Technical Connection

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PRE-BUDGET REPORT HIGHLIGHTS

1. Capital gains tax

A major reform of the taxation of capital gains accruing to individuals, trustees and personal representatives was announced. The corporate tax position on capital gains of companies will remain the same.

For disposals occurring on and after 6 April 2008, there will be a single rate of CGT of 18% which should result in a more straightforward system of tax. The annual exemption will be retained.

As a consequence of this simplification there are a number of "knock-on" changes, also effective from 6 April 2008. These are:

(i) The withdrawal of taper relief on both business and non-business assets. Currently, for business assets taper relief purposes, after a qualifying asset has been owned for at least two years, the chargeable gain is reduced by 75%. This means that the effective rate of tax on gains from such assets for a higher rate taxpayer would be 10% and 5% for a basic rate taxpayer.

Non-business assets taper relief could reduce the chargeable gain by 40% after 10 years' ownership giving an effective rate of tax of 24% for a higher rate taxpayer and 12% for a basic rate taxpayer.

(ii) The withdrawal of indexation allowance. Although indexation allowance was withdrawn for individuals with effect from April 1998, it still applied to holding periods between March 1982 and April 1998. Indexation allowance is applied to the unindexed gain to produce the reduced indexed gain. In the tax computation indexation is allowed first, then allowable losses are deducted and then taper relief is applied.

(iii) From 6 April 2008 the base cost of assets held before 31 March 1982 will be fixed at the 31 March 1982 value. Currently, in broad terms, a gain or loss can be calculated using the original acquisition cost of the asset or the value of the asset as at 31 March 1982 as the acquisition cost. The higher of the two amounts would be taken in determining the taxable gain and so yields the best result for the taxpayer.

(iv) When a capital gain arises on an asset acquired before 31 March 1982, that gain is deferred before 6 April 1988 (for example hold-over relief applied) and the deferred gain is subsequently brought into charge after 5 April 1988, then the deferred gain would, in certain circumstances, be halved. This relief is abolished from 6 April 2008.

(v) Following the introduction of taper relief in 1998 a complicated system was introduced to identify which shares out of a particular shareholding were being disposed of so as to determine their base cost. The current rules broadly apply on a LIFO (last in first out) basis. From 6 April 2008 shares of the same class in the same company will be treated as a single asset which takes us back to the old system of “share pools”. However, the rule matching shares disposed of and acquired on the same day and the 30 day “bed and breakfast” rule will remain.

Draft legislation is to be produced later and HMRC will discuss the changes with interested parties. However, it would be unwise to assume that we have heard the last of these changes.

Following widespread condemnation by businesses of the proposed introduction of the flat 18% CGT rate and the abolition of taper relief, on 31 October the Times reported a Government proposal that a gain, possibly as high as £100,000, will be exempt on the sale of a business on retirement. The introduction of this new form of the old “retirement relief”, which was phased out from 6 April 1998 and finally expired on 5 April 2003, will therefore be welcome.

At the same time, the Chancellor was also reported as considering further changes to help entrepreneurs with a further possibility being a tax break for people selling businesses rather than those just retiring.

COMMENT

Subject to any changes to the proposals, the winners from the proposed changes would include owners of shares and funds who have built up enough capital gains to pay CGT. Instead of paying anything up to 40 % CGT, from 6 April 2008 they will pay a maximum of 18%.

Although most shareholders will be potential winners, long-term investors with holdings dating back more than ten years could lose out. Existing taper relief and indexation allowance may mean that they can already reduce their effective rate of tax to less than the new 18% rate. Buy-to-let investors and owners of second homes are in a similar position to equity investors and could enjoy a cut in their tax rate from 40% to 18% when they sell their properties. The exceptions will, again, be those who have held their properties for long enough to benefit heavily from existing taper relief and indexation allowance.

Other losers will be private equity bosses who, as investors owning shares in a private company, were entitled to benefit from business assets taper relief, which allowed them to cut their effective CGT rate from 40% to 10% once they had held the shares for two years. Under the new rules they are going to be paying CGT at 18%. Similarly, people who invest in shares listed on the AIM also benefit from business assets taper relief as do employees in save-as-you-earn share schemes, entrepreneurs and others who hold shares in their own companies and they will in future pay flat rate CGT at 18%.

For those considering a lump sum pooled investment who are higher rate taxpayers and already using their annual CGT exemption, an investment into a collective – such as a unit trust/OEIC - will now look more attractive than a single premium bond from a capital gains tax perspective. However, there are a whole range of other factors to consider in making this decision – especially if the investor requires IHT efficiency – when a bond will frequently be the preferred choice.

2. Inheritance tax

Announcements on inheritance tax were expected and we were not disappointed.

1. The proposals

- Finance Bill 2008 will introduce legislation to allow a claim to be made to transfer any unused nil rate band (NRB) on a person's death to the estate of their surviving spouse who dies on or after 9 October 2007. "Spouse" in this connection includes registered civil partner. Draft clauses have been published.

- The new provisions will apply to anyone who dies on or after 9 October 2007, regardless of when their spouse died (including deaths before 1986 when IHT was introduced).

- The amount of NRB available for transfer will be based on the proportion of unused NRB at the time of death of the first spouse but at the rate applicable at the time of death of the surviving spouse. A maximum 100% of the NRB will be available on the death of a surviving spouse, although it can be accumulated on more than one occasion, for example if a person dies having survived more than one spouse.

- The unused NRB of a deceased spouse cannot be used by a surviving spouse during his or her lifetime.

- Claims for a transfer must be made by the personal representatives of the deceased surviving spouse within 2 years of his or her death (ie. following the second death – there is no need to do anything following the first death).

- The IHT rules for alternatively secured pensions (ASP) have been amended to take account of this change.

Examples

(i) On the first death in October 2007 all assets pass to a surviving spouse – no IHT is payable due to the spouse exemption but the nil rate band (£300,000) is unused. When the survivor dies, and assuming the NRB is then £350,000, his or her NRB is doubled to £700,000.

(ii) If, on the first death, there was a chargeable transfer of £150,000, ie. one half of the NRB, the survivor's NRB will be increased by 50% of the **then** NRB, ie. by £175,000 to £525,000.

2. The impact of this change

Effective use of the NRB has always been the main feature of IHT planning for married couples. Where the main asset that took them into the IHT net was their principal residence, planning was particularly difficult. Numerous schemes were devised over the years involving arrangements to ensure that the NRB was used while the surviving spouse was given security of tenure in the property and that the property would not have to be sold after the survivor's death solely to fund inheritance tax. Now for the vast majority of families potentially subject to IHT because of the ownership of their house, this threat has been lifted and there should be no need to enter into any contrived schemes just to utilise the NRB on the first death.

3. Planning points

The following are the main points:-

- The proposals do not require any immediate action with regard to IHT planning.

- When individuals have included a NRB trust in their Will there is no need to change it as there may be good practical reasons to have such a trust, particularly when the main asset is the principal residence. For example:-

  - the couple are on a second marriage with a desire for the assets of the first to die to pass to his/her children from the first marriage

  - there is a desire to incorporate planning to avoid the local authority taking account of assets of the survivor should he or she go into care

  - there is a desire to transfer assets to the next generation on the first death because of an expectation that values will substantially outstrip the increase in the nil rate band in the future

  - there may be a desire to protect assets from creditors/ex-spouses in the event of the insolvency/divorce of a child.

- An important point is that where, on death, all assets pass to the surviving spouse or are left on a life interest trust for the surviving spouse with the remainder passing to someone else (eg. the children), there will be no IHT to pay on the first death (without limit - provided the spouse is UK domiciled) and the NRB will be fully transferable. In other words, to be eligible for this relief it would mean that there is no need for the assets of the first to die to necessarily pass to the surviving spouse absolutely.

- If assets pass to a NRB Will trust on the first death and are then appointed to the surviving spouse within 2 years (but not within the first 3 months) of the first death, such an appointment would normally be treated for IHT purposes as if the assets were left to the spouse outright. In such a case the NRB (or the part of it equal to the amount distributed to the surviving spouse by the trustees) would not be used on the first death and could therefore be transferred to the surviving spouse on his or her subsequent death.

COMMENT

Clearly the proposals will make IHT planning much easier for couples whose combined assets do not exceed twice the nil rate band at the survivor's death. In particular, the fact that someone leaves all their assets to their spouse will no longer mean that their NRB is wasted.

The proposals will be of most use to those whose main asset is their private residence and who are therefore unable to implement any easy lifetime IHT planning strategy involving a reduction of their estate. However, it could also be said that for all those who have already implemented a strategy, which includes the use of the NRB on their death, the proposals do not give a substantial saving.

If the NRB has been fully used on the first death, there will be no increase in the NRB on the second death and the rate of IHT remains at 40% on everything in excess of the then NRB. And, of course, the proposals do absolutely nothing for those who are not married or in a civil partnership. For all such individuals and couples, the existing lifetime planning strategies remain as valid as ever.

3. Life policy taxation

Capital redemption bonds owned by a company are taxed under the loan relationship rules. This broadly means that each year realised and unrealised gains are treated as trading income and taxed as such.

From 1 April 2008 this tax treatment will also apply to "investment" life policies and annuities owned by a company, but not protection-type policies which cannot acquire any surrender value. On the first day of the first accounting period of the company to begin on or after 1 April 2008, the company will be treated as surrendering the policy or annuity contract. Any chargeable event gains arising on this deemed surrender will not however be taxed at that time but will be brought into account as a non-trading credit to be taxed in the accounting period in which the company actually disposes of its interest in the policy or annuity.

4. Life company taxation

- Legislation is to be introduced to prevent life assurance companies benefiting from tax relief for certain expenses incurred in reinsurance arrangements.

- Complex rules that were introduced when an insurance company reattributed its inherited estate (broadly the surplus of assets over liabilities) to its shareholders have been repealed. The issue of the taxation of the inherited estate remains under review.

- The law which applies to the transfer of long-term insurance business will be updated and simplified from 1 April 2008.

5. Non-domiciliaries

The announcement by the Conservatives of a proposal to tax non-UK domiciliaries living in the UK has ignited this whole area and the Government proposed measures in the PBR aimed primarily at targeting UK resident persons who pay tax on the remittance basis because they are non-UK domiciled (or non-UK ordinarily resident).

Currently, people who are UK resident but non-UK domiciled are taxed on the remittance basis on overseas income and capital gains. This means income and capital gains are only taxed in the UK if remitted to the UK.

In brief terms, with effect from 6 April 2008 it is proposed that after a non-domiciled individual has been resident in the UK for seven years they will only be able to use the remittance basis of taxation if they pay an additional tax charge of £30,000 a year. Where an individual decides not to use the remittance basis (and so does not pay the additional tax charge) they will be taxed on all their worldwide income and gains whether or not they are remitted to the UK. For this purpose all previous years of residence will count from 6 April 2008. Clearly the very wealthy will consider that £30,000 a year is a small price to pay for the continuing benefit of the remittance basis – albeit with no ability to use the income tax personal allowance in the future. For those with overseas income of less than £75,000 a year, they will need to more carefully assess their position.

The Government has also announced that, in future, in determining a person's residence position in the UK, days of arrival and departure will be counted as days of presence in the UK for residence test purposes.

6. Pensions

The PBR has included a number of changes to both private and State pension provision.

1. Inheriting tax-relieved pension savings

The Government has brought in draft legislation, to be included in the Finance Bill 2008, that will mean that where a member of a scheme receives an increase in pension rights, which arises on the death of another scheme member/dependant who was in receipt of a lifetime annuity, scheme pension, dependant's annuity or dependant's scheme pension this will be subject to unauthorised payment charges where the receiving member was a "connected person". This will apply in respect of the death of the original member/dependant on or after 6 April 2008.

In addition, where the original member/dependant dies at or after age 75, any lump sum paid to enhance the benefits of another scheme member will be liable to IHT.

The effect of these changes is that scheme pensions/lifetime annuities will be subject to the same tax/IHT treatment as for ASP benefits. This will effectively kill off the idea that a scheme pension under a SSAS/SIPP could be used to pass on tax-relieved pension savings to the next generation.

Provision will also be made in the Finance Bill 2008 that where an individual surrenders their right to a lifetime annuity, dependant's annuity, scheme pension or dependant's scheme pension on or after 10 October 2007 this will result in unauthorised payment charges.

2. Spreading of tax relief for employer contributions

New legislation has been drafted, which will be included in the Finance Bill 2008, to stop the spreading of employer contributions being circumvented by routing these via a new company. These new provisions will be effective for employer contributions made on or after 10 October 2007 under binding obligations entered into on or after 9 October 2007.

3. Changes to BCE 3 test rules

Three main changes are to be made to the BCE 3 test rules (ie. which apply to increases of pensions in payment for members of DB schemes) in order to reduce the number of occasions on which schemes will be required to carry out a BCE 3 test. These are:

- Any scheme where at least 20 members are paid the same increase at the same time will be exempt from the BCE 3 test. This will be the case irrespective of whether the increases to pensions under that scheme are in respect of all or only some of the scheme's pensioners.
- Schemes will be exempted from applying the test provided the increase for pensioners does not exceed a "normal rate of increase" in a 12 month period. For this purpose the "normal rate of increase" is defined as 5%, or the RPI if higher.
- The reference period on which the RPI is based will be changed to that applicable two months before the pension increase occurs.

These changes are backdated to have effect from 6 April 2006, except for the change to the RPI calculation date which will apply from 6 April 2008.

A further technical change is being introduced from 10 October 2007 which allows for the indexation of previous BCE 3 crystallisations when a further BCE 3 test is undertaken.

4. Protected pre A-Day cash

Where a member has protected pre A-Day cash under a scheme he can currently receive an additional tax-free cash sum provided "relevant benefit accrual" has occurred. This then effectively allows an additional PCLS of 25% of any accruals of pension rights since A-Day. The need to check whether "relevant benefit accrual" had arisen was causing major administrative problems for some DB schemes and HMRC are now removing the requirement for this check. This change will be backdated to 6 April 2006.

This appears to permit a member in such circumstances to accrue further PCLS under the scheme but to avoid schemes having to undertake an onerous check.

5. Taxable property

The definition of an investment regulated scheme will be changed so that it does not include schemes where individual members could not realistically be expected to influence scheme decisions to invest in taxable property. This change has been made to stop large occupational schemes, in particular, falling foul of the taxable property rules. This will be backdated to 6 April 2006.

6. IHT on overseas pension schemes

Legislation will be included in the Finance Bill 2008 to restore IHT protection to UK tax-relieved pension savings held in overseas pension schemes so that they will be given the same protection as for funds held in UK registered pension schemes. This change will be backdated to 6 April 2006.

7. Lifetime allowance – dependant's scheme pension

HMRC had introduced a consultation following the Pre-Budget Report (PBR) 2006 to see whether any simplification could be made of the rules applicable to a dependant's scheme pension resulting from the death of a member aged 75 or over who was in receipt of a scheme pension. HMRC is making no changes to the rules at this stage as the responses to the consultation are still being considered.

8. Review of open market annuities

The Treasury has set out the results of the open market annuity review, which was announced in the consultation on the "Annuities Market" issued at the time of the PBR 2006.

9. New types of retirement benefit provision

In its consultation paper "The Annuities Market" issued with the PBR 2006 the Government had expressed its wish to encourage the development of new retirement benefit products. In light of this it is disappointing to read the comment in paragraph 5.66, taken from the 2007 Pre-Budget Report, which is set out below.

5.66 *Following a commitment in the 2006 Pre-Budget Report, the Government has consulted widely with industry on tax barriers to the further development of 'hybrid' decumulation products, which combine an element of drawdown with a guaranteed income. The Government has decided not to change the tax rules as this would add complexity to the tax system and potentially benefit only a small number of consumers with large pension savings.*

10. State pensions

The Upper Earnings Limit (UEL) will be replaced by the Upper Accrual Point (UAP) for the calculation of S2P benefits (and the payment of National Insurance rebates on contracting out) with effect from 6 April 2009, instead of 6 April 2012 as originally envisaged.