Technical Connection

BUDGET ISSUE

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INCOME TAX

(A) TAX RATES

The starting rate of 10% for the tax year 2007/08 will apply to the first £2,230 of taxable income (i.e. after allowances and reliefs). From 2008/09 the 10% rate will no longer apply to earned income and pensions. For 2007/08 the basic rate of tax is held at 22% and will apply to income in the band £2,231 to £34,600 (savings income in this band is taxed at 20% and dividend income at 10%). However, from 2008/09 the basic rate of tax will reduce to 20%. The higher rate threshold has been increased to £34,600.

(B) PERSONAL ALLOWANCES

Personal allowances and the age allowance threshold are increased for 2007/08 in line with inflation as follows:

- Standard personal allowance £5,225
- Age allowance £7,550 (for those aged 65-74) and £7,690 (for those aged 75 and over)
- The level of income that a person can enjoy before age allowance is cut back is £20,900

- The married couple's allowance (MCA) for those aged between 65 and 74 (provided at least one spouse was aged 65 or over before 6 April 2000) is £6,285, and for those aged 75 and over £6,365

- In calculating the reduction in age allowance when income exceeds £20,900, the MCA is cut back to not less than £2,440 (the "minimum amount")

CAPITAL GAINS TAX

The annual exemption increases to £9,200 in 2007/08 for individuals and personal representatives, and (in most cases) £4,600 for trustees. The rates of tax for individuals are held at 10%, 20% and 40%. The rate of tax payable by trustees (other than the trustees of a bare trust) is also held at 40%.

INHERITANCE TAX

The nil-rate band has been increased from £285,000 to £300,000, as announced in Budget 2005, and will apply to chargeable transfers occurring on or after 6 April 2007. In 2010/11 the nil-rate band will be £350,000. Unlike last year, no other changes have been made to inheritance tax. **HMRC has now confirmed that, in its view, bare trusts for minors will NOT be treated as settlements for IHT purposes.**

CORPORATION TAX

The small companies' rate for the first £300,000 of profits is from 1 April 2007 increased from 19% to 20%. Profits in excess of £1,500,000 continue to be taxed at 30%, with the marginal rate of relief for profits in the band £300,000 to £1,500,000 reducing from 32.75% to 32.5%.

NATIONAL INSURANCE

The rates and thresholds that will apply for the tax year 2007/08 are as follows:

- The rate of employer's National Insurance contributions is 12.8%.

- The threshold above which employers/employees pay contributions is £100 per week.

- Employees' contributions at 11% are levied on earnings up to the upper earnings limit of £670 per week (£34,840 pa). In addition, a 1% charge applies on all earnings in excess of £34,840 pa.

- The Class 4 (self-employed) rate is 8% on profits between £5,225 and the upper profits limit (£34,840 pa). In addition, a 1% charge applies on all profits in excess of £34,840 pa.

In tax year 2008/09 the weekly upper earnings limit (UEL) and the weekly equivalent of the upper profits limit (UPL) will be increased to an amount equal to £75 over the indexed amount. From tax year 2009/10 the UEL and UPL will be aligned with the point at which higher rate income tax is paid after the personal allowance has been taken into account.

TAX-FAVOURED INVESTMENTS

ISAs

No changes were announced for 2007/08 which means that the £7,000 maximum subscription limit and £3,000 limit for cash continue.

From 6 April 2008 the ISA will be reconstructed to:

- Remove the distinction between mini and maxi ISAs
- Allow transfers from the cash component into the stocks and shares component of ISAs
- Allow Child Trust Fund accounts to be rolled over into ISAs on maturity

Also from 6 April 2008, the annual subscription limits for an ISA will increase. The limit for a cash ISA will rise to £3,600 and for a stocks and shares ISA to £7,200, subject to an overall annual subscription limit of £7,200 to both ISAs. From the same date all personal equity plans will become stocks and shares ISAs.

Venture Capital Trusts, Enterprise Investment Schemes and Corporate Venturing Schemes

There are no changes to subscription limits but there have been some changes to the regulations companies must comply with to attain VCT, EIS and CVS status. The main changes are as follows:

- Currently there is no restriction on the number of employees who work for a company raising money under the venture capital schemes (EIS, VCT and CVS). New rules will require that a company (or group of companies) raising money under the schemes must have fewer than 50 full-time employees (or their equivalents) at the date on which the relevant shares or securities are issued.

- A new investment limit will apply to a company raising money under the venture capital schemes. For an "investment" to qualify for relief under the EIS or CVS, or be treated as a qualifying holding of a VCT, the company must have raised no more than £2 million under any or all of the schemes in the 12 months ending on the date of the relevant investment. If the limit is exceeded, none of the shares or securities within the issue that causes the condition to be breached will qualify for relief or rank as a qualifying holding.

Both of these measures will apply to EIS and CVS shares issued from the date that Finance Bill 2007 receives Royal Assent and to investments made out of funds raised by VCTs on or after 6 April 2007.

Investment in AIM shares

Because AIM shares are not listed on a recognised stock exchange investment in shares quoted on the AIM can be attractive for a number of tax reasons, for example:-

- They potentially qualify for 100% inheritance tax business property relief after 2 years of ownership and 75% capital gains tax business assets taper relief after a similar period.

- If the AIM shares satisfy the conditions for EIS relief, income tax relief at up to 20% will be available on any investment up to £400,000 in a tax year.

The Chancellor announced that legislation will be introduced in Finance Bill 2007 to allow HMRC to designate as a recognised stock exchange for tax purposes any investment exchange designated as a recognised investment exchange (RIE) by the FSA. This will ensure equal tax treatment for FSA-listed shares, regardless of which RIE is used as the primary market for the shares. The power to designate overseas exchanges is not changed.

We can't of course be certain of the Government's future intention in this area but this new provision would appear to make it very easy for HMRC to, in the future, designate the AIM as a recognised stock exchange if the FSA had previously designated it a recognised investment exchange. If that happened 100% business property relief (for IHT) and the qualification condition for 75% business assets taper relief would be prejudiced.

A potential benefit of a share being one listed on a recognised stock exchange would however be that the share may qualify for a tax privilege e.g. be a permissible ISA investment.

Property Authorised Investment Funds

During the development of UK-REITs, the Government has continued to consider the taxation position for Authorised Investment Funds (AIFs) investing in property. Following discussions with working groups, industry and other representative bodies, a framework for the taxation of property AIFs has been developed for taking this issue forward. The framework moves the point of taxation from the AIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned real property or UK-REIT shares directly.

The Government will now take this framework and use it for further discussions with the industry.

TRUST TAXATION

Following the bombshell called "BN25" in last year's Budget on 22 March 2006, which introduced what was probably the biggest shake up of trust taxation in the last 20 years, we are pleased to report that the only announcements relating to trusts in the 2007 Budget are two amending measures designed to remedy omissions in the Finance Act 2006 and a provision to give relief from the 40% tax rate for service charges and sinking funds.

The two omissions concern payments received by trustees following the purchase by a company of its own shares and the interaction of trustees' tax pools with payments received by trustees which are chargeable event gains on certain life assurance policies.

PENSION TERM ASSURANCE

The introduction of the new pensions tax regime had seen a considerable increase in the volume of individual pension term assurance (PTA) sales. Many new products were launched to address this market where the tax relievable premiums made such contracts more attractive, in many cases, than ordinary term policies.

Individuals will no longer have the right to pensions tax relief on the cost of new PTA policies under both personal and occupational schemes.

This change will apply to:

- all personal contributions made to an occupational scheme on or after 1 August 2007 in respect of PTA policies, unless the insurer received a PTA application before 29 March 2007 and the policy was taken out as part of the pension scheme before 1 August 2007

- all contributions made to PTA policies on or after 6 April 2007 unless the insurer received a PTA application before 14 December 2006 and the policy came into force before 6 April 2007.

Where an individual continues to be eligible for relief on such contributions as he met the above criteria he will cease to be entitled to relief if the policy to which the contribution relates is varied outside its original terms so as to increase the sum assured or lengthen the term of the insurance. However, if there is an option under the policy, which is then exercised, this will not affect the relief due.

The above change will not affect the position regarding PTA secured by employer contributions, and such contributions will continue to be eligible for tax relief. This may tempt some controlling directors to set up PTA arrangements on their own lives funded by employer contributions. Such an approach may not, however, work as the employer contribution would still need to meet the "wholly and exclusively for the purposes of the trade" criteria to qualify for relief. Moreover, HMRC has included the following warning in Budget Note 18, "the Finance Bill legislation will also provide new powers to pass secondary legislation which will enable the Government to act quickly to remove relief from new products sold with a view to avoiding the new restrictions on tax relief."

The Government has indicated that it is happy to hold further discussions with the industry between now and the Finance Bill 2007 Committee Stage about the detail of the draft legislation to ensure that it only catches the policies and contributions intended.

PENSIONS

The Pre-Budget Report 2006 (PBR) heralded changes in the treatment of Alternatively Secured Pensions (ASP), dropped the pension term assurance bombshell (see above) and proposed a number of technical changes to improve the working of the new simplified pensions tax regime.

We have set out further details of the first two areas and also included further details on the tax charges which the Government is proposing to introduce which will stop scheme pensions being used to pass on tax-free capital to other scheme members on the death of a member (ie. effectively killing off the idea of the family SIPP/SSAS).

The Government is proceeding with the other technical changes announced at the time of the PBR, but space prohibits us from outlining details of these, other than to refer to the most significant change which will permit the payment of a Pension Commencement Lump Sum (tax-free cash sum) within 12 months after the commencement of a scheme pension/lifetime annuity or income withdrawal benefits.

ALTERNATIVELY SECURED PENSIONS

A number of changes will be made to the ASP rules with effect from 6 April 2007.

Minimum and maximum amounts of income

With effect from the first "ASP year" starting on or after 6 April 2007, a member (or dependant taking dependant's ASP) must take a minimum income of at least 55% of the "basis amount" (i.e. the annuity based on GAD rates for an individual aged 75) in each ASP year. It should be noted that this is a reduction in the amount of minimum income that must be taken, when compared with the 65% set out in the PBR.

The only exceptions to the above will be in

- the "ASP year" which ends immediately before the death of the member or dependant, or

- the "ASP year" in which all of the member's/dependant's ASP funds are used to provide a scheme pension, lifetime annuity, dependant's scheme pension or dependant's annuity, as appropriate.

Where the member or dependant does not take an income of at least the minimum level in an "ASP year", the difference between the minimum income level and the actual income paid, if any, will be treated as a scheme chargeable payment, and result in a scheme sanction charge.

For example, Joe was taking ASP and the minimum income level for an "ASP year" was determined as £10,000 (55% of the "basis amount"). However, no income was paid to Joe in that year. This results in a scheme chargeable payment of £10,000. The scheme administrator will therefore be liable to a scheme sanction charge of £4,000 (i.e. 40% x £10,000).

With effect from the first "ASP year" starting on or after 6 April 2007 a member may take a maximum income of 90% of the "basis amount" (as defined above).

Treatment of lump sum death benefits

Under the existing rules where a member (or dependant) taking ASP dies without leaving a dependant of the member it is possible for the deceased member's (or dependant's) ASP fund to be paid as a "Transfer Lump Sum Death Benefit" to enhance the benefits of another scheme member. Such a payment is an authorised lump sum payment.

With effect from 6 April 2007 any "Transfer Lump Sum Death Benefit" will no longer be an authorised lump sum payment. Instead, it will be subject to an unauthorised payments charge of up to 70% where the deceased member's residual ASP fund is transferred to the pension fund of another member(s) of the scheme. Rights payable in these circumstances will be renamed as "alternatively secured rights". These provisions will not apply where the member or dependant dies on or before 5 April 2007.

The payment of such rights to another member will be treated as an unauthorised payment to that member (or that member's personal representatives).

Changes will be made to sections 151A to 151C of the IHT Act 1984 so that for deaths on or after 6 April 2007, IHT will be calculated on the basis that the IHT nil-rate band will be set first against the estate of the deceased excluding ASP funds. Further amendments will be made to introduce a special calculation for cases where there is an amount of nil-rate band available to offset against the value of the ASP funds.

Where there is an unauthorised payment charge and an IHT charge on the ASP funds, the aggregate of the two taxes is the same in whichever order the two taxes are charged. This is demonstrated by the following example where the member died while taking ASP leaving a residual fund of £1 million and with no unused nil-rate band.

Where the unauthorised payments charge is taken first:

£1 million x 70% = £700,000 tax charge
IHT charge of 40% on residual fund of £300,000 = £120,000
Total tax charge = £820,000

Where the IHT charge is taken first:

£1 million x 40% = £400,000
Unauthorised payments charge of 70% on residual fund of £600,000 = £420,000
Total tax charge = £820,000

A special IHT provision is being made to cater for cases where a person dies while taking ASP and it has not been possible to fully utilise the IHT nil-rate band (£300,000 on or after 6

April 2007) in respect of his non-ASP chargeable estate . This will only apply where the IHT charge arises before any unauthorised payment charge and provides for the amount of any unused IHT nil-rate band to be grossed up. The ASP funds will be charged to IHT on the excess over the grossed-up nil-rate band. This approach recognises that the gross ASP funds will be subject to subsequent unauthorised payment charges of up to 70%.

If in the above example, where the member left a residual ASP fund on death of £1 million, £100,000 of his nil-rate band was unused, the total tax due would effectively fall by £40,000 (ie £100,000 x 40%) to £780,000

The section 151B charge arises on left-over ASP funds once a relevant dependant's pension benefits cease and the rates of tax are those applying at the date of that event rather than at the date of death of the scheme member. This rule will be modified so that if the IHT nil-rate band was not fully used against the personal estate when the original owner of the ASP died then the same proportion that was unused will be applied to the amount of the nil-rate band in force at the date of the later event and be available against the ASP.

There will be no change to HMRC's current procedures for calculating and notifying scheme administrators of the IHT due on ASP funds.

Guarantee period

In the PBR it was noted that any payments under a guarantee from an ASP fund will be unauthorised payments with effect from 6 April 2007. This would mean that no authorised payments of pension may be made from the member's ASP fund after his death (other than dependants' pension benefits). This has not been mentioned further in the Budget Notes.

Charity Lump Sum Death Benefit

Similarly, there is no further mention concerning the payment of charity lump sum death benefits whereas in the PBR it was stated that draft legislation will amend the legislation concerning who can nominate where a charity lump sum death benefit is paid. The PBR stated that the change would enable a scheme administrator to select a charity to which a charity lump sum death benefit may be paid in the absence of a member nomination (in respect of the member's ASP funds) or in the absence of a member or dependant nomination (in the case of lump sums paid to a charity out of a dependant's ASP fund).

SCHEME PENSIONS

Having closed the door on the ability to pass on ASP funds to younger generations the Government has issued a consultation paper "Tax relief for pensions: Inheriting tax-relieved pension savings", which considers how to stop scheme pensions and annuities being used as a means to pass on tax-relieved pension savings in an IHT efficient way. The Government intends to introduce the proposed measures as soon as possible. These will impose similar tax and IHT charges on scheme pensions and annuities in payment that enable remaining pension funds to be passed onto a person(s) connected with the deceased member (other than where the funds are used to provide authorised dependants' benefits or pass to a charity).

It is intended that the new measures will apply to all existing arrangements that have been put in place that will enable capital to be passed on death to connected persons. They will not, however, affect arrangements where the member or dependant died before the introduction of the measures.

This consultation paper builds on the comments made in the PBR and confirms the demise of the concept of the "family SIPP/SSAS".

LIFE COMPANY/POLICYHOLDER TAXATION

LIFE COMPANY TAXATION

Certain technical changes will be made in Finance Bill 2007. The main ones may be summarised as follows:-

- From the date the Finance Bill 2007 receives Royal Assent, when tax exempt business (which is not life assurance, for example permanent health insurance) is transferred to a life assurance company, the transferred business will retain its tax exempt status.

The following two changes run from accounting periods which begin after 31 December 2006

- HMRC has the right to choose when a life assurance company is taxed on the I minus E basis or under Case 1 of Schedule D. Legislation is to be introduced which will set down rules to enable a determination to be made as to which method applies in a particular situation. However, there will also be changes to the I minus E basis which will ensure that tax is always paid on the higher of the profit computed on the Case 1 basis and that computed on the I - E basis.

- The general rule for chargeable gains is that losses on transactions between connected parties can only be set against gains on transactions made between the same connected parties. This rule is to be relaxed where a life assurance company makes a loss on the disposal of units in an authorised unit trust or shares in an OEIC managed by a company in the same group.

LIFE POLICYHOLDER TAXATION

To date it has been possible for a high net worth investor to make good, net of tax, short-term profit on a single premium bond by the intermediary rebating the commission. For example, say on a £100,000 investment the investor received a commission rebate of £4,000. For chargeable event purposes the premium paid remained the gross premium (say £100,000) whereas the investor would have expended something considerably less in net terms (£96,000). The chargeable event gain and tax on the transaction was therefore restricted. So, if the investor encashed the bond for, say, £100,000 while the investor will have invested a net £96,000 and received £100,000 they will have made no chargeable event gain.

This could be a particularly attractive strategy where there was no risk under the policy, ie. the investment fund selected was cash.

The legislation will make clear that, for policies and contracts within the scope of the new rules, the amount of premium that will be allowable in calculating any gain on these chargeable events

- is reduced by the amount of any commission which is passed on to a policyholder or connected person by an intermediary such as a financial adviser

- does not include any amount of commission waived by an intermediary that is reinvested in the policy, for instance by enhancement of units.

Subject to the commencement rule (see below) and an anti-fragmentation rule, this measure will apply to any policy or contract on which a person is potentially liable for chargeable event gains where

- the premiums paid under the policy or contract exceed £100,000 in any given tax year, and

- the policy or contract is surrendered, matures or is assigned for money or money's worth before the end of the third tax year after that in which the premium threshold is crossed.

The measure will apply to

- policies and contracts made on or after 21 March 2007, and

- existing policies and contracts where the benefits secured are increased on or after that date, either by a variation of the policy or contract, or by the exercise of an option in the policy or contract

The measure will ensure that where commission is passed on by an intermediary, the insurer is required only to report to the policyholder and to HMRC the amount of any chargeable event gain calculated under the existing reporting rules. This is because the insurer is unlikely to be aware of any such rebate. The person liable to pay tax on the gain must add the amount of rebate to any gain reported on the certificate to arrive at the amount to include in their self-assessment return.

RESIDENCE AND DOMICILE

In the 2003 Budget, the Chancellor announced that there would be a review (and possible consultation) on changes to the residence and domicile rules affecting the taxation of individuals. In his 2007 Budget the Chancellor announced that the review is continuing, and will be followed up by a consultation paper.

As usual, the contents of this bulletin are based on the proposals put forward by the Chancellor in his Budget speech and need to be approached with caution as details may change during the passage of the Finance Bill through Parliament.