

MACFARLANES EMERGENCY BUDGET UPDATE 2010

This summary will provide you with a snapshot of the issues that will affect you and your business.

BUDGET HEADLINES:

As well as announcing a number of specific measures (some of which had been expected), the Chancellor has signalled that the Government is planning to review and reform the UK tax regime to ensure that it is conducive to economic recovery.

Personal taxation

- ◆ Capital gains will be taxed at 28 per cent to the extent the individual's total income and gains exceed the income tax basic rate band of £37,400 with effect from 23 June. Gains below that threshold will continue to be taxed at 18 per cent. The entrepreneurs' relief lifetime limit below which gains are taxed at 10 per cent will be increased to £5m.
- ◆ The income tax personal allowance will increase by £1,000 to £7,475 for those under 65 from 6 April 2011 with the long term objective of being increased to £10,000. Higher earners will not benefit, as the threshold for higher rate income tax will remain fixed.
- ◆ The Government will be revisiting the tax treatment of pension contributions made by higher earners, and is considering allowing tax relief at higher rates but significantly reducing the annual cap on contributions attracting relief.
- ◆ Settlers of trusts will be required to pay to their trust any tax reclaimed where they do not pay tax at the 50 per cent rate.
- ◆ There will be a consultation on extending the disclosure of tax avoidance schemes (DOTAS) regime to inheritance tax on trusts, and to SDLT on high value residential property.

Business taxation

- ◆ The main rate of corporation tax will be reduced from 28 per cent to 27 per cent from 1 April 2011, and then by one per cent each year until the rate reaches 24 per cent by 2014.
- ◆ Capital allowances will be reduced from 20 per cent to 18 per cent per annum for expenditure on plant and machinery allocated to the main pool, and from 10 per cent to 8 per cent for plant and machinery in the "special rate pool" (which includes long-life assets and integral features) with effect from April 2012. The annual investment allowance, which gives 100 per cent relief, will be reduced from £100,000 to £25,000 with effect from April 2012.

- ◆ The standard rate of VAT will increase from 17.5 per cent to 20 per cent for supplies made on or after 4 January 2011. The higher rate of insurance premium tax will also rise to 20 per cent from that date. No changes will be made to the VAT rules on zero rated and lower rated supplies. Anti-forestalling rules will be introduced to prevent artificial acceleration of supplies aimed at securing the lower rate of VAT.
- ◆ Retrospective legislation will be introduced to ensure that the corporation tax dividend exemption introduced in 2009 does not inadvertently result in many more distributions being taxed as capital gains.
- ◆ In a statement released jointly with the Governments of France and Germany, the UK Government has announced plans to introduce a levy of 0.07 per cent on the relevant aggregate liabilities of banking groups above a minimum size, with an initial rate of 0.04 per cent with effect from 1 January 2011.
- ◆ New rules will be introduced to counter avoidance schemes which involve the "derecognition" of income from certain loan relationships and derivatives for accounting purposes by overriding the accounting "derecognition" for tax purposes in certain circumstances.
- ◆ A series of consultations has been announced for later this year, including a general review of the structure of corporation tax; further reform of the taxation of foreign profits, including the UK's controlled foreign company rules; consideration of a general anti-avoidance rule; and proposals to reform the process of tax policy making.

CONTENTS

1	BUDGET HEADLINES
2	TAXATION OF INDIVIDUALS
6	COMPANY TAXATION
12	INDIRECT TAXES
14	PROPERTY TAXATION
15	PERSONAL ALLOWANCES & TAX RATES

TAXATION OF INDIVIDUALS

Introduction

This Budget, the first of the new Conservative/Liberal Democrat Coalition, contained a number of widely expected changes. As far as personal tax is concerned, these are not as wide ranging and extensive as in some previous Budgets. However, the changes to the rate of capital gains tax will have a long term effect and influence the investment decisions of many private investors. Both the increases in the personal income tax allowance for basic rate taxpayers and the increase in the rate of VAT will also have a significant impact. No changes to inheritance tax were announced apart from a widening of the disclosure rules; nor were any concrete announcements made about changes to the taxation of non-UK domiciled individuals.

This is, however, just the beginning and further changes can be expected from the present Chancellor in subsequent Budgets.

Capital gains tax

Raising the rate of capital gains tax

There has for some time been speculation about the rise in the capital gains tax rate. In recent years the regime has been through a number of guises. From 1988 until 1997, capital gains were (in the absence of any relief) taxed at an individual's highest marginal rate of tax (40 per cent for most disposals by higher rate taxpayers). Between 1998 and 2008, taper relief operated to reduce the effective rate of tax on assets held over a long period. For business assets, the rate could be reduced to as little as 10 per cent after two years.

From April 2008 onwards, taper relief was abolished, and a new uniform flat rate of 18 per cent was introduced. Although the introduction of the 18 per cent rate made some sense as a political compromise between the expectations of entrepreneurs and other taxpayers at the time, it has begun to look increasingly anomalous following the introduction of the new 50 per cent additional rate of income tax.

Although it was widely anticipated that Alistair Darling would raise the capital gains tax rate - either in the Pre-Budget Report 2009 or in what proved to be his last Budget in March - he failed to do so on both occasions. If an increase in the rate proved to be a difficult political decision for a Labour Government, one could be forgiven for thinking that it would be a much less appealing nettle for an incoming Conservative administration to grasp. So the announcement in the Coalition Agreement in May that capital gains tax would be increased to a rate "similar to" income tax rates came as something of a shock.

The wording of the Coalition Agreement provoked fears that the new rate could be as high as 50 per cent (if the rate were to be aligned with the additional rate of income tax to prevent taxpayers from implementing strategies to yield capital gains rather than income returns). However, in the Queen's Speech, the statement concerning capital gains tax was watered down to refer to new rates "closer to" income tax rates. Finding the right balance was clearly going to be a difficult decision for George Osborne, as the subject elicited a good deal of high profile adverse comment from backbenchers including John Redwood.

In addition to speculation over the rate, there has also been much discussion over the timing of any increase. Would it take effect on the date of the Emergency Budget (i.e. 22 June) or might it be backdated to 6 April 2010? The balance of professional opinion was that backdating the increase would be unconscionable, and introducing a rise in rates part of the way through a tax year would present too many difficulties. It was widely thought that any change would therefore take effect from 6 April 2011, thus encouraging taxpayers to make disposals in the run-up to the change which would swell the Treasury's coffers.

In the event, the Chancellor announced that basic rate taxpayers will still pay tax at 18 per cent on capital gains. However, higher rate taxpayers, personal representatives and trustees will pay a higher rate of 28 per cent capital gains tax on disposals made on or after 23 June 2010. This announcement is surprising for two reasons. First, the rise in rates is not as drastic as had been feared, meaning that there is still a significant advantage in obtaining a capital gains tax return rather than an income tax return for many taxpayers; and secondly, the Chancellor has decided to implement the change part way through a tax year.

Draft legislation implementing the rise (which can be expected to include detailed transitional provisions) has not yet been published and we will need to wait until the Finance Bill is available for further details. However, HMRC has produced a "Questions and Answers" document which gives an insight into the way the new regime will function.

For disposals on or after 23 June 2010, the rate of tax will be determined by adding the amount of the gain to the individual's taxable income for the year. If the individual has any unused lower rate band available (i.e. in most cases if his income is lower than £43,875 for 2010/11 - being the sum of the personal allowance and lower rate band) then he will pay capital gains tax at the 18 per cent rate on the portion of the gain which falls within that amount. Any portion of the gain which exceeds the unused amount of the taxpayer's basic rate band will be chargeable at 28 per cent.

Clearly, for taxpayers with income in excess of the lower rate band, the entire gain will be charged at 28 per cent.

It is clear that disposals made before 23 June will be taxed simply at the 18 per cent rate. However, gains realised before 23 June 2010, the tax on which has been deferred (e.g. by investing in shares qualifying for the enterprise investment scheme, or (it seems) by selling shares in exchange for qualifying corporate bonds on a share-for-share exchange) will be potentially chargeable at the higher rate if the deferred gain comes into charge on or after 23 June 2010.

The questions and answers also make it clear that taxpayers can set off their losses before 2010/11 and their annual exempt amount in whatever way is most beneficial for them. So it seems that losses can be used first against gains accruing on or after 23 June 2010 which would otherwise be subject to the higher rate of tax.

For non-domiciled taxpayers qualifying for the remittance basis, the relevant rate on gains on foreign assets will be the rate in force at the date of remittance. So even where gains have been triggered prior to 23 June 2010, if they are remitted to the UK on or after that date the potentially higher rate of 28 per cent will be in point.

One point which is not addressed in the materials provided to date is the treatment of capital gains attributed to beneficiaries who receive capital payments from offshore trusts. For gains realised in tax years prior to the year in which they are attributed to a beneficiary, the effective rate of capital gains tax increases. Under the 18 per cent regime, the maximum rate was 28.8 per cent for gains realised six or more years before a matching distribution. Although there is no detail available on this, it seems that the new maximum rate for a beneficiary who is a higher rate taxpayer will be 44.8 per cent.

It is currently unclear how capital payments made during the current tax year on or before 22 June will be taxed. The legislation currently provides that attributed gains are treated as gains of the beneficiary "for the year" in question. Although on the face of things this could mean that all capital payments are vulnerable to the new higher rate, it would be consistent with HMRC's approach to other split year issues expressly covered in the questions and answers they have published if the year were treated as split into two, so that capital payments received before 23 June (and matched to gains which are realised before that date) are taxed under the old regime and those received on or after 23 June are taxed under the new regime.

A final word on the rate rise. The following appears among the questions and answers published by HMRC:

"Q13 The Coalition Agreement talked about CGT rates becoming more closely aligned with income tax rates. Does this mean that the 28 per cent rate will go up to 40 or 50 per cent next year?"

A13 The Chancellor will decide the rates of CGT for 2011-12 in the Budget in 2011".

This disconcerting statement keeps the possibility for a further rate rise open.

Extension of entrepreneurs' relief

The Coalition Agreement referred to balancing the introduction of a higher capital gains tax rate with generous reliefs for genuine entrepreneurs. Again, there has been much speculation over the form of any such reliefs; and in particular whether they would be as generous as business assets taper relief (which, in its final form, applied (among other things) to gains realised in respect of any unquoted shares in a trading company). In the event, the Chancellor has announced an extension to entrepreneurs' relief.

Entrepreneurs' relief was introduced in 2008 as a trade-off for the abolition of business assets taper relief. The relief allows individuals (and in some cases their trustees) disposing of business assets (including shares in the trading company of which the individual is an officer or employee) to pay tax at an effective rate of 10 per cent. The availability of the relief has, since inception, been subject to a lifetime cap.

Originally, this meant that the relief could only be claimed on gains of up to £1m over a taxpayer's lifetime. In his last Budget Alastair Darling announced that this would be increased to a £2m cap. Today, the Chancellor announced that the cap will be increased to a lifetime limit of £5m from 23 June 2010. This will not be backdated; where individuals or trustees have made qualifying gains above the limits previously in force before 23 June 2010, no additional relief will be allowed above the limit in force at the time. However, if they make further qualifying gains on or after 23 June 2010 they will be able to claim relief on the "unused" amount of the new cap.

The extension of the relief, although less generous than many had hoped, now means that entrepreneurs' relief is a more significant issue for owner/managers. Whereas on the inception of the relief the maximum tax saving was £80,000, under the new rates and with the new lifetime cap that saving has increased to a potential £900,000. So there will be more

of a premium by ensuring the relief applies. Those with a stake in a business for whom the relief might be available should consider taking advice to ensure there are no impediments to obtaining the relief in full on a disposal.

Income tax

The income tax personal allowance

From 6 April 2011, the income tax personal allowance for those aged under 65 will be increased by £1,000 to £7,475.

When calculating a person's income tax liability, their personal allowance is first deducted from their gross income and then the relevant rate or rates of income tax applied to the different bands of income. The effect of increasing the personal allowance is that some individuals will no longer have any taxable income at all. Also, if this was the only change, all other taxpayers (including higher rate taxpayers) would also have less taxable income. However an additional change has been announced which will mean that higher rate taxpayers do not receive any overall benefit from the increase in personal allowance.

The point at which income tax becomes payable at the higher rate (as opposed to the basic rate) will be reduced so that although higher rate taxpayers will have less taxable income, more of it will be taxed at the higher rate. The threshold will be set at the level necessary to ensure that the effect of the increase in personal allowance is neutralised for these taxpayers. The relevant figure will be determined in the autumn.

This is therefore a carefully targeted measure, designed to give relief to lower earners whilst safeguarding the tax revenue from those with larger incomes.

Indexing ISA limits

It has been confirmed that the ISA contribution limit will increase in line with inflation from 6 April 2011. Any increase will be calculated by reference to the Retail Prices Index for the September before the start of the tax year in question. If inflation is negative, the ISA contribution limit will remain the same as the previous tax year.

The ISA contribution limit is currently £10,200 (with the limit for cash ISAs being £5,100).

Settlors and trusts

Where a settlor is able to benefit under the terms of a trust, the trust income is treated as his for tax purposes. As to the mechanics, the trustees will pay tax at the trust rate (now 50 per cent from 2010/2011 onwards); where the settlor is liable to tax personally at a lower rate, HMRC will in practice allow the

settlor to receive the difference between the trust rate and their personal rate as a tax repayment.

Under the measures announced in today's Budget, the settlor will be required to pass on any repayment of tax he receives to the trustees. Under the inheritance tax changes introduced in 2006, any payment to a trust would otherwise be an immediately chargeable transfer for inheritance tax purposes; however, it will be provided that the repayment to the trust by the settlor will be disregarded and not be a chargeable transfer for inheritance tax purposes.

This measure, which had been announced in the March 2010 Budget but which was not implemented, will now be taken forward and introduced with effect from 6 April 2010.

Furnished holiday lettings

As part of the 2009 Budget, measures were announced by the then Government to withdraw the furnished holiday lettings rules which apply to individuals, partnerships, trustees and companies who have income or capital gains from the commercial letting of furnished holiday accommodation. The current furnished holiday letting rules were due to be withdrawn for income tax and capital gains tax purposes from 6 April 2010 and for corporation tax purposes from 1 April 2010.

The rules allow profits arising from the letting of furnished holiday accommodation to be treated as profits of a "trade" rather than of a property lettings business. Amongst other things, this enables owners to set off losses realised from the letting of the accommodation against other income and to benefit from the capital gains tax reliefs that apply to business assets (including entrepreneurs' relief).

In a measure that will please the tourist industry, the Chancellor has confirmed that the existing rules relating to furnished holiday lettings will remain for the tax year 2010/2011. Moreover, the current practice of HMRC to apply the furnished holiday lettings to qualifying properties situated elsewhere in the European Economic Area (EEA) will continue to apply for the tax year 2010/2011.

The Chancellor has announced that the Government will publish a public consultation over the summer with details of planned changes to the tax treatment of furnished holiday lettings which will apply from April 2011. This consultation will specifically focus on:

- ◆ ensuring that the furnished holiday lettings rules apply equally to properties in the EEA;
- ◆ increasing the number of days that qualifying properties

have to be available for letting to the public (currently only 140 days in the tax year) and the actual number of days the property must be let (currently only 70 days); and

- ♦ changing the way in which loss relief is available to furnished holiday lettings.

Pensions

Removing the effective requirement to buy an annuity

Currently, individuals who do not acquire an annuity or otherwise secure an income from their registered pension schemes by age 75 are subject to restrictions on income withdrawal and to potentially harsh inheritance tax rates on their pension pots. The abolition of this regime was a shared policy of the Conservative and Liberal Democrat parties so an announcement to this effect was therefore expected.

The requirement to purchase an annuity will be removed with effect from 6 April 2011 when new rules will come into force. The Government will be consulting interested parties in the meantime. For individuals who turn 75 on or after 22 June 2010, transitional rules are to be put in place which, amongst other things, defer the age at which a pension must be annuitized to age 77, thereby giving those individuals time to seek advice on how to deal with their pensions in light of the new rules.

Pensions tax relief

The Government is set to repeal the legislation enacted under the former Labour Government which would, from 6 April 2011, have withdrawn higher rate tax relief on pension contributions for those earning over £150,000 per annum. The Government acknowledges however that reform is required in order to tackle the fiscal deficit and has announced that it will launch a consultation process to consider in particular whether their desired result can be better achieved through significantly reducing the annual allowance for pension contributions. The allowance is currently set at £255,000 per annum (from 2010/11 to 2015/16) and contributions above this incur a 40 per cent charge on the pension scheme provider. The Government's announcement indicates this allowance may be reduced to £30,000-45,000 per annum. The anti-forestalling measures which prevent significant contributions (over and above any history of regular contributions) being made in advance of the change in regime will, however, remain in force for the time being.

Inheritance tax

Disclosure of schemes

The Government will consult on extending the regulations for the Disclosure of Tax Schemes (DOTAS) to inheritance tax on trusts. Broadly speaking, these rules require those involved with

the implementation of tax avoidance schemes to notify HMRC of details of the planning. The rules were first introduced in 2004; but to date they have not applied to inheritance tax planning.

This announcement follows on from the introduction in the Pre-Budget Report 2009 of two specific anti-avoidance rules regarding trusts. At that time it was announced that the Government would look at further measures to prevent avoidance inheritance tax involving trusts. For the moment it appears that HMRC's approach will be to monitor more closely inheritance tax avoidance through the application of the DOTAS rules before any further measures are introduced.

Taxation of non-UK domiciled individuals

Following the radical changes to the tax treatment of individuals resident but not domiciled in the UK implemented in 2008, such individuals and their advisors had hoped to see no further changes to the regime for some time. However, the Coalition Agreement included a statement that the taxation of non-UK domiciled individuals would be reviewed. This is perhaps unsurprising given that one of the Liberal Democrats' manifesto pledges was to remove the privileged tax treatment of non-UK domiciled individuals who have been resident in the UK for more than 7 years.

The Chancellor made no substantive announcement about the taxation of non-UK domiciled individuals. However, tucked away in the additional briefing materials is the following statement:

"As announced in the Coalition Agreement, the Government will review the taxation of non-domiciled individuals. This will assess whether changes can be made to the current rules to ensure that non-domiciled individuals make a fair contribution to reducing the deficit, in return for greater certainty and stability for those bringing skills and investment to the UK".

This is rather ominous and does not offer any comfort to those who might have hoped that the "review" was largely an exercise in shelving the issue whilst placating the Liberal Democrats. It seems that real changes may follow at some stage in the not-too-distant future.

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COMPANY TAXATION

Review and reform

The Emergency Budget contains a number of specific measures designed to increase taxes to help reduce the country's deficit. At the same time, the Chancellor has signalled that the Government is embarking upon a process of reviewing and reforming the UK tax regime more generally, including the way in which tax law changes are made.

The Government plans to reform the corporate tax system and, to this end, is setting up a business forum to consult with multinational business on the UK's tax competitiveness. The Government believes that a system with a broad tax base, a low tax rate and a more territorial approach will improve competitiveness. The previous administration's review of the corporate taxation of foreign profits was fraught with problems, contributing to the perception that the UK was not a favourable location for multinational groups. In relation to the UK's controlled foreign company regime and the taxation of foreign branches, the lengthy review process had not completed by the general election in May. The Coalition Government confirms that these are areas it will reform. It will consult this summer on interim changes to the existing CFC regime, to be legislated in spring 2011, and plans to make wider reforms in spring 2012. It is generally assumed that these wider reforms will not be based on the previous administration's proposals. Consultation on some aspects of foreign branch profits will also take place this summer, with changes scheduled for 2011.

The Government has announced plans to review some specific aspects of the corporate tax regime, including the taxation of intellectual property and small business tax, which will be reviewed together with the application of IR35. It is confirmed that the outstanding consultation on the capital gains rules for groups will be continued.

In a welcome development, the Government promises "a new approach" to tax policy making. The Coalition parties have listened (in the days before they came into power) to complaints from business and professionals about the way in which changes to the UK tax regime have been made over recent years. A more considered approach is advocated, with earlier and fuller consultation and greater scrutiny of draft legislation. It is acknowledged that the process of tax reform (as well as the tax rules themselves) contributes to the way in which a country's tax regime is perceived. The Government is really grabbing the bull by the horns; it also intends to set up an independent Office of Tax Simplification.

This Budget, like others in recent years, contains a number of specific provisions countering tax avoidance schemes. As part of its new approach to tax policy, the Government plans to examine the merits of introducing a general anti-avoidance rule. This has been considered before and was dropped as a proposal when it proved to be very difficult to draft an effective rule and was considered unworkable without a potentially expensive pre-transaction clearance process to reduce uncertainty for taxpayers. It will be interesting to see how this progresses.

Corporation tax rates

The main rate of corporation tax (applicable to companies with profits in excess of £1.5m per year) will be reduced from 28 per cent to 27 per cent from 1 April 2011. The main rate will be further reduced by 1 per cent in each of the three financial years from 1 April 2012 until the rate reaches 24 per cent from 1 April 2014.

The small companies' rate of corporation tax (applicable to companies with profits below £300,000) will be reduced from 21 per cent to 20 per cent from 1 April 2011.

For companies with ring-fenced profits arising from oil extraction or oil rights in the UK or the UK Continental Shelf, the main rate of corporation tax will remain at 30 per cent and the small companies' rate of corporation tax will remain at 19 per cent.

These are welcome changes which should assist the Coalition Government's stated aim of making the UK's corporate tax system more internationally competitive. The reduction will widen the gap between the headline rate of UK corporation tax and the US corporate income tax rate of 35 per cent (excluding state taxes), and the UK rate will compare favourably to headline corporate tax rates in many other European jurisdictions - for example, France at 33.33 per cent, the Netherlands at 25.5 per cent and Spain at 30 per cent - though it will still lag behind Ireland's rate of 12.5 per cent and Germany's rate of 15.83 per cent.

Capital allowances

Legislation will be introduced to reduce the rates of capital allowances and the amount of capital expenditure that qualifies for the annual investment allowance (AIA). It is intended that these reductions will help to subsidise the lower headline rate of corporation tax. However, whereas the main corporation tax rate will start to taper away with effect from April 2011, the changes to the rates of capital allowances and the AIA will not take effect until April 2012.

Writing down allowances

Capital allowances allow a tax deduction for businesses which incur capital expenditure on qualifying plant and machinery. They are intended to replace depreciation, which is not allowable for tax purposes.

Historically, the rates at which capital expenditure could be written down have been relatively generous: prior to April 2008, the writing down allowance (WDA) for plant and machinery allocated to the "main pool" was 25 per cent of the reducing balance of that pool; since that date the WDA has been 20 per cent. The Chancellor announced that this WDA will be reduced to 18 per cent.

The rates at which long life assets can be written down will also change. Prior to April 2008, the WDA for long life assets was 6 per cent. After that date, long life assets and integral features (fixed plant and machinery, such as lifts and air conditioning) have been allocated to the "special rate pool" which attracts a WDA of 10 per cent. It was announced in the Emergency Budget that the WDA of the special rate pool will be reduced to 8 per cent.

Both reductions in the rates of WDAs will be deferred until April 2012. Transitional rules will apply to so that those businesses whose chargeable periods span that date will be subject to a "hybrid" WDA.

Annual investment allowance

Since April 2008, most businesses have been able to claim an AIA on up to £50,000 of expenditure on plant and machinery. The AIA provides an immediate 100 per cent tax deduction for qualifying expenditure. At the last Budget, the AIA was doubled to £100,000, with effect from April 2010. In the Emergency Budget, the Chancellor announced that this AIA will be reduced to £25,000 with effect from April 2012, with transitional rules to be published in due course.

Research and development tax relief

The Government has confirmed that it will implement a measure proposed in the Pre-Budget Report 2009 relating to enhanced tax relief for expenditure on research and development. In relation to expenditure in an accounting period ending on or after 9 December 2009, it will no longer be a requirement that any intellectual property deriving from the research and development be owned by the company claiming the relief.

Bank levy

In a joint statement released today, the Governments of the United Kingdom, France and Germany have proposed the introduction of a bank levy. The levy will be calculated according to banks' balance sheets. All three levies aim to encourage banks to adjust their balance sheets in order to reduce the risk inherent in their funding profiles.

Broadly speaking, the bank levy will be applied to the consolidated balance sheet of UK banking groups and building societies and will be based on the total relevant liabilities shown in that balance sheet (excluding Tier 1 capital, insured retail deposits, "repos" secured on sovereign debt and policyholder liabilities of retail insurance businesses) if such relevant liabilities exceed £20bn. The current proposal is that the main rate of the levy will be set at 0.07 per cent although a lower rate of 0.04 per cent will apply during 2011 and other reduced rates may apply in certain circumstances. Anti-avoidance rules are also expected to be introduced.

The UK Government intends to consult with the banking industry over the summer in relation to the nature and application of the levy with final details expected to be published later in the year. It is currently expected that the bank levy will take effect from 1 January 2011.

Company distributions

Retrospective legislation will be introduced to correct the rules on the taxation of company distributions introduced last year so that they do not result in many more distributions being taxed as capital gains.

In Finance Act 2009, the Government introduced a new regime for the taxation of company distributions. This provided a series of relatively broad exemptions for distributions received by UK companies from other companies, whether resident in the UK or outside the UK. Distributions "of a capital nature" were, however, excluded.

At the time, several commentators raised concerns that the new rules might result in many previously exempt distributions paid by one UK company to another becoming taxable as capital gains. Some assurances were given by the Financial Secretary to the Treasury, Stephen Timms, in the Parliamentary debates that the legislation would not have this effect.

That position became untenable as a result of the arguments raised by HMRC in the case of *First Nationwide v HMRC*. In that case, HMRC argued that certain dividends paid out of capital reserves could not be dividends because they were not

paid out of reserves created from normal commercial profits. Even though those arguments were regarded by many as heretical and were robustly rejected by the Tribunal, they gave rise to considerable uncertainty about the correct tax treatment of company distributions.

In February 2010, the Government announced that legislation would be introduced to restore the position for most distributions to that which obtained before the introduction of the new regime in July 2009. Draft legislation was not ready in time for the March Budget, but has now been issued.

The key features are as follows.

- ◆ Retrospective legislation is proposed to repeal the exclusion of "distributions of a capital nature" from the exemption regime introduced in the 2009 legislation. Distributions which fall within those exemptions will also not be taxed as capital distributions.
- ◆ There is also a specific provision to treat distributions paid out of reserves created on a reduction of capital as a distribution and not as a repayment of capital. This provision is designed to address the arguments raised by HMRC in the First Nationwide case, although many commentators consider it unnecessary. It applies to distributions made after 1 July 2009 for corporation tax purposes and to distributions made after 22 June 2010 for income tax purposes.
- ◆ Taxpayers will be able to opt out of the retrospective impact of these rules.

Some issues remained unresolved.

- ◆ It is still not clear whether certain distributions in specie made between UK companies will continue to fall outside the exemption regime and so still be taxed as capital distributions.
- ◆ The proposed legislation extends the new rule for dividends paid out of reserves created on a reduction of capital to individual taxpayers. It raises the prospect that individual taxpayers might claim capital treatment for certain historic distributions, such as those paid out of reserves created on a reduction of capital (on which they previously paid tax as income), and possibly a refund of tax paid in relation to them. Such claims would have to be made on the basis of the arguments raised by HMRC in the First Nationwide case. Those arguments were of course rejected by the Tribunal, but there is no reason for the new legislation unless one believes - as we must assume HMRC do - that those arguments were correct at the time.

Corporate debt

Income tax withheld at source

Individuals and other non-corporate entities are required to deduct income tax at source on certain annual payments, including interest and royalty payments. Income tax withheld at source must currently be reported and accounted for to HMRC "without delay" and may, in certain circumstances, form part of the taxpayer's self-assessment.

Following consultation with taxpayers, HMRC plan to update the reporting and payment procedures for income tax withheld at source by individuals and other non-corporate entities. It is expected that a new form will be introduced to enable these taxpayers to report and account for income tax withheld at source separately from their other income tax liabilities.

The relevant legislation will be introduced later in 2010. The proposed changes do not affect income tax withheld at source by companies under the CT61 procedure.

Loan relationships anti-avoidance

Profits and losses arising from loan relationships and derivatives are normally calculated for corporation tax purposes based on the treatment of the relevant transactions in the accounts (drawn up in accordance with generally accepted accounting practice).

HMRC have become aware of a number of tax avoidance schemes whereby certain loan relationships or derivatives (and their associated cash flows) are "derecognised" in the accounts in accordance with generally accepted accounting practice (notably IAS 39) in order to take the relevant credits and debits out of account for corporation tax purposes.

Legislation will be introduced in the Finance Bill 2010 to counter these schemes. The legislation will provide that the corporation tax rules will override any "derecognition" in the accounts in certain circumstances. In particular, a "derecognition" in the accounts may be overridden where it arises as a result of the acquisition or variation of certain capital interests or where it is triggered by an event that occurs in a later accounting period.

The new legislation will take effect for any credits and debits arising after 22 June 2010. A Technical Note clarifying the scope of the new legislation will be published in early July 2010.

Group mismatches anti-avoidance

The Government has confirmed that it will continue a consultation exercise started by the previous administration on introducing legislation to counter tax avoidance using group mismatches and financial instruments.

Worldwide Debt Cap

The Worldwide Debt Cap legislation came into force on 1 January 2010 and restricts the level of deductions that can be claimed by a company for its UK interest payments where those costs exceed the financing costs of the company's worldwide group. The regime is designed to complement the introduction of the dividend exemptions for corporation tax payers.

The previous administration announced (in the Pre-Budget Report 2009 and the Budget of 24 March 2010) that it intended to introduce amendments to the current legislation in order to resolve anomalies and address concerns raised by taxpayers.

The new Government has restated that intention and has produced an updated summary of the amendments proposed. These include:

- ◆ amendments to ensure that, where the same borrowing is taken into account in calculating both UK and worldwide debt figures (for example, as part of the "gateway test"), the same amount is used - the intention is to eliminate mismatches that have been identified;
- ◆ the introduction of a general power to correct any further mismatches through secondary legislation;
- ◆ the exclusion of certain securitisation companies from the scope of the legislation; and
- ◆ amendments to ensure that long-term arrangements that have the economic effect of loans are taken into account for the purposes of the "gateway test".

Draft legislation effecting these amendments will be introduced later in 2010.

Consortium relief

The Government has proposed two changes to the consortium relief rules. These rules allow losses of one company to be surrendered to another company in a way similar to the group relief rules, but apply where one company (the "consortium company") is 75 per cent owned by a number of other companies (each a "consortium member") each of which holds at least 5 per cent of the consortium company.

Losses may also be surrendered to or from group members of a consortium member (the "link company") provided that the link company is established in the UK, or trades in the UK through a permanent establishment. The proposed changes would extend this to include a link company established anywhere in the EEA, following the recent decision of the First-Tier Tax Tribunal in Philips Electronics which held that the existing rules were incompatible with freedom of establishment under EU law.

The Government further proposes that an additional test is added to the provisions restricting the amount of losses that can be claimed from a consortium company. The current rules calculate the "ownership proportion" of a consortium member as the lowest of:

- ◆ the member's holding of ordinary share capital;
- ◆ the member's entitlement to distributions of profits; and
- ◆ the member's entitlement to distributions of assets on a winding up.

The proposed change would mean that the amount of losses that can be surrendered to the relevant consortium member would be further restricted by reference to the member's proportion of voting rights or the extent of control exercised by the member.

Authorised investment funds

The regulations governing the taxation of authorised investment funds (AIFs) are to be amended to prevent corporate investors avoiding tax through the creation, inflation or repayment of UK tax credits on distributions received from the AIF where no UK tax has been paid on the underlying income received by the AIF.

Under the current rules, an AIF is treated as distributing all its income shown as available for distribution in its accounts. In the case of corporate investors, however, the AIF must "stream" the income it is treated as distributing to the investor between, broadly speaking, "franked" (exempt) dividend income and "unfranked" (taxable) income. This is intended to reflect the underlying source of the AIF's profits and to ensure the corporate investor does not obtain an unintended tax advantage by investing via an AIF. The "unfranked" element is treated as an annual payment with an associated deemed tax credit which, taking into account the corporation tax payable by the AIF itself (at the special rate of 20 per cent), is intended to ensure that the correct total amount of corporation tax has been paid.

Two new amendments to the AIF regulations will be made to ensure that the "streaming" rules continue to apply as intended. The first change will restrict the corporation tax deduction allowed in a "bond fund" AIF for the interest distributions it

makes to the extent that those distributions are derived from dividend income which is exempt from corporation tax. The second amendment will ensure that where foreign tax has been suffered by an AIF on the income it receives, any tax credit deemed to arise in the hands of a corporate participant (including another AIF) will be treated as a foreign tax credit for all tax purposes (and, consequently, a proportionate part of the income deemed to have been received by the corporate investor will be treated as being foreign income). This change parallels the similar rules introduced for unauthorised unit trusts in Finance Act 2010.

The new rules will have effect on and after 22 June 2010.

In addition, the Government has confirmed that it will consult with industry on a range of issues which affect the UK's asset management sector more generally. These include such issues as the impact of the implementation of the UCITS IV Directive, the possibility of introducing a (tax transparent) "contractual" fund vehicle, and undertaking further reviews of the taxation of Investment Trust Companies, the impact of the new Funds Investing in Non-Reporting Funds (FINROF) regulations and the application of stamp duty reserve tax to investments made by authorised funds.

Enterprise managements incentives

Enterprise management incentive (EMI) options are employment related share options which are eligible for beneficial tax treatment provided certain conditions are met. The regime is aimed at smaller companies and groups.

One of the many conditions to be satisfied is that the company (or in the case of the group, a company within the group) carries on a qualifying trade "wholly or mainly" in the UK. Therefore, the regime was not available to international groups which carried out only part of their trade in the UK through a permanent establishment (i.e. a branch).

With effect from Royal Assent to the Finance Bill, this rule will be changed so that the regime will also be available to companies which carry out a qualifying trade through a permanent establishment in the UK, even if the trade as a whole is not carried out wholly or mainly in the UK. The reason for the change is to bring the requirements in line with the EU's guidelines on state aid.

Venture capital schemes

Venture capital trusts

Venture capital trusts (VCTs) are listed companies which raise capital from investors to make venture capital investments in

small companies. Where the conditions are satisfied there are certain income tax and capital gains tax reliefs available for investors in a VCT in relation to the amount they have invested.

One of the conditions for a VCT to qualify for this treatment is that it is listed on the UK Official List. This requirement is to be amended so that a VCT can be listed on any regulated market within the EU in order to qualify. The effective date of this change is yet to be announced.

There are also a number of conditions which must be met by investee companies and the holdings of the VCT in those companies. Until now, one requirement has been that at least 30 per cent of the VCT's holdings must represent holdings of "eligible shares". Eligible shares are defined as shares which do not carry any present or future right to a preferential dividend and do not carry any present or future right to be redeemed.

This condition will be amended such that in future at least 70 per cent of the VCT's holdings must be in eligible shares, but the definition of eligible shares will be widened to include some shares which carry preferential rights to dividends. This change will not affect monies raised by VCTs prior to the date the change becomes effective (which will be on a date to be announced).

Venture capital trusts and enterprise investment schemes

Two more changes to the rules for VCTs have been announced which will apply equally to enterprise investment schemes (EIS). EIS is a regime which provides income and capital gains tax reliefs for individuals investing directly in companies which meet conditions similar to those for investment by a VCT.

The first change is that companies will not qualify for either the EIS or the VCT rules where they would be treated as an "enterprise in difficulty" for the purposes of the European Commission's Rescue and Restructuring Guidelines (which broadly includes companies which are insolvent or likely to go out of business in the short to medium term).

The second change is that, until now, it has been a requirement that the company invested in must carry out a qualifying trade wholly or mainly in the UK. This requirement is to be changed so that in future a company may qualify for EIS or VCT investment provided it carries out a qualifying trade through a permanent establishment (i.e. a branch) in the UK.

The effective date of these changes has yet to be announced.

Employee taxation

A consultation on employee held shares which benefit from “geared growth”, announced in the last Budget, will still be undertaken during 2010.

The previous Budget also announced that action would be taken to change the tax treatment of arrangements using trusts to reward employees. It is confirmed that the Government intends to take action along these lines with effect from 6 April 2011. No further details are known at this stage, but it has been confirmed that Employer Financed Retirement Benefit Schemes (EFRBS) will be included in the scope of any changes.

The Government also intends to consult on making the PAYE system easier to operate. In the meantime there will be two additional consultations, the first with employers and payroll providers on the introduction of mechanisms to support providing more frequent or real time PAYE data to HMRC, and the second on introducing a power for HMRC to require financial security where PAYE and NICs are at serious risk of non-payment. The previous Budget had announced legislation on providing security to be included in the next Finance Bill; it is hoped that consultation will lead to a more measured result.

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INDIRECT TAXES

Standard rate of VAT

The standard rate of VAT will increase from 17.5 per cent to 20 per cent with effect for supplies, acquisitions and importations made on or after 4 January 2011. There will be no changes to zero rated and lower rated supplies. The Government has listened to retailers and the entertainment industry by timing the change to allow the New Year hangover to clear before the change comes into effect for the January sales. This should avoid a repeat of the various concessions announced following lobbying from those sectors when the VAT rate change took place at midnight on 31 December 2009.

Increases in the flat rate scheme rates will be introduced to reflect the increase in the standard rate of VAT.

To prevent taxpayers from benefiting from the reduced rate of 17.5 per cent for goods or services supplied on or after 4 January 2011 (for example, by pre-payment or pre-invoicing), anti-forestalling legislation will be introduced along similar lines to that which was brought in for the VAT rate increase in January 2010.

The anti-forestalling legislation will operate by introducing a top-up charge of 2.5 per cent on the supply of goods or services where the recipient of the supply cannot recover all the VAT and one or more of the following three conditions are met:

- ◆ the supplier and the customer are connected; or
- ◆ the supplier funds the purchase; or
- ◆ a VAT invoice is issued where payment is not due for at least 6 months.

In addition, a top-up charge of 2.5 per cent will also apply where a pre-payment of more than £100,000 is made before the rate increases to 20 per cent but the supply to which the prepayment relates is not made until after that date. However, the top-up charge will not apply if the prepayment is in accordance with "normal commercial practice in relation to such supplies when no VAT rate increase is expected".

Zero-rating of "qualifying" aircraft

Under the current law, the supply, repair, maintenance, modification or conversion of an aircraft is zero-rated for VAT purposes if it weighs 8,000kg or more (or will do so after the modification or conversion) and is not designed or adapted for recreational or pleasure use. This has allowed many large private aircraft to enjoy zero rating, but was arguably more generous than the European legislation permits.

Following a formal request from the European Commission, and as was announced in the last Budget, changes will be made with effect for supplies of aircraft made on or after 1 January 2011 to align the domestic VAT legislation with the European VAT rules. From that date, an aircraft will be zero rated only if it is used by a commercial airline operating on international routes, regardless of weight. This change will affect a number of operators of private aircraft.

Place of supply of gas, heat and cooling

Under the current law, the supply of natural gas, heat and cooling is broadly treated as supplied where a wholesale customer is established or the gas is consumed.

As was announced in the last Budget, changes will be made with effect for supplies made on or after 1 January 2011 to extend existing rules to cover supplies of natural gas via pipelines and via networks including liquefied natural gas supplied by tankers. This will have the effect of extending the reverse charge procedure to such supplies.

Postal services

As the universal provider of public postal services, Royal Mail's supplies (including those made by Parcelforce) have been exempt from VAT. Following the ECJ's ruling in the TNT Post UK case that exemption should only apply to public postal services, HMRC issued a brief in October 2009 stating that it was discussing Royal Mail's VAT treatment with them and in the last Budget there were proposals to change the VAT exemption to apply only to supplies of public postal services and incidental goods that Royal Mail is required to make under its licence, including those where Royal Mail allows private postal operators access to its postal facilities.

As was announced in the last Budget, supplies that Royal Mail is not required to make under its licence, including those made by Parcelforce and services provided on freely negotiated terms, will be subject to the standard rate of VAT.

The changes will have effect for supplies made on or after 31 January 2011.

"Lennartz" accounting

In some circumstances, input VAT on goods purchased both for business and private purposes can be recovered upfront and in full. This provides a cash-flow benefit to businesses as output VAT is then paid over to HMRC in subsequent years in respect of the private use of the asset. This is known as "Lennartz" accounting, after the ECJ case which established its availability.

Following a more recent ECJ decision, HMRC released a briefing in January bringing the application of “Lennartz” accounting in the UK in line with EU VAT rules, meaning that it now has only limited application.

As was announced in the last Budget, amendments will be made in relation to the application of “Lennartz” accounting to immovable property, boats and aircraft to ensure that VAT will only be recoverable in respect of the business use of the asset and any private use by the taxpayer or the taxpayer’s staff will lead to irrecoverable VAT with effect from 1 January 2011. Changes to the capital goods scheme will also be introduced so that it will take account of changes in private use over subsequent years.

This change is expected to have particularly adverse results for many charities, which often purchase assets for non-business uses.

Insurance Premium Tax

The higher rate of insurance premium tax will be increased in line with the VAT rate changes from 17.5 per cent to 20 per cent. In addition, the lower rate of insurance premium tax (the “standard rate”) will be increased from 5 per cent to 6 per cent. Both changes will take effect for premiums received or written on or after 4 January 2011.

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PROPERTY TAXATION

Real estate investment trusts (REIT)

Following the announcement in the last Budget, the Government has confirmed that the REIT legislation will be amended to allow REITs to use stock dividends to satisfy their income distribution requirement.

REITs are usually required to distribute 90 per cent of the profits from their exempt property rental business to their investors in each accounting period. Legislation will be introduced in the next Finance Bill to allow REITs to pay all or part of the dividends they pay in the form of stock rather than cash.

The stock issued in lieu of a cash dividend will be liable to tax in the hands of a shareholder in the same way (and to the same extent) as the receipt of a cash dividend from the same shares.

This is a move that has been advocated very strongly by the REIT community over the last year or so. The charge has been led by the British Property Federation after a similar move was made in other jurisdictions (particularly the USA) in response to the economic downturn.

Stamp duty land tax (SDLT) on high value property

The Government will consider whether changes to the rules on SDLT on high value property transactions are needed to prevent avoidance in this area. This reflects the publication of Spotlight 10 by HMRC on 7 June which suggests that tackling SDLT avoidance is high on HMRC's agenda.

The Government will also review the SDLT relief for first time buyers, taking into account its "impact on affordability and value for money".

Both of these proposals are referred to in the HM Treasury Budget document and no further details have yet been given.

Repayments of stamp duty land tax (SDLT) (and petroleum revenue tax)

New legislation will be introduced to amend the current rules on claiming back SDLT (and petroleum revenue tax) from HMRC when an overpayment has been made by a taxpayer.

This measure was announced by the previous Government in the last Budget. Draft legislation was put out for consultation on the proposed changes to the rules with a closing date for responses of 3 March 2010, but HMRC has not yet published any reply to the responses it received.

The current rules only allow a reclaim to be made where an overpayment of SDLT has been made due to a mistake in a return or has been paid under an assessment by HMRC. The new rules will remove these two conditions and align the treatment for overpaid SDLT with the rules already in place for income tax, capital gains tax and corporation tax.

The period for making a claim for an overpayment will be reduced from six years (under the current rules) to four years (under the new rules), aligning the provision for SDLT with that for other taxes.

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PERSONAL ALLOWANCES AND TAX RATES

Income tax allowances	2010/2011	2011/2012
Personal allowance ¹ (under 65)	£6,475	£7,475 ²
Age related allowance (65-74)	£9,490	£9,490 ³
Age related allowance (75 and over)	£9,640	£9,640 ³
Income limit for age-related allowances	£22,900	£22,900 ³
Married couples allowance (age 75 or over)	£6,965	£6,965 ³
Married couples allowance - minimum amount	£2,670	£2,670 ³
Blind person's allowance	£1,890	£1,890 ³

¹ For those earning over £100,000, the personal allowance is reduced by £1 for every £2 earned, so those earning over £112,950 have their personal allowance completely removed entirely in 2010/11 (over £114,950 in 2011/12).

² The basic rate limit will be reduced so that higher rate taxpayers do not benefit from the increase in the personal allowance. The exact figure will be confirmed after the Retail Prices Index (RPI) for September 2010 is published in October 2010.

³ These allowances are subject to confirmation. The Government will set the relevant amounts for 2011/12 after the RPI for September 2010 is published in October 2010.

Income tax rates	2010/2011	2011/2012 ⁶
Income taxed at 20% on first	£37,400	£37,400
Income at 40% on	£37,401- £150,000	£37,401- £150,000
Income at 50% on	£150,001+	£150,001+
Dividends:		
Basic rate taxpayers	10%	10%
Higher rate taxpayers	32.5% ⁷	32.5% ⁷
Additional rate taxpayers	42.5% ⁸	42.5% ⁸
Most trusts:		
Dividends ⁹	42.5%	42.5%
Other income ¹⁰	50%	50%

⁶ Rates and thresholds subject to confirmation.

⁷ An effective rate of 25% (taking into account the 10% dividend tax credit).

⁸ An effective rate of 36.1% (taking into account the 10% dividend tax credit).

⁹ The same effective rates apply as for higher rate taxpayers.

¹⁰ The first £1,000 of trust income is taxed at basic non-savings, dividends or savings rates, depending on the type of income received.

NICs	2010/2011	2011/2012
Employees' primary Class 1 rate from £110 to £844 per week	11%	12%
Employees' primary Class 1 rate above Upper Earnings Limit (£844 per week) ⁴	1%	2%
Employers' secondary Class 1 rate above Secondary Threshold (£110 per week) ⁵	12.8%	13.8%

⁴ The alignment of the Upper Earnings/Profits Limit (UEL/UPL) with the higher rate threshold (the total of the personal allowance for those aged under 65 and the basic rate limit) will be maintained by reducing the UEL/UPL.

⁵ The secondary threshold will rise by £21 per week above indexation in 2011/12. The RPI for September 2010 will be published in October 2010.

Capital gains tax	2010/2011	2011/2012
Rate for individuals whose taxable income and gains are less than £37,400	18%	18%
Rate for individuals whose taxable income and gains exceed £37,400	18%/28% ¹¹	28%
Rate for trustees and personal representatives	18%/28% ¹¹	28%
Annual exempt amount: individuals	£10,100	£10,100
Annual exempt amount: trustees	£5,050	£5,050
Entrepreneurs' relief: lifetime allowance	£2m/£5m ¹²	£5m

¹¹ The higher 28% rate applies to gains or parts of gains above the income tax basic rate band realised on or after 23 June 2010.

¹² The increased £5,000,000 allowance applies from 23 June 2010. The rate is 10% on gains to which the relief applies (the previous calculation of reducing tax by 4/9 is no longer be used).

Inheritance tax	2010/2011	2011/2012
Nil rate band	£325,000	£325,000
Rate of tax on death on excess	40%	40%

Corporation tax	2010/2011	2011/2012
Small companies rate - for companies with profits (other than ring fenced profits) not exceeding £300,000	21%	20%
Marginal relief for companies with profits (other than ring fenced profits) between £300,000 - £1.5m	Marginal relief fraction 7/400	Marginal relief fraction 7/400
Main rate - for companies with profits of £1.5m+ which are not ring fenced profits	28% on whole of profits	27% on whole of profits ¹³
Small companies rate - for companies with ring fenced profits not exceeding £300,000	19%	19%
Marginal relief for companies with ring fenced profits between £300,000 - £1.5m	Marginal relief fraction 11/400	Marginal relief fraction 11/400
Main rate - for companies with ring fenced profits of £1.5m+	30% on whole of profits	30% on whole of profits

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¹³ To be reduced to 26% in 2012/13, 25% in 2013/14 and 24% in 2014/15.

Value Added Tax	2010/2011	2011/2012
Standard rate	17.5% / 20% ¹⁴	20%

¹⁴ 20% from 4 January 2011

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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