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CAPITAL GAINS TAX SIMPLIFICATION

Draft legislation published
Entrepreneurs' relief

Introduction

The draft legislation to simplify capital gains tax (CGT) in respect of disposals made on or after 6 April 2008 by individuals, trustees and personal representatives has been published, together with explanatory notes. This draft legislation does not cover the new entrepreneurs' relief, announced by the Chancellor on 24 January, for which draft legislation and an explanatory note will be produced as soon as possible – see later.

Simplification

The new legislation does not affect the availability of the annual exemption. Also the rules for corporation tax on chargeable gains are not affected by the changes. The main changes, which are considered in turn, give rise to the following implications from 6 April 2008:-

- the replacement of the current system that, in effect, treats gains as the top slice of income, with a single 18% rate of CGT;

- the abolition of four reliefs that add complexity to the computation and charging of capital gains; and

- simplify the identification rules for what are known as "fungible" assets. Examples of "fungibles" are stocks and shares of the same class in a company including "same class" shares in OEICs and "same class" units in unit trusts.

(i) The flat rate of tax

The main effect of the legislation is to charge CGT at a single rate of 18%, replacing the current rules for individuals that charge CGT at the rate that would apply if the gains were the top part of the taxpayer's taxable income. Of course, trustees currently pay a flat rate of 40% and this will reduce to 18%.

(ii) The abolition of taper relief

For disposals on or after 6 April 2008, taper relief on both business and non-business assets is withdrawn. 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% (50% after one year). This means that the minimum 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 5% after 3 years' ownership increasing by 5% per annum with maximum relief of 40% after 10 years' ownership.

(iii) The withdrawal of indexation allowance

Although indexation allowance was withdrawn for individuals and trustees for periods of ownership after 5 April 1998, it still applied to holding periods between March 1982 and April 1998.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 first allowed, then allowable losses are deducted and then taper relief is applied. Indexation allowance continues to apply to companies.

(iv) Rebasing

From 6 April 2008 the base cost of all assets held before 31 March 1982 will be fixed at the 31 March 1982 market value. Currently, in broad terms, a gain or loss can be calculated using the original acquisition cost of the asset and the value of the asset as at 31 March 1982 as the acquisition cost (the rebased cost). The lower of the two gains would be chargeable to tax, or the lower of the two losses allowable. If there is a gain and a loss, there is a no gain/no loss situation. Alternatively, an individual could elect for **all** of his assets to be rebased to their 31 March 1982 values.

(v) "Halving relief"

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 "halving relief" is abolished from 6 April 2008.

(vi) The identification rules

Following the introduction of taper relief in April 1998 a complicated system was introduced to identify which shares out of a particular shareholding (comprised of shares acquired at different times and at different prices) 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 the identification rules will largely fall away. The order will become:

1. Same day acquisitions;
2. Acquisitions within the following 30 days (the anti-"bed and breakfast" rules);
3. Previous acquisitions in a single (non-indexed) pool. For this purpose shares held at 31 March 1982 will be included in the pool at their 31 March 1982 value.

(vii) Deferred gains

In certain circumstances the charging of CGT on an asset can be deferred eg. an amount equal to the gain is reinvested in an EIS. For a disposal before 6 April 2008 the deferred gain may have taken account of indexation allowance, rebasing or "halving relief", but not taper relief. The amount of a pre 6 April 2008 deferred gain will remain unchanged after 5 April 2008.

Entrepreneurs' relief

One concession has been given by the Government in connection with gains arising on the disposal of certain business assets when an effective rate of CGT of 10% will apply.

The so-called entrepreneurs' relief will apply to qualifying gains of up to £1,000,000, on a cumulative basis, made on the disposal of a sole proprietor's trading business, an interest in a trading partnership or shares in a trading company disposed of by an officer or employee of that company who holds at least 5% of the company's shares and which enables him to exercise at least 5% of the voting rights in that company.

The relief will be given by reducing gains of up to £1,000,000, on a cumulative basis, by 4/9ths which will result in an effective rate of tax of 10% (ie. 5/9ths x 18%). By way of example, Bill sells his first trading business in May 2008 for a gain of £630,000 (before entrepreneurs' relief). Assuming the whole gain qualifies for relief and the relief is claimed, the gain of £630,000 will be reduced by 4/9ths (£280,000) and £350,000 of gains will be liable to CGT at 18%. Assuming there are no allowable losses available to set against the £350,000 reduced gains and assuming that the annual exemption will be used elsewhere, tax at 18% on £350,000 would be due which amounts to £63,000 - an effective rate of 10% on the whole gain.

There is no age limit for the relief and the conditions for the relief will need to be satisfied for only one year before disposal.

Trustees will be able to benefit from the relief in appropriate circumstances and the definition of "trading company" will be that applying for taper relief. As mentioned earlier, at the time of writing the legislation on entrepreneurs' relief had not been published.

COMMENT

Apart from entrepreneurs' relief the legislation is along the lines of the changes proposed in the 2007 Pre-Budget Report.

Because the changes take place from the end of the current tax year, this should focus the attention of investors and business owners alike who have assets carrying substantial gains which they wish to dispose of or may have to dispose of in the near future. In some cases, it may be better to make the disposal before 6 April 2008, in others it may be better to wait. In all cases commercial considerations will dominate in practice unless there is a buyer on the horizon and it makes commercial sense to sell. The only planning that may be possible in practice may be the disposal of business assets (eg shares) to a settlor-interested trust to crystallise the gain under the current regime. However, it must be borne in mind that the tax will actually be payable on 31 January 2009.

DOMICILE AND RESIDENCE

Draft legislation published

In his 2007 Pre-Budget Report the Chancellor announced proposals to change the income tax and capital gains tax rules as they apply to those who are UK resident but either non-UK domiciled or not ordinarily resident in the UK. In what follows the expression "non-domiciliaries" means those who are UK resident but either not domiciled or not ordinarily resident in the UK. It should be noted that the changes do not apply to inheritance tax.

Following on from the consultation document "Paying a fairer share; a consultation on residence and domicile" issued last December, HMRC has recently published draft legislation, effective from 6 April 2008, technical notes and frequently asked questions.

The main changes set down in the draft legislation are as follows:-

(i) Domicile

(a) Individuals

- Currently, non-domiciliaries are subject to income tax and capital gains tax (CGT) on foreign income and gains on the remittance basis. This means that, in general, they will only pay UK tax when they remit that income or those gains to the UK.

- With effect from 6 April 2008, non-domiciliaries who are UK resident in the current tax year and who have been UK resident in at least seven out of the nine tax years (continuous or broken) preceding the current tax year will be taxed on the arising basis unless they claim otherwise and pay a £30,000 remittance basis charge. This rule will not apply though for any tax year in which an individual has unremitted foreign income or gains of less than £1,000. For such individuals the remittance basis will apply automatically.

So, in cases where tax would otherwise be levied on a non-domiciliary on the arising basis, to keep the remittance basis for a particular year, a charge of £30,000 has to be paid and

- a claim made for access to the remittance basis. To make a claim, a box has to be ticked on the self assessment return;
- unremitted foreign income and gains must exceed £1,000 for the tax year in question;
- the claimant has to be UK resident in the tax year; and
- the claimant has to have been UK resident for at least seven of the nine tax years preceding the tax year for which the remittance basis is claimed.

- It will be possible to choose, on a year-by-year basis, whether to pay the £30,000 charge (and keep the remittance basis) or continue on the normal basis of taxation (ie. payment of tax on foreign income and gains when they arise).
- The £30,000 annual charge is not income tax but for UK purposes it will be collected and administered as though it were income tax through the self assessment system, and normal filing and payment dates will apply. Whether or not the payment falls to be treated as income tax for the purposes of relief from double tax under a double taxation agreement will depend on how each individual country views the payment. If the £30,000 payment is remitted to the UK then it will itself be taxed on the remittance basis.

  It should be noted that if the £30,000 charge is paid for a particular tax year then if any foreign income or gains derived in that tax year are later remitted to the UK they will be taxed. In other words, the payment of the £30,000 charge does not exempt remittances from tax for the year in question.
- Some tax allowances and reliefs are lost for any tax year for which the remittance basis is claimed by payment of the annual £30,000 charge. These are:

(i) the personal allowance and blind person's allowance
(ii) the married couple's allowance
(iii) relief for payments up to £100 pa which secure life insurance under a trade union or police organisation scheme, or for family members in certain circumstances.
(iv) the annual capital gains tax exemption.

(b) Offshore companies

Under section 12 Taxation of Chargeable Gains Act 1992 (TCGA) gains arising to an overseas company, which would be a close company if resident in the UK, are assessed to capital gains tax on UK resident shareholders unless the gain attributed to the shareholder is less than 10% of the gain. Currently, such a gain is not assessed to tax on a UK resident non-domiciliary. From 6 April 2008 new section 14A TCGA will charge to tax any such gain remitted to a non-UK domiciliary.

(c) Offshore trusts

Under the current law, when a settlor, who is UK domiciled and UK resident or ordinarily resident, has an interest in an offshore trust, gains arising to that trust are assessed on the settlor. Having an "interest" in this context means, broadly, that under the trust one or more beneficiaries include the settlor, settlor's spouse, any child of the settlor/settlor's spouse and certain other close family members. If, however, the settlor is non-domiciled no tax arises on the gains, even UK assets, at the time of disposal. This position has been rectified from 6 April 2008 whereby gains will be assessed on a non-domiciled settlor on the arising basis. This will not apply if the gains arise on foreign assets where the settlor has claimed the remittance basis. Therefore gains arising on UK assets arising to offshore trusts under which the settlor has an interest will be assessed to tax in the tax year in which the trustees make a disposal.

Also under current legislation, in cases where an offshore trust has been created by a non-UK domiciled settlor and gains are not assessed to tax on the settlor then, provided the settlor continues to be non-UK domiciled, for CGT purposes any capital gains of the trust will count as "trust gains". No immediate CGT liability will arise but those trust gains will be attributed to capital payments made to a beneficiary who is then UK resident or ordinarily resident and UK domiciled and will be charged to capital gains tax. A 10% per annum supplementary charge may apply (subject to a maximum of 60%).

As can be appreciated from the foregoing offshore trusts set up by non-domiciliaries currently offer the scope for tax deferral with the possibility of complete CGT avoidance if the capital of the trust is eventually paid to a non-domiciled beneficiary.

From 6 April 2008, in the case of trusts where the settlor does not have an interest or where gains arise on non-UK situs assets, a CGT charge will also apply on payments to non-UK domiciled beneficiaries who are either UK resident or ordinarily resident. In addition, for a non-domiciled beneficiary the charge will apply whether or not the gains are remitted to the UK.

(ii) Residence

From 6 April 2008, when deciding if an individual is resident in the UK for tax purposes, days of arrival and departure will be treated as days of presence in the UK for the residence test. Under the residence rules, a person who is currently not resident in the UK will always be treated as resident in the UK if they spend 183 days or more in the UK in a tax year. If they visit the UK on a regular basis and spend, on average, 91 days or more in the UK in a tax year (taken over a period of 4 years) they will be treated as resident in the UK from the beginning of the tax year in which they make the first visit.

All days spent travelling to and from the UK will count as a day of presence for the purpose of the residence test. It will not matter what the reason for travelling is.

All days of arrival and departure will count as days of presence in the UK for the purposes of the 183 days test (which becomes a statutory test). This includes a day where an individual both arrives in and departs from the UK. The only exception to this rule is for passengers who are in transit, so that where the individual is a passenger remaining in a part of an airport or port not accessible to members of the public (except when they are arriving in or departing from the UK) the day will not count as a day of presence.

The 91 days test, which is non-statutory, will be applied in a way "consistent" with the new 183 days test.

(iii) Miscellaneous

Certain other changes have been made to amend current "flaws and anomalies" that allow tax on foreign income and gains to be sidestepped. The main ones are:-

- an amendment to the legislation to override the effect of the "ceased source" loophole that stops tax applying if the source of the income or gain no longer exists in the tax year when funds are remitted

- the setting down of clear rules to overcome the problems with taxing remittances from "mixed funds" ie. a mixture of foreign income, employment income, capital gains and capital

- the meaning of "received in the UK" is expanded so as not to apply solely to receipt by the individual to whom the income or gain arose

- the introduction of legislation in respect of income by which "sums received" means not only money but income in any form.

DEEDS OF VARIATION AFTER 8 OCTOBER 2007

Death of one spouse before 9 October 2007
Review of the Will of the deceased spouse
The IHT "transferable" nil rate band

In a case we recently reviewed a husband had died in September 2007 with a Will which left the whole of his very substantial estate (in excess of £2 million) to his UK domiciled widow. As a consequence no inheritance tax (IHT) was due on his death as the spouse exemption applied to the whole of his estate.

His widow was keen for some value to pass to her son and two grandchildren immediately. It had been proposed that the deceased's Will be varied to enable cash legacies of £100,000 to pass to each of the son and two grandchildren (£300,000 in total). By this action the deceased's nil rate band would have been used in full.

Before 9 October 2007 such a variation should have merited very serious consideration as, without this variation, whilst the whole of the deceased's estate would have passed to his widow free of inheritance tax, this would have meant at least £120,000 extra inheritance tax (IHT) would have been payable on the widow's subsequent death. However, since 9 October 2007, if part of a deceased spouse's nil rate band is unused, the proportion of the nil rate band unused can be claimed by the personal representatives of the surviving spouse on his or her subsequent death. This rule applies regardless of the date of death of the first spouse to die ie. it can precede 9 October 2007. The proportion claimed is applied to the nil rate band applicable when the surviving spouse dies.

For example, if the nil rate band on first death is £300,000 and £150,000 is used then 50% remains unused. When the surviving spouse dies then if, say, the nil rate band then is £500,000 the personal representatives of the surviving spouse can claim an extra £250,000 of nil rate band (ie. 50% of £500,000). If none of the nil rate band is used on the first death, two full nil rate bands will be available on the second death.

Despite this facility it may, in certain circumstances, be appropriate to maximise use of the nil rate band on the first death. For example, it may be relevant to use the nil rate band on the first death if there was a specific desire to benefit non-exempt beneficiaries on the first death or if it is felt the future growth in the value of assets using the nil rate band will exceed the future growth in the nil rate band.

Before executing a deed of variation it was suggested that it might be worth instead leaving the deceased's Will as it is (so none of the nil rate band is used on the first death) and the widow then making a lifetime gift of cash.

If the gift is an outright gift it will be a potentially exempt transfer with no immediate IHT implications. On survival for seven years the gift would be outside of the widow's estate. On death within seven years the gift would reduce the nil rate band available to the death estate. Also if the assets gifted were those inherited from the deceased husband, it is likely that there would be little or no capital gains tax because those assets would have been revalued on death and so any CGT calculation would only be based on growth since the first death. One drawback to this approach would be that it would not be possible for the widow to benefit from the gift or the gift with reservation or pre-owned assets tax rules would apply. Of course, some access for the "donor spouse" may be possible if a loan trust or discounted gift trust were effected.

By this lifetime gift the son and grandchildren could benefit immediately. Moreover, if the widow survived her gift by seven years the potentially exempt transfer will be left out of account for IHT purposes, so saving £120,000 on the widow's subsequent death. In addition, on the widow's subsequent death there could be available to her estate two full nil rate bands at their level at that time. As a consequence there would not be any need to vary the deceased's Will.

COMMENT

Because of the new "transferable" nil rate band it is no longer necessary to vary a Will so as to make use of a deceased's unused nil rate band for IHT purposes. Each case will need to be judged on its merits bearing in mind that to be valid any variation must be made within 2 years of the deceased's death.

CORPORATE INVESTMENT IN LIFE ASSURANCE BONDS

The application of the loan relationship rules
A worked example

From 1 April 2008 "investment" life policies, such as single premium bonds, owned by a company will be taxed under the loan relationship rules. Protection-type policies which cannot acquire any surrender value will continue to be taxed under the chargeable event rules.

(i) Policies in force before the commencement of the investing company's first accounting period beginning on or after 1 April 2008

Where a company has an existing investment life policy the company will be treated as surrendering that policy on the first day of the first accounting period of the company to begin on or after 1 April 2008. Any chargeable event gain arising on such a policy will not, however, be taxed at that time but will be brought into account as non-trading income to be taxed in the accounting period in which the company actually encashes or sells the policy eg on full surrender. Growth accruing after this deemed surrender will be taxed as described in (ii) below.

(ii) The new provisions

Subject to what is said in (i) above, for investment policies effected on or after the first day of the first accounting period of the company to begin on or after 1 April 2008 a company will be taxed on realised and unrealised gains. Such gains (which are technically called non-trading credits) will be subject to corporation tax as non-trading income under Case III Schedule D.

Gains (and losses) under loan relationships are calculated on either an "amortised cost basis of accounting" (broadly an accruals basis) or "fair value basis of accounting" (broadly on a "mark to market" basis) under which values are based on arm's length prices.

Under a life policy income earned on the underlying life fund, (such as dividends and interest), is not paid to the policyholder but rather the capital value of the policy is increased to reflect the income earned by the underlying fund. For this reason it would seem reasonable to use the fair value basis of accounting in which case the arm's length price (the market value) would reflect what a willing buyer would pay. In this respect, a willing buyer would probably pay no more than its encashment value ie. the surrender value.

Gains (and losses) will be calculated over the period from the start of the accounting year (or when the policy started if later) to the end of the accounting year (or when the policy was fully surrendered if earlier).

Where a policy forms part of the basic life assurance and general annuity business (BLAGAB) of an insurer taxed in the UK, a 20% tax credit is available by way of relief against corporation tax otherwise payable. The relief is based on the grossed-up gain as illustrated in the example below. Under a policy issued by a company which is not taxed in the UK, there would be no tax credit for the company (unless fund tax is at a rate of 20% or more for an insurer that is resident in an EEA country).

A realised or unrealised loss on a policy (which is technically known as a non-trading deficit) can be set against profits (which includes capital gains) of the accounting period in which the non-trading deficit arises, set against earlier profits from non-trading loan relationships (ie. against non-trading credits) or carried forward against non-trading profits (ie. profits exclusive of trading income).

It is for the investing company to determine which of the two methods of accounting it will need to adopt.

EXAMPLE – REALISED AND UNREALISED GAINS

This example is based on a UK company which pays corporation tax at 28% (the main rate for the financial year beginning 1 April 2008) and is invested in a single premium bond issued by a UK resident life company.

Step 1 – fund taxation

Gross return to the life company	£12,500
Less: corporation tax assumed at 20%	£ 2,500
Profit (ie. gain) to the investing company (reflected in unit values)	£10,000

Step 2 – the gain for loan relationship purposes

The gain of £10,000 is grossed up at 20%: (100/ (100-20)) X £10,000 = £12,500

Step 3 – fund tax relief

Relief at 20% is based on the grossed-up gain and is £2,500

Step 4

The relief can be offset against corporation tax on the non-trading income (ie. the gain to the company of £10,000).

Step 5

Profit to the investing company (under the loan relationship rules)	£10,000
Tax on the grossed-up profit of £12,500 @ 28%	£ 3,500
Less: tax relief (for fund taxation)	£ 2,500
Corporation tax payable	£ 1,000

Step 6

Profit to the investing company	£10,000
Less: corporation tax	£ 1,000
Net return to the company	£ 9,000