



2007 Pre-Budget Report – Key Issues

For a change, the Pre-Budget Report contained some interesting tax announcements, but not all of these are to be welcomed. Changes to capital gains tax, which in the Chancellor's speech were claimed to be ensuring "that those working in private equity pay a fairer share", were, on a thorough reading of the detail behind the speech, found to be a completely new system for taxing gains, under which all types of assets would be treated alike. This represents a complete U-turn on the favourable treatment of 'business assets' introduced by the now Prime Minister nine years ago. The other two main changes on inheritance tax and non-domiciled taxpayers appear to be late changes following on from David Cameron's success at the Conservative Party Conference.

- **Capital gains tax** – heralded by Alistair Darling as the reform to the capital gains tax system, ensuring those working in private equity pay a "fairer share", this represents a revolution in the tax system for individuals, trustees and personal representatives (companies are unaffected), particularly as the distinction between 'business assets' and 'non-business assets' will cease from 6 April 2008. The new system will apply to disposals made on or after 6 April 2008:
 - There will be a single rate of capital gains tax set at 18% (unaffected by the taxpayer's marginal tax rate);
 - The annual exemption (currently £9,200 for individuals; £4,600 for some trustees) will remain, with the allowance for 2008/09 to be announced in the 2008 Budget;
 - Taper relief and the indexation allowance are withdrawn;
 - There is no longer any distinction between 'business assets' and other assets;
 - The base cost for assets owned prior to 31 March 1982, will be the market value on that date;
 - The rules for identifying shares will be simplified, with all shares being held in one 'pool', subject to initially identifying disposals with 'same day acquisitions', followed by those in the next 30 days (the 'bed and breakfasting rules');

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- Realising 'business assets' (eg AIM listed shares (trading companies), employee owned shares in quoted companies, private trading company shares and property let to businesses) already showing substantial gains, prior to 6 April 2008 could save significant amounts of tax, as the effective rate prior to 6 April 2008 could be as low as 10%, compared to 18% afterwards;
- Unincorporated trading businesses should consider again the opportunity to incorporate their business prior to 6 April 2008. This should be a sale at full market value triggering a capital gains tax liability (potentially at 10% for business assets) in respect of (free) goodwill. The consideration payable by the company would often constitute a loan to the business and available to be withdrawn from the company without a further tax charge.

- Where assets are not easily realisable (eg shares in a privately owned trading company), they could be sold to a new company prior to 6 April 2008 (trusts are likely to be unsuitable as a disposal vehicle because of the potential inheritance tax liabilities resulting from the new (FA 2006) trust tax regime. Disposing of a private trading company ('Target') before 6 April 2008, could be achieved by capitalising Newco to the value of 'Target', and then selling Target's shares to Newco (resulting in a 10% tax charge where full business asset taper relief applies). Alternatively, Target could be sold in return for a loan (left outstanding) from the shareholders. The first option, would be better should yet another change in the capital gains tax rules provide for enhancement of base costs, but the second option would enable cash to be realised from Newco – providing that a reduction in cash did not adversely affect its ability to carry on trading. Subsequently Newco could be sold (with its Target subsidiary), with only the uplift in value subject to the 18% rate of tax. Properties (qualifying for business asset taper relief) could also be disposed of in this way, but stamp duty land tax at (maximum) 4% would be due, compared to 0.5% on a share sale;
- As far as non-business assets are concerned, delaying the disposal until after 5 April 2008, will reduce the tax liability from a minimum effective rate of 24% to 18%. However, the effective rate of 24% is based on the taxpayer being subject to the 40% rate of income tax. Those making small disposals and not breaching the 40% threshold, could still save tax by disposing of non-business assets prior to 6 April 2008;
- By ceasing to distinguish between 'business assets' and 'non-business assets', the new regime will reduce the capital gains tax charge on the sale of buy-to-lets, and reduce the disadvantage of holding investment properties in companies;
- Land and buildings owned by individuals only qualify for partial IHT relief if they are occupied by their business or a business carried on by their personal company. In contrast land and buildings used by companies qualifies for full IHT relief if owned by the company. The potential increase in capital gains tax, therefore may well encourage property owners to transfer such property to the company, if used by a company which they own;
- **Inheritance tax** – in a move aimed at negating post Conservative Party Conference euphoria, the Chancellor announced changes to the IHT regime, which will make will writing a less complicated affair. Thanks to these changes, all married couples and those in civil partnerships can now benefit from what has become known as the 'nil rate band will trust' without actually having the provision written into their wills:
 - Where a surviving spouse or civil partner dies on or after 9 October 2007, their estate will benefit from the transfer of any unused nil rate band on the death of the first partner (regardless of the date of death);
 - The amount of the nil rate band (currently £300,000) transferable will be the proportion, not utilised on the earlier death, of the amount of the nil rate band on the second death. Thus if on the first death £150,000 of assets are chargeable (ie not inherited by the spouse or civil partner), when the nil rate band is £300,000; on the second death, when the nil rate band is £350,000, £525,500 of assets will be free of IHT (ie £350,000 plus 50% of £350,000);

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- It may still be worth using a 'nil rate band will trust' if assets likely to rapidly increase in value, can be transferred to someone other than the surviving spouse/civil partner on the first death;
- Likewise, transferring assets qualifying for relief such as agricultural property relief and business property relief should be similarly transferred on the first death, as those assets or assets derived from them may not qualify for these reliefs on the second death
- **Residence and domicile** – it seems that the Conservative Party Conference has enabled the government to do in a matter of days, what it has not previously been able to do in a decade, as a review of the taxation of those not domiciled in the UK has been under review for almost ten years. These changes will take place with effect from 6 April 2008:

- Currently UK residents who are not domiciled or not ordinarily resident in the UK, can be taxed on their foreign income and gains on the 'remittance basis' (ie they pay UK tax only on the foreign income and gains which are brought into the UK);
- In future, once a non-domiciled individual has been resident in the UK for seven years (regardless of when UK residence commenced), they will only be able to use the remittance basis if they pay an additional annual tax charge of £30,000. If they choose not to pay the annual tax charge, they will be taxed on their worldwide income and gains whether or not they are remitted to the UK. It is understood that the seven year rule is there to avoid 'hitting' internationally mobile employees;
- When deciding whether an individual is UK resident, days of arrival and departure will now be counted (without this new rule it is possible to work in the UK for nearly four days per week (assuming that the usual holiday allocation is spent outside the UK)) and still not be UK resident;
- UK residents who are not domiciled or not ordinarily resident in the UK will not be able to be taxed on the remittance basis *and* use their personal income tax allowances (personal allowance, married couple's allowance and blind person's allowance), unless unremitted income is less than £1,000 per year. It appears that those paying the £30,000 annual charge cannot use their personal allowances;
- Other measures include preventing the manipulation of the remittance basis rules and reducing the scope for avoiding taxation by the use of off-shore structures such as companies and trusts;
- The remittance basis will apply in respect of Irish investment income and earnings for work carried out outside the UK for an Irish employer, with effect from 6 April 2008. This change is an anti-discrimination EU measure;
- The government will consult on the detail and on a wider range of options, including specifically whether those who have been resident here for more than 10 years should contribute more. This could have far reaching implications, leading possibly to the ultimate withdrawal of the remittance basis for long-term resident non-domiciliaries.

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- Unfortunately there appears to be little which can be done;
- **Other measures and announcements:**
 - Following Mr & Mrs Jones' success in the Arctic Systems case, the government will be consulting, on draft legislation to take effect from 2008/09 to address income shifting. The legislation will work alongside the existing rules on businesses deductions and settlements, and will seek to remove the tax advantage obtained from income shifting. It would only apply when the income is in the form of distributions from a company (dividends) or partnership profits. Income from employment, interest on savings and any other source will not be affected. Consideration will be given to the work done by the individuals in the business, the investments made and the risks to which they are subject through the business. Clearly this is aimed as legalising HMRC's stance prior to losing the Arctic Systems case in the Courts;
 - The government will shortly launch three reviews where HM Treasury and HMRC will work in partnership with business to evaluate how a range of tax policies could be simplified. This will include how to simplify the corporation tax (CT) rules for related companies
 - Holiday pay schemes, under which employees could receive holiday pay from an 'independent fund', on which no National Insurance contributions were due, will cease to be effective from 30 October, subject to a five year transitional period for the construction industry;
 - From 1 January 2008, renovations and alterations to residential property will be subject to the reduced rate of VAT (5%), where the property has been empty for at least two years (currently properties must be empty for at least three years to qualify for the reduced rate);
 - From 2009/10, taxpayers subject to income tax self-assessment will not have to make payments on account of their tax liability, where their income tax liability is less than £1,000 (£500 for tax years

up to and including 2008/09). Any liability will be payable by 31 January following the end of the tax years concerned;

- For employees with ‘company cars’, who also received free car fuel, the basis of the free fuel benefit will increase from £14,400 to £16,900 on 6 April 2008 (this amount is multiplied by the relevant CO₂ percentage to arrive at the taxable benefit figure). It should be noted, that unless an employee has very high private mileage, it is cheaper in terms of tax and National Insurance to pay a ‘fuel allowance’;
- Legislation will be introduced in the Finance Bill 2008 to ensure that where there is a transfer of an interest in a property within an investment partnership there will be no charge to SDLT.
- Following on from action in 2006-07 on stamp duty land tax avoidance, the Government will consult with interested parties later this year on how to extend the disclosure regime to high value residential property transactions.
- Government will also consult with interested parties later this year on the practicalities of addressing the use of special purpose vehicles to reduce stamp duty land tax liability on high value residential property.
- The introduction of the Planning Gains Supplement has been postponed
- As usual there are numerous anti-avoidance measures. These include:
 - the manipulation of plant leasing arrangements to save tax;
 - blocking tax avoidance schemes involving accelerated interest payments;
 - ensuring that ‘spreading’ applies to tax relief on very large employer pension contributions;
 - ensuring that the unauthorised payments charge and IHT (if applicable) will be applied where a member of small pension scheme (generally known as SSASs), where pension benefits are inherited by surviving members;

If you would like to know more about how the changes in the Pre Budget will affect you, please contact Mark Sheen at mrcs@barlow-andrews.co.uk or Tim Lwin at tl@barlow-andrews.co.uk.