BUDGET ISSUE

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INCOME TAX

TAX RATES

(i) The starting rate of 10% for the tax year 2008/09 will apply to the first £2,320 of taxable **savings income** (i.e. after allowances and reliefs). This is a change from previous tax years because the 10% rate applies to all types of income until 5 April 2008. The fact that the 10% starting rate will only apply to savings income is a subtle change from last year's proposals which merely excluded earned income from being taxed at 10%.

The result is that if an individual's taxable non-savings income is more than £2,320 (as is would be for most earners and pensioners because of their entitlement to earned and/or pension income) then the 10% savings rate will not apply. This is because in calculating a person's tax liability, savings income "sits on top" of non-savings income. So, for example, if an individual had taxable savings income of £5,000 and taxable non-savings income of £1,500 then only £820 (the savings rate limit of £2,320 less non-savings income of £1,500) of savings income would benefit from the 10% rate.

(ii) For 2008/09, the basic rate of income tax reduces to 20% and the higher rate threshold has been increased to £36,000. The basic rate of tax will apply to income in the band £1 to £36,000 - subject to the special rules on savings income described in (i) above. For qualifying Gift Aid donations made before 6 April 2011 the Government will make an additional repayment to the charity so that the overall effect is that the 22% basic rate of tax still applies for repayment purposes.

(iii) The dividend rates remain at 10% and 32½%, with the 10% rate applying to income in the £1 - £36,000 basic rate band.

PERSONAL ALLOWANCES

Personal allowances and the age allowance threshold are as follows:

- Standard personal allowance £5,435
- Age allowance £9,030 (for those aged 65-74) and £9,180 (for those aged 75 and over)
- The level of total income that a person can enjoy before age allowance is cut back is £21,800
- The married couple's allowance (MCA) for those aged between 65 and 74 is £6,535, and for those aged 75 and over £6,625. This allowance is only available if at least one spouse was aged 65 or over before 6 April 2000.
- In calculating the reduction in age allowance when total income exceeds £21,800, the MCA is cut back to not less than £2,540 (the "minimum amount")

DIVIDENDS FROM FOREIGN SHARES

A UK resident investor receiving dividend income from a UK resident company is entitled to a 10% tax credit. The credit satisfies the liability of a basic rate taxpayer (from 6 April 2008), and reduces the rate of tax borne by a higher rate taxpayer from 32½% to 22½%. In no circumstances can the tax credit be reclaimed.

Previously the 10% tax credit was not available for dividends from non-UK resident companies (which includes offshore funds). However, from tax year 2008/09 a 10% tax credit will be available on dividend income from non-UK resident companies where the recipient has a shareholding of less than 10% in the non-UK resident company(ies). It is proposed that the 10% shareholding limit will be removed from 6 April 2009 provided the dividend has been subject to corporate tax, similar to corporation tax, in the country of source.

Higher rate taxpayers who are liable to tax at 32.5% will, in practice, only owe 25% (of the net dividend) because part of the tax liability will be covered by the tax credit. Basic rate taxpayers who are liable to tax at 10% will, in practice, not pay any tax on dividends from non-UK companies because the tax liability will be entirely covered by the tax credit.

Previously it was announced that this treatment would only apply to a maximum of £5,000 of foreign dividend income in a tax year but this condition has now been dropped.

CAPITAL GAINS TAX

The annual exemption increases to £9,600 in 2008/09 for individuals and personal representatives, and (in most cases) £4,800 for trustees. The rate of tax for individuals, personal representatives and trustees is a flat rate of 18% as proposed in the Pre-Budget Report.

It has been confirmed that from 6 April 2008 taper relief and indexation allowance are abolished and entrepreneurs' relief will be introduced. In very brief terms, entrepreneurs' relief means that the first £1 million of cumulative chargeable lifetime capital gains arising on the sale of a non-listed trading business will be taxed at an effective rate of 10%. There are a number of conditions that need to be satisfied to qualify for the relief.

INHERITANCE TAX

- As announced in earlier Budgets, the nil rate band has been increased from £300,000 to £312,000 and will apply to chargeable transfers occurring on or after 6 April 2008. The Chancellor estimated that only 5% of estates will be subject to IHT in 2008/09 (compared with 6% in 2007/08).

- Schedule 20 Finance Act 2006 changed the rules for interest in possession (IIP) trusts but provided a transitional period until 5 April 2008 to enable trustees of pre 22 March 2006 trusts to change the beneficiary with the IIP and not cause the trust to be subject to the discretionary trust rules. In such circumstances, the new interest is regarded as a "transitional serial interest" (TSI). However, the effect of the new rules was not clear where a pre-22 March IIP for a beneficiary was replaced by an IIP for the same beneficiary but on slightly different terms. Did this amount to a TSI or not? HMRC's view was that it did not but this was disputed.

  Fortunately, it has been confirmed in the Budget that legislation will be introduced in Finance Bill 2008 to ensure that where the same beneficiary is given an IIP but on slightly different terms, that new interest will be a TSI and so the trust will not be subject to the discretionary trust rules. On the other hand, the discretionary trust rules will apply if an IIP is replaced **after** the transitional period with another IIP whether for the same or another beneficiary.

  In addition (and presumably to allow trustees enough time to take appropriate action based on the revised provisions) the transitional period is extended by 6 months so that it will now end on 5 October 2008.

- The only other inheritance tax measure in the Budget related to the transferable nil rate band and the interaction with the capital gains tax (CGT) provisions. This measure provides for a consequential amendment to CGT provisions to prevent the revision of the base cost of any asset for CGT purposes where the valuation of that asset is subsequently ascertained for IHT purposes. This will address the situation where the value of the asset in the estate of the first to die was not valued for IHT purposes but needs to be ascertained on the death of the second in order to determine the amount of the transferable nil rate band. Without this amendment the ascertained value would have to be used for other CGT calculations, which are likely to have occurred in the past.

CORPORATION TAX

The rates of corporation tax for the financial year starting 1 April 2008 are as follows:-

- The small companies' rate of corporation tax is increased from 20% to 21% and applies where a company has profits of up to £300,000.
- The main rate of corporation tax is reduced from 30% to 28% and continues to apply to profits of a company of more than £1,500,000. The 28% rate will be held for the financial year starting 1 April 2009.
- Between £300,001 and £1,500,000 marginal rate relief applies. This operates to increase the overall rate of tax on the profits to somewhere between the small companies' rate of 21% and the main rate of 28%. Profits in excess of £300,000 will effectively bear tax at the marginal rate of 29.75%.

NATIONAL INSURANCE

The National Insurance rates and contribution limits announced in the Pre-Budget Report apply as follows for 2008/09:-

- The employee's Primary Class 1 National Insurance rate is 11% on earnings between the Primary Threshold (£105 per week) and Upper Earnings Limit (£770 per week).
- Employees, in addition, pay 1% Primary Class 1 National Insurance on all earnings above the Upper Earnings Limit.
- The Employer's Secondary Class 1 contribution rate on earnings above the Secondary Threshold (£105 per week) is 12.8%.
- The self-employed Class 4 rate on profits between the lower (£5,435 pa) and upper profits limit (£40,040 pa) is 8%.
- The self-employed, in addition, pay Class 4 contributions at a rate of 1% on all profits above the upper profits limit.
- The Class 3 voluntary contribution rate is £8.10 per week.

As indicated in Budget 2007, from tax year 2009/10 the upper earnings limit and upper profits limit will be aligned with the point at which higher rate income tax is paid after the personal allowance has been taken into account.

The Government is publishing a consultation document called "Improving the collection of National Insurance Contributions from the Self-Employed".

TAX-FAVOURED INVESTMENTS

ISAs

Some minor changes were made to reduce the administrative burden of ISA managers; and the special treatment for investors with Northern Rock ISAs, announced on 18 October 2007, was confirmed.

The Child Trust Fund (CTF)

Regulations will be laid in due course to remove the requirement for providers and distributors to collect the CTF voucher from parents in order to open a CTF account. This change will apply to all applications processed by providers or distributors from 6 April 2009.

Enterprise Investment Scheme (EIS)

Subject to State aid approval of this change by the European Commission, the limit on the amount invested on which an investor can claim EIS income tax relief in any one year will be increased from £400,000 to £500,000 from 6 April 2008.

Property Authorised Investment Funds

New regulations for authorised investment funds (AIFs) will be introduced, providing a tax regime for investment into real property and certain property companies, which will enable certain AIFs to elect for a tax treatment that will move the point of taxation from the fund to its investors.

The new regulations will enable a property AIF to provide an open-ended fund alternative to the existing closed-ended UK-REITs.

Offshore Funds

(i) Distributor / Non-distributor funds

Legislation will be introduced in Finance Bill 2008 to provide powers to make regulations dealing with the taxation of investors in offshore funds and the rules for allowing certain funds to be classed as 'reporting funds'.

Currently, where an offshore fund is certified by HMRC as a qualifying fund (ie. a distributor fund), which is a test that must be satisfied each year, then the fund is required to distribute at least 85 per cent of its income and any investor disposing of their interest in the fund is subject to a more favourable tax treatment than if the fund is non-qualifying (ie. a non-distributor or roll-up fund). This is because on disposal of their interest they are liable to capital gains tax (or corporation tax if a corporate investor) on chargeable gains, instead of being chargeable to income tax (or corporation tax) on chargeable gains, as they would be if the fund was a non-qualifying offshore fund.

This measure will mean that, in order to retain capital gains tax treatment for investors disposing of an interest in the fund, an offshore fund will no longer have to make a distribution but will instead be able to 'report' income to investors who will then be subject to tax on the reported income.

Draft regulations will be published shortly after the Finance Bill, which set out the conditions that an offshore fund must fulfil in order to ensure that a disposal of an interest in the fund is subject to capital gains tax treatment. It is expected that the conditions for obtaining the new qualifying fund status will be less onerous, and the test required for this will only be applied at the outset (instead of, as now, annually).

(ii) Dividends from offshore funds

As mentioned earlier, from 6 April 2008 a 10% tax credit can be available for overseas dividends – including those from offshore funds.

The Saving Gateway

Following the success of pilots in promoting saving and financial inclusion, the Saving Gateway will be introduced nationally, with the first accounts available to savers in 2010. The Saving Gateway is a cash saving scheme for those on lower incomes under which the Government will match the saver's contributions.

TRUST TAXATION

Income of beneficiaries of settlor-interested trusts

A measure was announced to amend a rule under which a beneficiary of a discretionary trust who receives trust income which is already treated as income of the settlor (because it is a settlor-interested trust) may end up with a higher tax liability on other income simply because of the order in which certain types of income are taxed. The discretionary trust income from a settlor-interested trust comes with a non- repayable notional tax credit at 40%.

Under the current rules income from a trust is charged before savings and other income. The result is therefore that other income (savings etc) may be pushed into higher rates of income tax . Under the new rule the income from a settlor-interested trust will be treated as one of the highest slices of income so such anomalies will be avoided.

Offshore trusts

When the Pre-Budget Report announced proposals for the reform of the domicile and residence rules, it mentioned removing certain anomalies. However, it is probably true to say that when the consultation paper was launched on 6 December 2007 most practitioners were surprised that the effect of the new rules would be to entirely change the tax rules for offshore trusts and companies. Following a considerable amount of lobbying the Chancellor relented somewhat and the draft legislation published on 18 January was watered down a little. The draft legislation published with the Budget is even less severe.

The new rules, which will apply from 6 April 2008, are briefly as follows:

- For CGT purposes the exemption from the settlor charge for non-UK domiciled settlors of offshore trusts (under section 86 TCGA 1992) will remain.

- Income and gains in an offshore trust will be taxed on a non-UK domiciled beneficiary when they are remitted to the UK, even if these derive from UK assets. In this respect the settlor may be taxed if he or she receives trust benefits as a beneficiary.

- The beneficiary charge in section 87 TCGA 1992 will apply to non-UK domiciled beneficiaries in the same way as it applies to UK domiciled beneficiaries. If the settlor actually receives a benefit from the trust he or she will be taxed under section 87.

- The charge under section 87 will be subject to the remittance basis where the non-UK domiciled beneficiary has claimed the remittance basis.

- Non-resident trustees will be given an option to rebase trust assets to the market value as at 6 April 2008 so that trust gains accruing but not realised prior to 6 April 2008 will not be chargeable if matched to capital payments made on or after 6 April 2008 to non-UK domiciled beneficiaries.

The above are only the key points of what is a very complex matter which cannot be dealt with comprehensively in this bulletin. Clearly trustees of offshore trusts with beneficiaries resident in the UK need to obtain and consider professional advice on their options as soon as possible.

PENSIONS

The main new pension changes announced in the Budget related to additional flexibility to be given to occupational schemes concerning the payment of trivial commutation and the introduction of several new authorised payments.

In addition, a number of amendments were made to the provisions of the Finance Bill 2008 which were provided at the time of the Pre-Budget Report 2007. These were covered in our October bulletin.

Trivial commutation

The Government will introduce legislation in the Finance Bill 2008 providing easements to the rules regarding the provision of trivial commutation under an occupational scheme.

These easements will mean that a member's benefits may be trivially commuted under an occupational scheme where the value of those benefits is below £2,000. Similarly, regulations will spell out the circumstances in which "stranded pots" of money under an occupational scheme can be trivially commuted. It would appear that a "stranded pot", which is still to be defined, will represent small funds which would not be large enough to secure an annuity, which are not otherwise commutable under the normal trivial commutation rules, and which would otherwise have been paid out as an unauthorised payment if no change had been made to the current rules.

Such payments can be made in addition to the normal 1% of standard lifetime allowance provision (ie. £16,000 in 2007/08). It should particularly be noted that this easement only applies to benefits payable under an occupational scheme.

This is a very important change and should help to ease the administrative requirements of occupational schemes.

New authorised payments

The legislation under the new regime lists what payments a registered scheme is authorised to make to a scheme member. Any other payments will be unauthorised and subject to total tax charges of up to 70%.

HMRC has now identified the following situations where pension schemes make payments, often in innocent error, that are categorised as unauthorised payments under the current rules but which were never intended to be caught in this way:-

- an overpayment of an ongoing pension
- a pension which continues to be paid after the member has died
- certain payments made after the member has died where payment before death was not possible

The Government intends to include legislation in the Finance Bill 2008 to amend the existing regulation power within section 164(f) of the Finance Act 2004 to enable regulations to be laid to make these payments authorised payments, and

- allow the regulations to have effect for payments already made provided they do not increase a person's liability to tax;
- describe how these payments must be treated for income tax purposes and who the tax charge should apply to; and
- ensure the payments can be tested against the lifetime allowance, if necessary

The above changes will ensure these payments can be treated and be taxed as authorised payments. This is also a very welcome change as it will significantly reduce administration requirements.

State Second Pension (S2P)

This was not a change in the Budget but rather an announcement on 14 March of the Low Earnings Threshold for S2P. For tax year 2008/09 this has been set at £13,500:-

The Low Earnings Threshold is a key component in determining the accrual of benefits under the S2P, which will be as follows for tax year 2008/09:-

Earnings	S2P Accrual Rate
£4,680 (Lower Earnings Limit) - £13,500 (Low Earnings Threshold)	40%
£13,500 - £31,100	10%
£31,100 - £40,040 (Upper Earnings Limit)	20%

For those individuals who have earnings in excess of the Lower Earnings Limit but less than the Low Earnings Threshold, their S2P benefit in 2008/09 tax year will be deemed to accrue on the assumption that their earnings are at the Low Earnings Threshold (ie. £13,500).

LIFE POLICYHOLDER/LIFE COMPANY TAXATION

Life policyholder taxation

It was announced that the Government "does not see the need for any change to the taxation of life insurance bonds as a result of CGT reform". This will mean that single premium investment bonds will continue to be subject to the current chargeable event rules.

Life company taxation

Legislation is to be introduced in Finance Bill 2008 to basically simplify the tax law relating to financing arrangements used by life insurance companies, align the tax treatment of transfers of tax exempt "other" business between friendly societies with transfers of such business between a friendly society and a life insurance company, change the definition of foreign currency assets and remove the power to modify the computation of chargeable gains in respect of structural assets.

DOMICILE AND RESIDENCE

In his 2007 Pre-Budget Report the Chancellor announced proposals to change the income tax and capital gains tax rules for those who are UK resident but either non-UK domiciled or not ordinarily resident in the UK (and here the expression "non-domiciliaries" means those who are UK resident but either not domiciled or not ordinarily resident in the UK). **None of these proposals apply to the inheritance tax treatment of non-UK domiciliaries.**

When originally announced, the proposals created huge concern in a number of quarters and strong representations were put forward to the Treasury by, among others, the Institute of Chartered Accountants and the Society of Trusts and Estate Practitioners. As a consequence some minor concessions were announced before the Budget and more concessions were announced in the Budget. Rather than pinpoint the Budget day concessions for the domicile rules, in what follows we outline the main changes to the current system.

(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 **adult** (ie. not children) and are UK resident in the current tax year and who have been UK resident in at least seven out of the ten tax years (continuous or broken and including the tax year in question) 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 £2,000 (up from £1,000 in the Pre-Budget Report). 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;
  - unremitted foreign income and gains must exceed £2,000 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 (ie. ten years including the tax year in question).

- The £30,000 annual tax charge will be payable through the self assessment system. If the £30,000 tax charge is paid from an offshore source directly to HM Revenue & Customs (HMRC) by cheque or electronic transfer, the £30,000 will not itself be taxed as a remittance. If the £30,000 is repaid it will be taxed as a remittance at that point.

- Individuals who have access to the remittance basis of taxation can choose each year whether they wish to claim the remittance basis of taxation or pay tax on their worldwide income and gains. Adults will not have to pay the £30,000 tax charge for a particular year if they do not claim the remittance basis for that year.

- The annual tax charge to be introduced from April 2008 will take a different form from the one set out in the draft legislation published on 18 January. It will be a tax charge on unremitted income and gains (or a combination of the two) rather than a stand-alone charge. Individuals paying the charge will choose what foreign unremitted income or gains the £ 30,000 is paid on. As a result the tax paid will either be income tax or capital gains tax. The unremitted income or gains upon which the £ 30,000 tax has been paid will not be taxed again when and if it is eventually remitted to the UK. There will be ordering rules that determine that untaxed unremitted foreign income or gains will be treated as remitted before income or gains upon which the £ 30,000 has been paid.

- The £30,000 charge will be income tax or capital gains tax (or a mixture) and should be treated as such for the purposes of Double Taxation Agreements. The tax will also be available to cover Gift Aid donations.

- 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.

- those using the remittance basis will not be required to make any additional disclosures about their income and gains arising abroad. So long as they declare their remittances to the UK and pay UK tax on them, they will not be required to disclose information on the source of the remittances. It is important to note that even if in a subsequent year the £30,000 charge is paid, the remittance in that year of income or gains that arose in a year when the remittance basis applied can still be subject to UK tax (subject, of course, to that income/gains not being taxable if used to meet the £30,000 fee in the current year).

(b) Offshore companies

Anti-avoidance legislation designed to prevent UK residents from realising chargeable gains free of tax through a holding in a non-UK resident company does not currently apply in cases where they are individual shareholders who are non-domiciled. The legislation will be amended so these anti-avoidance rules ensure that UK shareholders of foreign companies will be taxed on the chargeable gains accruing to the company irrespective of the shareholder's domicile. The legislation to achieve this was published in draft on 18 January 2008 although some minor changes will be made.

(c) Offshore trusts

This has been covered in the section on trust taxation.

(ii) Residence

In the Pre-Budget Report it was proposed that 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.

In his Budget, the Chancellor announced that, with effect from 6 April 2008, only days where the individual is present in the UK **at midnight** will count as a day of presence in the UK for residence test purposes. So, for example, if Jack flies into the UK on Tuesday morning and leaves on Friday evening, he will only be present here for 3 days for the purposes of the residence test.

There will be an additional exemption for passengers who are in transit between two places outside the UK. The exemption is wider than that proposed at the Pre-Budget Report as it caters for people who have to change airports or terminals when transiting through the UK. It will also allow people to switch between modes of transport, so they could fly in but leave by ferry or train for example. Days spent in transit, which could involve being in the UK at midnight, will not be counted as days of presence in the UK for residence test purposes so long as during transit the individual does not engage in activities that are to a substantial extent unrelated to their passage through the UK. So, for example, if they take time out to attend a business meeting then the transit exemption will not have effect.

(iii) Miscellaneous

Certain other changes have been made to amend current "loopholes and anomalies" that allow tax on foreign income and gains to be avoided. 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 but also include receipt by the individual's immediate family

- subject to a de minimis exception for personal effects costing less than £1,000, assets brought into the UK for repair and restoration and assets in the UK for less than a total 9 month period, an asset purchased out of untaxed foreign income which an individual owned on 11 March 2008 will be exempt even if imported later.

- the introduction of legislation in respect of income by which "sums received" means not only cash but assets purchased with overseas foreign income outside the UK.

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.