proceeds as originally suggested.

The OTS report, published in March 2011, recommended the abolition of this incentive on the basis the tax relief was not driving behaviour, not being cost effective and that remediation is carried out anyway as a normal part of construction. We firmly believe this conclusion can be improved for a number of reasons and are making representations to HM Treasury on behalf of several industry bodies.

The Treasury has acknowledged that it would be desirable to provide a period of notice before the abolition of some reliefs, including land remediation relief. The Budget statement is vague and gives no indication as to a timetable for withdrawal of the relief, other than to say that it will be after the 2012 Finance Bill, so we assume April 2013 at the earliest. The wording used does not confirm that the relief will be abolished as they have for the Finance Bill 2011 list, and state they intend to abolish, but will be consulting with the industry first. Land remediation tax relief's fate is, therefore, by no means certain at this stage.

The proposed removal of a tax relief for those businesses who meet the government's challenge of brownfield redevelopment takes away a valuable incentive. Replacing this system with a sector and location-specific initiative would seem to be incongruous with the Chancellor's opening remarks and the Treasury's stated aim of "fairness" in the tax system. We look forward to working with the industry as part of the consultation process to resolve this perceived imbalance.

Removal of the incentive for brownfield development may result in two main problems:

- Firstly, as most new homes at the more affordable end of the market are constructed on brownfield sites, their purchase prices will probably increase to cover increased costs.
- Secondly, it will become less attractive to build on brownfield, if the costs of development increase as the market cannot support the risk and cost of remediation.

The introduction of enterprise zones throughout the country to assist industry is welcomed. This tax relief is targeted, however, at a very select group through business rates relief and capital allowances. Homebuilders and property developers will not benefit from business rates relief, and as neither "stock in trade" expenditure nor residential properties form part of the capital allowances regime, they will not benefit from this new incentive. We would also suggest that the extension of the business premises renovation allowance for a further five years would appear to be inconsistent with the abolition of land remediation relief. Both types of relief are targeted at optimising land use and the benefit of the former is far more narrowly focused than the latter.

Conclusion

The residential sector has been assisted by the introduction of the FirstBuy scheme, which provides first time buyers with assistance towards a deposit to purchase a new home. However, this does not deal with the affordability issue of the homes in the first instance and will not provide the new homes that the country desperately needs.

Summary

Within this Budget Tax Special, we have looked in quite a bit of detail at four of the main tax areas that were covered in the Budget. We have deliberately ignored areas where there is very little else to say and concentrated our efforts in the areas where there is an element of uncertainty. Starting with carbon taxes, we have seen that the net effect of changes in this area of taxation is always going to be revenue positive for the Exchequer and therefore, negative for the taxpayer. As we mentioned earlier, the Treasury's supporting data highlights more tax "stick" than incentive "carrot" as far as the government's approach to carbon reduction is concerned. In addition, the incentives that are available are surrounded by considerable complexity and this whole area would benefit from being included in the ongoing quest for tax simplification.

On the subject of incentives, the capital allowances regime would appear to have been positively impacted by the Budget as far as the taxpayer is concerned. The extension of the cutoff period for SLA treatment is very welcome and the negative affect of the previously announced reductions to capital allowances have been further offset by the additional reductions to the corporation tax rate. However, income taxpayers and small companies will not benefit to the same extent as large companies and the property investment sector will benefit the least of all. In addition, the mandatory pooling of fixtures could further increase the complexity of the capital allowances legislation and changes to the anti-avoidance rules may add uncertainty.

The proposed changes to the legislation for REITs look to be both potentially significant and generous. Scrapping the conversion charge was one of the surprise proposals to come out of the Budget and the relaxations to the current rules can only benefit the future development of the U.K. REIT sector. In contrast, the proposed abolition of land remediation relief was a disappointment, especially for the house builders who are faced with rising costs at a time of muted demand. It is to be hoped that abolition of this relief, which was recommended in the interests of tax simplification, will be dropped in the interests of enterprise.

Finally, we anticipate that much of the uncertainty surrounding the issues that we have considered above should be addressed by the considerable volume of consultation documents that we can expect to see by the end of May. There will certainly be no shortage of tax issues for us to write about over the coming months.

National seminars

We will shortly be holding a number of seminars throughout U.K. commencing late May. If you are interested in attending, please email lorraine.morley@davislangdon.com with your contact details and we will send you our programme and invite when it becomes available. Alternatively, look out for the announcement over the next few weeks in our events section on our website at www.bankingtaxfinance.com.

Further information on issues raised

For further advice please contact the following specialists:

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Short listed for the Best Tax Consultancy Team; *LexisNexis Taxation Awards 2011*.

The Davis Langdon Banking Tax and Finance team has won a place on the shortlist for the best tax consultancy team category in this year's *LexisNexis Taxation Awards*. This is a notable achievement with the judges citing that "an incredibly high standard of entrants" had given them a tough job in determining the shortlist. We eagerly await the announcement of the winner at a gala dinner at the London Hilton on 26 May 2011.