



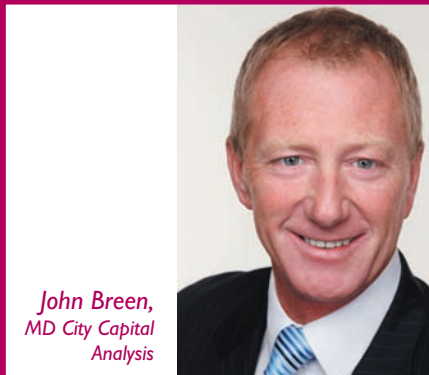
# CITY CAPITAL ANALYSIS

## Introduction

Welcome to the 2011 Budget edition of the City Capital newsletter for clients, interim managers and consultants. Recent events in Asia, Pacific, Europe and North Africa remind us of our mortality and cloud the world of finance.

Universal austerity packages, rising unemployment, soaring energy prices and inflation provoke revolution in Dictator led states.

We ask, has a form of Armageddon arrived or are we simply starting to pay the price for mankind's greed.



*John Breen,  
MD City Capital  
Analysis*

## Budget in summary Rescue, Reform, Recovery!

The Chancellor in his opening statement to this year's Budget admitted it would be "tax neutral" (the cost measures met by money raised), which we all pretty much knew, as he had little room for any give aways. The Chancellor still has the UK deficit (still the second largest in Europe), austerity measures, high inflation and a squeezed middle England to contend with!

George Osborne portrayed himself as the "Chancellor of Rescue" (the Emergency Budget June 2010 and the Spending Review), and now "Reform and Recovery" with this Budget aimed at growth and modernisation of the UK tax system.

The Budget was generally good for business, unless your sector is North Sea oil, which is paying for the reduced fuel duty, or a bank, with the increase in the bank levy.

The reduction in the corporation tax rate by 2% from this April will be welcomed, together with the increased benefits to business start-ups. An increase in EIS tax relief and the doubling of the capital gains entrepreneur's relief to £10 million are both measures which we all hope should encourage inward investment.

A new exemption for non-domiciled individuals enabling them to remit both foreign income and foreign gains tax free in to the UK for business investment should also be welcomed. Charities will welcome the improved changes to gift aid, both in the level of donations and in administration.

Most individuals and families will be treading water, even with the increase in the personal allowance. The cut in fuel duty is a welcomed major boost to us all (although petrol is still too expensive even with the cut!). However, hidden in the small print is the reference to future tax thresholds increasing with inflation each year, but only linked to the lower consumer price index (CPI), as opposed to the more generous retail price index (RPI). This means that the thresholds will increase at a much lower rate. For

example current CPI is 4.4% compared to RPI which is 5.5%.

One key message from the budget was "simplification", now that the UK's tax legislation has surpassed that of the long held record breakers, India (a psychological boost for our cricketer's, maybe?). There is to be a review, therefore, of large areas of UK taxation which are deemed either an administrative burden, for example the separate systems for income tax and national insurance, or viewed as not working very well, for example inheritance tax.

"Consultation" appears to be the way forward, at least allowing us a voice (if they will listen...). It is also clear with the issue of the forthcoming separate paper on Tackling Tax Avoidance that they will challenge where necessary.

Was this a "reforming Budget"? Probably not, but it did at least put in place steps for change.



# BUDGET 2011

# HEADLINES

## Personal Tax

- As previously announced in the Emergency Budget the personal allowance will increase to £7,475 from 6 April 2011. In April 2012 the personal allowance will rise by a further £630 to £8,105.
- The tax relief available on qualifying Enterprise Investment Scheme (EIS) investments is increased from 20% to 30% from 6 April 2011. From April 2012 the investment limits are to be increased (for individuals to £1 million) and, to enable more companies to benefit from investment, the qualifying conditions will be amended.
- There have been no changes to the capital gains tax rates. The capital gains tax annual exemption will increase to £10,600, an increase of £500, from 6 April 2011. (Trustees annual exemption increases to £5,300).
- From 6 April 2011 the lifetime limit for capital gains qualifying for Entrepreneurs' Relief is to double to £10 million. There have been no other changes to Entrepreneur's' Relief.
- The remittance basis charge of £30,000 which applies to non-domiciled individuals who have been UK resident for 7 out of 9 years is to rise to £50,000 for those individuals who have been UK resident for 12 years. There will be an exemption from tax for amounts remitted to the UK for the purpose of investing in UK business. These changes will be subject to consultation this summer ahead of the 2012 Finance Bill. The Government has also confirmed that there will be no further substantive changes to the taxation of non-UK domiciles in this Parliament, so as to provide a degree of certainty.
- The Government is to introduce a statutory tax residence test following a consultation this summer with the intention of legislating in Finance Bill 2012.
- The Chancellor confirmed that the 50% tax rate is a temporary measure. The monetary returns being generated are to be reviewed and compared to any detrimental impacts it may be having.
- Changes are to be made to the Inheritance Tax regime from April 2012 so that there will be a 10% cut in the rate of Inheritance Tax for those leaving 10% or more of their estate to charity.
- First time home buyers are to receive help from the Government with getting on the housing ladder. First time buyers who earn less than £60,000 and who can raise a 5% deposit will get assistance from the Government of 10% of the purchase and 10% from the house builder to purchase a new build property. This will also assist with kick starting the construction industry.

## Corporate and Business Tax

- The mainstream corporation tax rate is to fall by 2% in April 2011 to 26%, rather than the previously announced 1%. There will then be a further 1% cut for each of the next three years, to reduce the rate to 23% from April 2014. (The Treasury is to publish a paper looking at the potential to cut corporation tax in Northern Ireland even further than for the rest of the UK to stimulate growth).
- As previously announced, the small company rate of corporation tax will fall from 21% to 20% in April 2011. No further cuts to this rate were announced.
- The Research & Development (R&D) small company's relief will increase to 200% of qualifying expenditure from April 2011 and then to 225% in April 2012. The minimum expenditure level of £10,000 will be abolished for all companies from 1 April 2012.
- From April 2011 the period over which expenditure on plant and machinery can be given "short life" asset treatment is increasing from four years to eight years. This will be beneficial for assets where the useful life is shorter than the period over which capital allowances are usually given. The change will be effective from 1 April 2011 for companies and 6 April 2011 for other businesses.
- As previously announced the rate of writing down allowance for plant and machinery will be reduced from 20% to 18% effective from 1 April 2012 for companies and 6 April 2012 for those businesses liable to income tax.
- The allowances applicable to longlife and other special rate pool assets will reduce from 10% to 8% from the same dates.
- The annual investment allowance which is currently £100,000 per annum will still be reduced to £25,000 from April 2012.

## Employment Taxes

- The Government is to consult on merging the operation of income tax and National Insurance Contributions, aimed at reducing the administration burden for business. This will take "a number of years to complete" and will be both a highly emotive and political topic.

- The Approved Mileage Allowance Payment (AMAP) of 40p is to increase to 45p per mile from 6 April 2011. The first rise in ten years. The 25p rate for business miles in excess of 10,000 is to remain in place.
- **Hopes that the IR35 tax rules were going to be reviewed were dashed. These rules outline how self-employed consultants (commonly referred to as "freelancers") are treated for tax purposes, employed or self-employed. Instead of a review, better administration by HMRC is being introduced with a dedicated helpline staffed by specialists.**
- A consultation is to take place regarding the potential abolition of tax relief on late night taxis from 2012.

## Anti-Avoidance

- Specific measures were announced to target three stamp duty land tax schemes and a couple of other very specific tax avoidance measures.
- The Budget provided no further details on the proposed Disguised Remuneration legislation, due to come into effect on 6 April, other than that the relevant updated draft legislation will not be published until 31 March
- As part of the Budget, a separate paper was specifically published called Tackling Tax Avoidance, which included reviews of areas of the legislation which have been the subject of repeated avoidance schemes; proposals to address the continued use of "highly aggressive and artificial tax avoidance schemes". One area being considered was tying up disputed tax liabilities, so that the taxpayer did not have the cash flow advantage, looking at measures to pay the disputed tax early or face late penalties.



## Indirect Tax

- Fuel duty cut by 1p a litre from 6pm on Budget day
- The increase in fuel duty planned for April 2011 is to be deferred until January 2012, with the April 2012 rise deferred until 1 August 2012.
- The taxable turnover threshold, which determines whether a person must be registered for VAT, will be increased from £70,000 to £73,000 from April 2011. The taxable turnover threshold below which a person may apply for deregistration will be increased from £68,000 to £71,000.
- To promote trade in the UK high street book and music shops, the VAT Low Value Consignment Relief threshold (below which goods imported from outside the EU are VAT free) is to be reduced from £18 to £15 from November 2011. The Government is also to explore further options to limit the scope of the relief to prevent offshore internet warehouses taking business out of the UK.
- Private jets will be brought within the scope of Air Passenger duty, while the Government explores ways of reforming the duty.
- The system for calculating stamp duty land tax on bulk purchases of residential properties that meet certain conditions are to be made fairer.

## Charities

- The amount of benefit that charities will be able to provide to donors making gifts of more than £10,000 will be increased from £500 to £2,500. However, the benefit provided still must not exceed 5% of the value of the gift.
- Charities receiving up to £5,000 in donations of £10 or less, and who have a history of compliant Gift Aid claims, will be able to claim Gift Aid repayments without the need for signed donor declarations from 6 April 2013.

## Investment Market Summary

*John Breen MD, City Capital Analysis.*

### The Japanese market has gone mad: stay calm

March 15. The Japanese Nikkei index had plunged 10.5% overnight amid widespread selling. It registered a stomach churning 17.5% fall over the previous three trading sessions.

Investor sentiment was black. Almost everything was dumped in the panic. Even gold dropped 3% on the day, as mounting worries over Japan's nuclear crisis prompted a flight to liquid assets like cash.

However this indiscriminate sell off looks like trigger happy speculators shooting first and asking questions later. It's a classic case of panic induced selling by hedge funds and traders. The way we see it, they are all making a bad decision.

Offloading quality companies just because the herd is doing so, regardless of value, is not only daft but also expensive.

### Don't overreact to Japan

There will be a handful of clear losers in Japan including almost certainly Tepco, the Fukushima plant operator. The company has a long history of safety violations and cover ups. I suspect that when the truth about the nuclear crisis comes out, the explanation for why it has continually escalated beyond the expectations of many nuclear specialists will not be pleasant reading.

This is very likely to damage plans for nuclear energy elsewhere. That's a shame in many ways. I think nuclear is one of very few immediate solutions to our energy problems. But accidents like this make it very hard to argue the case.

So, in my view, we should not see this disaster in isolation as something that profoundly alters the fundamentals of the markets.

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### How the Fed could pull the plug on equities

Signs of sustainable job creation make it very unlikely now that the Federal Reserve will expand "QE2" beyond the \$600bn due for completion on the 30th June. And that is an ugly prospect for many investors.

Quantitative easing has affected all financial markets – stocks, currencies, commodities, and bonds. Nobody can dispute that the Fed's purchases have been the main stimulus spurring asset prices over the last year.

This soaring paper wealth has even kick started spending again. In some parts of affluent New York and London, racy new Jaguar cars can be seen revving up at traffic lights alongside slick Porsches and Ferraris.



The problem is what could happen when this tap of easy money is switched off unexpectedly.

Well, we've already had a dress rehearsal. Between April and August 2010, the FTSE fell around 15% when the Fed stopped printing money in the period between QE1 and QE2.

And there's every chance something similar could be just around the corner catching a hell of a lot of people unawares.

## How Wall Street will be caught unawares

Wall Street is deluding itself. It is convinced that equities are a no lose bet. It thinks that if the economy improves, stocks will rise; and if it tanks, the Fed will come to the rescue again with QE3. This is one of the reasons the dollar has weakened during a period of extreme tension in the Middle East. Normally such geopolitical turmoil would trigger a flight to safety, and the dollar - given its status as the world's reserve currency - would appreciate. But this time round this risk aversion is being smothered by investors selling the greenback because they assume higher oil prices will result in QE3.

And Wall Street has another problem: US politicians are beginning to notice the disastrous side effects of printing too much money.

You see QE2 has not only pumped up assets such as oil, commodities, gold and food - it has also led to the toppling of governments in Egypt and Tunisia and social unrest throughout a politically sensitive region. Libya is mired in civil war, and Yemen, Algeria, Morocco, Jordan, Iran or even heaven forbid Saudi Arabia could be next. Full scale revolution in the oil kingdom would heap untold damage on the global economy.

This is a massive security worry for Capitol Hill, and White House politicians are taking notice. These events will necessitate a total reappraisal of America's profligate monetary policy. I am sure they will try to stop Fed Chairman Ben Bernanke from firing up inflation any more.

Which is the bigger risk? Ending QE and watching US GDP drop by 1% to 2%? Or going ahead with QE3, and allowing much of the Arab world to fall into the hands of extremists?

Because that really could happen. The arrival of democracy in dictatorships sounds great. So the odds of the Fed extending QE beyond June are low. Having to fight another 'war on terror' outside of Iraq /Afghanistan would be tantamount to diplomatic suicide.

What's more, President Obama even has a ready-made excuse to say no to QE3. The domestic economy is improving, whatever the sceptics say.



## We could see a 15% tumble in the FTSE

So what does this all mean? Well, when the Fed puts its wallet away the results will be dire for every asset class that has benefited from QE. That means gold, silver, oil, commodities, banks, bonds and equities in general.

I expect the Fed to start signalling soon that there won't be another round of QE. And this will be a major wake up call for investors, possibly causing a 15% tumble on the FTSE.

Much depends on the prospects for the global economy. The revolt against the tyranny of non-democratic regimes in the Middle East and North Africa will not be easily quashed which means that oil prices will remain elevated for the indefinite future. While this is good for Mr Osborne (via his Fair Fuel Stabiliser), the risk for the global economy is a loss of recovery momentum which transfers through to a loss of momentum in the growth of corporate earnings.

**It is against this back drop that City Capital remain cautious in our outlook for market returns and where possible prefers to hold some strong Cash reserves. We expect this summer to prove decisive in pointing the best way forward.**

The contributors I would like to acknowledge are:

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