SQUIRE SANDERS

BUDGET OF 21 MARCH 2012: PRIVATE EQUITY BUDGET UPDATE

Introduction

This note overviews the key tax issues for individuals who hold shares/incentive packages in private equity backed companies and for the companies themselves.

Taxation of Individuals

- Before discussing today's changes to the income tax rates, it is important to mention the news regarding capital gains tax rates – nothing happened. This is good news. Entrepreneurs' relief, which allows an individual to claim a 10 percent capital gains tax rate on the first £10 million of their gains so long as qualifying conditions are met, has been very popular in the industry. Further, the budget has not announced any changes to fund managers' carry, which is taxed at the 28 percent capital gains tax rate rather than at the income tax rates.
- There was also good news for EMI option schemes. These are tax favoured option schemes where the gain is taxed at the capital gains tax rather than at the income tax rates. To date, EMI options can only be granted over shares worth £120,000 calculated as at the grant date. The plan is to extend the limit to £250,000 but this is subject to European Union (EU) state aid approval. The Chancellor also noted that capital gains on EMI options would be capable of qualifying for entrepreneurs' relief from 6 April 2012. Again, this change is subject to EU state aid approval.
- The decision to cut the additional rate of income tax from 50 percent to 45 percent, with effect from 6 April 2013, still means that income gains are charged at a premium to capital gains (where the highest rate of tax is 28 percent). Therefore, individuals investing in private equity based companies still have incentives to structure their returns so that they are taxed as capital rather than as income. Individuals who cannot structure their returns to avoid employment income treatment, such as the holders of phantom and unapproved options, may choose to take steps to defer income recognition until on or after 6 April 2013 so they can benefit from the cut.
- The Chancellor today announced an extension to the personal allowance to £9,205 from 6 April 2013. This extension adds to the 60 percent tax trap for individual taxpayers with income over £100,000. The individual taxpayer loses £1 of personal allowance for every £2 by which his income exceeds £100,000. Therefore, taxable income from £100,000 to £118,410 will be subject to a 60 percent effective tax rate. Private equity backed companies need to consider this point when they devise reward packages for their key employees.
- The government has announced that it will implement a general anti-avoidance rule (GAAR) in 2013 and there will be a prior consultation period. It remains to be seen whether the GAAR will be restricted to its stated objective of targeting highly-abusive tax schemes or whether there will be the "mission creep".

Taxation of Companies

- The government decision to accelerate the corporation tax cut to 24 percent for the tax year 1 April 2012–30 March 2013 will be welcome news for private equity backed companies. The government has also announced a cut to 23 percent for 1 April 2013-30 March 2014, and a further cut to 22 percent for 1 April 2014-30 March 2015. However, it should be remembered that headline tax rates are not the same as effective tax rates and it will be necessary to take into account the full range of tax reliefs available to a private equity backed company to establish the real economic consequences of these developments.
- The work on the patent box regime continues and the plan is for the new rules to have a phased implementation with effect from fiscal year 1 April 2013 onwards. The policy intention is, through the use of enhanced deductions, to enable companies to achieve a 10 percent effective tax rate from their patented income and from product sales which use patented components. Private equity backed companies should review their sources of revenue to establish if they can bring some or all of their revenue within the patent box.
- Private equity backed companies which have non-UK subsidiaries should note that the UK's Controlled Foreign Companies Reform project continues and legislation is likely to take effect for accounting periods beginning on or after 1 January 2013. The new rules are very technical. However, they reduce the circumstances in which HMRC can tax the non-UK resident subsidiaries of UK parent companies to where there has been artificial avoidance of UK tax. Private equity backed companies should assess the non-UK resident companies within their group structure to see if they can benefit from these proposals.
- The comments made on the GAAR for individuals are equally relevant to corporate tax payers. Again, it will be important to monitor whether the GAAR is restricted to its stated objectives or whether there will be "mission creep".