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PRE-BUDGET REPORT HIGHLIGHTS

This year's Pre-Budget Report was less a "curtain raiser" for the Budget in 2009 and more an emergency budget to deal with the current economic crisis and to set tax polices for years into the future.

With the focus understandably on fiscal and monetary stimulation of the economy most of the tax changes announced will take effect in the future.

The strongly leaked changes - the new top rate of 45% for income over £150,000 and the temporary reduction in VAT - duly came to pass. The former being deferred until 6 April 2011 and the latter taking effect from 1 December this year.

Despite the "deferred" nature of many of the changes we have endeavoured, where possible, to give a view on what the changes might mean to you and your clients.

We have been selective in the subjects we cover in this bulletin and trust that you will agree with and secure value from our selection.

1. VAT

Indirect taxes are rarely at the top of the financial planners "to do" list and this will probably remain the case. However, one of the "big news" (albeit heavily leaked) items was the temporary reduction of the VAT rate from 17.5% to 15% from 1 December this year for 13 months until 31 December 2009.

Comment

For those businesses who are not VAT registered but who engage professionals to deliver VATable *services (eg accountants, lawyers…. Technical Connection!) a real reduction in cost will be experienced - which has to be good news.*

As to whether the reduction in VAT causes the economic stimulus intended - we shall have to see. Of itself it would seem to have little chance of achieving the overall purpose. Well…. if M & S can offer 20% off everything an extra 2.5% (assuming it is passed onto consumers) would seem unlikely to make much difference, especially since it is generally accepted that the main drivers of consumer spending are more confidence and trust and less (relatively light) fiscal stimulus.

2. INCOME TAX - THE PROPOSED NEW 45% INCOME TAX RATE EFFECTIVE FROM 6 APRIL 2011

The Chancellor has announced in his Pre-Budget Report that it is planned, from 6 April 2011, that there will be a new top rate tax of 45% applying to all of an individual's taxable non-savings (which includes earned income) and savings income above £150,000 in a tax year. There will also be a new 37.5% (up from the current 32.5%) rate on dividend income received by those with taxable income above £150,000 on and after 6 April 2011.

Comment

What follows are some thoughts on planning that may be worth considering should this tax increase be introduced (and it must be borne in mind that its introduction is deferred until after the next election and is, presumably, dependent on the Labour party being re-elected). It is assumed that the CGT rate will remain at a "stand-alone" 18%.

Many of these thoughts are a re-statement of tax planning that higher rate taxpayers should already be considering-but heightened by the additional "5%" on the higher rate of tax for those whose income may be over the £150,000 threshold in two years' time.

- *Consider investing for capital growth (taxed at 18% after the annual exemption) rather than income (taxed at 45%).Of course, tax should not be the sole determinant of investment planning strategy but a 5% increase in the income tax rate for wealthier taxpayers cannot be ignored.*

- *For those investors affected by the new rate, to the extent that investment returns arise predominantly from capital growth, the "Bonds v Collectives" balance would tip further in favour of collectives. Despite indexation allowance being available within the UK life fund (but this is scheduled to fall dramatically in the coming months and years), the tax payable by a 45% taxpayer on chargeable event gains realised under UK investment bonds would be 25% -up from 20%. And this rate will apply to gains that are already depleted by whatever the effective rate is on gains and income inside the UK life fund. Gains realised under offshore bonds would be assessed at the full rate of 45% with no tax credit – but with no 'internal' fund taxation.*

  An investment bond would, however, continue to represent a more tax attractive home for reinvested income as it currently does. Inside a UK bond, UK dividend income would bear no further tax and other income would be subject (broadly speaking) to a 20% tax rate at life fund level. There would be a 20% tax credit when a chargeable *event gain was realised and, of course, tax effective withdrawals using the "5% rule" would be possible.*

As well as the "5% rule" more attention will undoubtedly be focused on tax planning strategies to minimise the tax on taking benefits from the bond. Those who anticipate being able to exercise a strong element of control over their income at the time of any future bond encashment may be able to implement an attractive strategy of tax deferment during the period of accumulation followed by tax minimisation on withdrawal of benefits.

As is the case now, there will continue to be a number of issues to take into account in determining the most effective tax wrapper for a particular portfolio. The balance between income and gains on the portfolio in question will, as it is now, be a particularly important one.

- *The attraction of the tax free investment growth and income secured inside a registered pension scheme and an ISA will increase for people suffering 45% tax on income.*

- *Assuming that higher rate tax relief on pension contributions remains and that, where appropriate, relief will be available at the new highest rate, then the immediate appeal of such contributions (and a salary sacrifice to facilitate it) will be heightened. However, if the contribution is made when relief is secured at 40% but the emerging income is taxed at 45% then the tax attraction ,while still strong (given the greater sum invested as a result of the tax relief and the tax freedom of the underlying fund) will be somewhat diminished. Some may be tempted, especially as the election nears and if a Labour government looks likely, to defer contributions so as to receive relief at the higher rate….assuming higher rate relief on pension contributions is still with us. In this case an investment into an ISA offering tax free growth with later tax free encashment and tax relief at a higher rate on the contribution made to a registered pension scheme could be appealing to some. However, those embarking on this course should factor in the possibility that higher rate relief on pension contributions cannot be guaranteed in a future world where tax revenues are likely to be in high demand given the current levels of Government borrowing being embarked upon.*

  With the freezing of the pensions annual and lifetime allowance for 5 years more people may be open to considering non-pension solutions as a means of providing for financial independence and security in retirement.

- *There may be increased interest in the use of employee benefit trusts and family benefit trusts as a means of securing access to funds without immediate income tax or NIC cost. HMRC action will, however, need to be carefully monitored following the recent Sempra Metals case.*

- *Company owner/managers may well see merit in reinvesting into their business (rather than taking sums out by way of dividend or salary).The sums reinvested will have borne corporation tax only (possibly at the "held" small companies' rate of 21%) instead of income tax, and if the value of the business is increased as a result of the reinvestment then up to £1 million of the gain eventually realised will, with the benefit of entrepreneurs' relief ,only be taxed at effectively 10% and at 18% for any gains over the lifetime capital gains limit of £1 million. Of course, despite the* *undoubted tax attraction of an effective 10% tax rate on capital gains of up to £1 million, there is an inherent risk in relying on one's business as the SOLE source of future financial security….however tax attractive that strategy may be.*

- *Still on the company owner/managers theme, the dividend v salary decision would have been made even easier than it is now for those wishing to minimise the "outflow to the authorities" if the 45% rate only applied to earnings. However, it would appear that the 45% rate would apply to all income so that the dividend v salary choice would remain as it is now with the dividend having the (often overwhelming) advantage on tax/NIC grounds.*

  The announced future increase in NIC rates by 0.5% for both employers and employees in 2011 will tilt the balance even more in favour of dividends. With so many companies having a calendar year end, NOW is an excellent time to schedule a pre-year end 'remuneration audit' – taking account of the Pre-Budget Report proposals.

- *A 45% tax rate may give greater incentive to those "affected" business owner/managers to "shift" income. Since the Government's loss in the now famous "Arctic Systems" case we have been on notice that anti-avoidance measures would be introduced. We also knew that the anti-avoidance legislation that was "stalled" earlier this year could be incorporated into the 2009 Finance Act with the provisions taking effect from 6 April **2008**. There has, however, been a deafening silence on the progress of these provisions from official sources since earlier this year. And it has now been announced that, while the Government are keeping this issue under review, they will not be bringing forward legislation in the Finance Bill 2009.*

  The aim of these provisions, should they ever be introduced, will be to assess the "shifted income" (through salary, dividends or partner's profit share) on the person making the main contribution to the business. It is expected that where the "shifted" payment can be justified (based on the receiving person's contribution to the business) it will be fully effective with the income being assessed on the person who receives it and not attributed to the "shifter".

- *VCTs may look even more attractive given that dividend payments from them are tax free. The tax relief on input will not be affected by the new 45% rate. Of course, one must consider the risk element of such investments.*

3. INCOME TAX – PERSONAL ALLOWANCES

The Chancellor made a number of proposed changes to personal allowances as follows:-

1. The permanent implementation of the increase in personal allowance that was made to compensate people for the loss of the 10% tax band. For tax year 2009/10 the personal allowance will increase from £6,035 to £6,475.

2. A restriction in the level of the personal allowance for those individuals with total income above £100,000 and £140,000 with effect from 6 April 2010.

3. The general removal of any remaining benefit from the personal allowance for those with income of more than £140,000 with effect from 6 April 2010.

We all remember the problems this Government created following the removal of the 10% tax band on earnings - this band having been retained for savings income only. To compensate, the Government increased the personal allowance but, in order to prevent higher rate taxpayers benefiting from this change, the higher rate income tax threshold was reduced by £1,200 from £36,000 to £34,800. The Government has now decided to permanently adopt this increase to the personal allowance so that basic rate taxpaying earners are not disadvantaged by the changes to the 10% tax band announced last year. However, higher rate taxpayers will continue to miss out.

Currently everybody benefits from a full personal allowance – irrespective of their level of income. For a higher rate taxpayer this is worth about £2,500 pa in saved income tax. From 6 April 2010, those with a gross income of £100,000 or less will continue to be entitled to the full personal allowance. Where total income exceeds £100,000, for every £2 of excess income, the personal allowance will be reduced by £1 until it reaches 50% of the basic personal allowance.

If an individual's gross income is above £140,000, the (remaining) personal allowance will be reduced by a further £1 for every £2 above £140,000, until all entitlement to a personal allowance is exhausted. For those who lose all of their personal allowance, the tax increase is effectively £2,500 per annum.

Comment

If we assume a personal allowance of £7,000 in tax year 2010/11 and we assume this change will take place as described in the Press Release, this means that:

- *for those individuals with gross income of £100,000 or below they will be entitled to a £7,000 personal allowance*

- *for those individuals with gross income of £107,000 to £140,000, they will be entitled to a £3,500 personal allowance*

- *for those individuals with gross income of £147,000 or more they will have no personal allowance.*

The people most affected are therefore those whose income falls between £100,000 and £107,000 and £140,000 and £147,000. These will bear a high effective marginal rate of tax (60%) on income falling between these bands (£100,000 - £107,000 and £140,000 - £147,000).

Clearly there is little action that a taxpayer can take to secure their personal allowance if they enjoy sizeable earned income. However, for those with investment income which causes their gross income to be just over the £100,000 and £140,000 thresholds, they could consider reinvesting into capital growth orientated investments or investments that produce tax free income (e.g. ISAs). Clearly the investment risks need to be considered as do the CGT implications on reinvestment (although, of course, chargeable gains that exceed the annual exemption are now only taxed at a flat 18%).

4. INCOME TAX – INCOME SHIFTING

As alluded to in the section of this bulletin dealing with the proposed new 45% income tax rate, the Government has decided not to bring forward legislation to deal with this perceived problem in the Finance Bill 2009. However, they will be keeping the issue under review.

Comment

Those advising "husband/wife" businesses (companies or partnerships) should probably not take this announcement (following the Government's loss in the Arctic Systems case) as a green light to "shift as much as you like" though.

The news is, however, encouraging for those who (in our view rightly) were extremely sceptical about the legal validity (under current legislation) of attempting to secure a tax result that seemed misaligned with the legal realities of being a partner or shareholder. The Arctic Systems case showed the difficulty that HMRC had in enlisting the settlements legislation (as it currently stands) to secure the result they desired.

5. TRUST TAXATION

Currently, discretionary trusts and accumulation and maintenance trusts benefit from a standard rate tax band of £1,000. Trust income that exceeds that figure suffers income tax at 40% (32.5% if dividend income). Trustees must account for this income tax but it can be recovered if a distribution is made to a non-taxpayer, 10% or basic rate taxpayer (except for the 10% tax credit on dividends which is non-reclaimable).

If the trust is a settlor-interested trust (ie a trust where the settlor or settlor's spouse can benefit), all income is assessed on the settlor although the trustees are primarily liable for tax at the trust rates. Where the settlor is not a higher rate taxpayer he/she can recover any tax overpaid by the trustees from HMRC.

With effect from 6 April 2011, the 40% trust rate will increase to 45% (with the dividend rate increasing to 37.5% from 32.5%). This is a serious increase for trustees and, unlike the 45%/ 37.5% rates for individuals, it is not restricted to income that exceeds £150,000.

Comment

For settlor-interested trusts, if the settlor is not a higher rate or 45% taxpayer he/she will be able to recover the overpaid tax. This means there will be occasions where a higher rate (ie 40%) taxpayer will be entitled to claim back the excess 5% tax.

For all other discretionary trusts there will be at least a 12.5% increase in tax on trust income. Action that the trustees could take to mitigate this is as follows:-

- *They could consider reinvesting in capital growth orientated assets with a view to reducing taxable income and replacing it with assets that will produce capital gains. While tax is important, it is not the only consideration to be taken into account when* *making investment decisions. Subject to this, though, an 18% tax rate and the use of the trustees' annual exemption will be more appealing that the new income tax rates.*

- *Single premium bonds could look more tax attractive as trustee investments to the extent that the chosen investment portfolio produces income. Inside a UK bond dividends will be reinvested tax-free and other income will, broadly speaking, be taxed at 20%. There will be no tax inside an offshore bond. The tax rates on encashment (for settlor or trustees as appropriate) will, however, rise to between 25% and 45% depending on the circumstances. The usual strategies to minimise tax on withdrawing benefits will be appropriate and, in particular, the potential to assign policies "in specie" (and tax free) to potentially lower rate taxpaying beneficiaries.*

- *Where the trust has non-taxpaying or 10%/basic rate taxpaying beneficiaries and the trust has income, it could make good tax sense for the trustees to make income distributions in order to enable that beneficiary to recover some of the higher rate tax suffered by the trustees. It should not be forgotten that a beneficiary cannot recover the 10% tax credit on dividend income paid to the trust.*

6. NATIONAL INSURANCE

For 2009/10, the Upper Earnings Limit (UEL) for primary Class 1 national insurance contributions (NICs) will be aligned with the level at which people start to pay higher rate income tax. For 2009/10 this threshold will be £43,888.

From 2011/12, the NICs primary threshold will be broadly aligned with the basic personal allowance.

From 2011/12, the main rate of Class 1 and Class 4 NICs will be increased by 0.5% to 11.5% and 8.5% respectively.

From 2011/12, the Class 1 employer rate of NICs will be increased by 0.5% to 13.3%. The increased rate will also apply to Class 1A and Class 1B contributions.

From 2011/12, the additional rate of Class 1 and Class 4 NICs will be increased by 0.5% to 1.5%.

All of these changes will require a National Insurance Bill before they can be implemented.

Comment

Any increase in national insurance increases the fiscal incentive to withdraw funds from a business by way of dividend rather than as salary/bonus. At current corporation tax, income tax and NIC rates it is always most fiscally attractive to take a dividend. This will be even more so once the increases take effect.

Subject to the acceptability of pension contributions on non-tax grounds, a pension contribution will remain highly fiscally attractive.

7. CORPORATION TAX FOR SMALL COMPANIES

The Government has confirmed that the planned increase in the small companies' corporation tax rate to 22% will not take place. Therefore the rates of corporation tax for the financial year starting 1 April 2009 will be as follows:

- The small companies' rate of corporation tax will be 21% and applies where a company has profits of up to £300,000.

- The main rate of corporation tax is to remain at 28% and continues to apply to profits of a company of more than £1,500,000.

- 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%.

Comment

Subject to a company having a corporation tax liability, corporation tax reducing strategies continue to be relevant. In particular, contributions to registered pension schemes (covered in section 9 below) will be particularly effective.

It will also be necessary to take full account of the relevant corporate tax rates in determining the best way to take funds from the business i.e. by salary or dividends or pension contributions.

For companies where the profit is in excess of £300,000, any strategy (such as making a deductible employer contribution to a registered pension scheme or incurring expenditure qualifying for 100% capital allowances) to reduce profit in excess of £300,000 will result in an effective corporation tax saving of 29.75%. So if a company with profits of, say, £350,000 made a £50,000 allowable pension contribution, its corporation tax bill would fall by £14,875 making the net cost of the contribution £35,125.

For a company that will continue pay to corporation tax at 21%, a pension contribution made on or after 1 April 2009 will now secure slightly less tax relief than was previously thought.

Those with corporate clients (particularly those with calendar year ends) have an excellent opportunity to inform them about what the changes mean to them.

8. LOSS RELIEF FOR TRADING BUSINESSES

Currently businesses can offset trading losses against profits in the preceding year without limit. Special rules apply to start-up unincorporated businesses and businesses that cease to trade.

The Chancellor has announced that all trading businesses who suffer a trading loss will be able to offset that trading loss against profits that have arisen in any of the three previous years. For companies the trading loss must be incurred in the accounting periods ending between 24 November 2008 and 23 November 2009 and for unincorporated businesses this relief will be available for trading losses for the tax year 2008/09.

However, there will be restriction on this extended relief. In particular, whilst the amount of loss that can be carried back to the preceding year remains unlimited, there will be a maximum of £50,000 of the balance of unused losses that can be carried back to the earlier 2 years.

This temporary measure will apply for one year from 24 November 2008 for companies, and for the 2008/09 tax year for unincorporated businesses. Tax repayments from the extended relief will be made to businesses from Budget Day 2009.

Comment

For companies with available funds (or through judicious use of loan back facilities) a contribution to a registered pension scheme that is fully deductible under the wholly and exclusively rules could generate a trading loss. It may be possible to carry that loss back against profits that arose in previous accounting years and recover tax. As ever, great care must be exercised before any such strategies that tie up cash are embarked upon. Companies should always be encouraged to consider likely future cash needs before committing sums where future access may be difficult. This is especially so whilst access to credit is still extremely tight.

9. PENSIONS

1. Lifetime allowance/annual allowance

The standard lifetime allowance and the annual allowance are to remain at their levels in tax year 2010/11 for the following five tax years. This means they will stay at £1.8 million (lifetime allowance) and £255,000 (annual allowance) up to and including the tax year 2015/16.

When the new regime started in 2006, the Treasury announced the levels of the standard lifetime allowance and the annual allowance for the 5 tax years ending in 2010/11. While these allowances were increased in each of these years there was no guarantee that they would be uprated subsequently as this would be subject to the discretion of the Treasury when it reviewed the limits for the next 5 tax years. The freezing of these limits makes it even more important that individuals, who feel their benefits may exceed the lifetime allowance, make their election to HMRC for transitional protection in the form of enhanced and/or primary protection before the deadline for so doing ends on 5 April 2009.

The freezing of the standard lifetime allowance (SLA) will not only affect those individuals whose benefits are likely to exceed that level but will also impact on other benefits that are based either on a percentage of the SLA (e.g. the trivial commutation limit) or increase in line with the SLA (e.g. protected pre A-Day cash). HMRC has indicated that other benefits based on the SLA will also be restricted by the freezing of the SLA limit unless a separate announcement is made in respect of them.

The freezing of the SLA may also inhibit pension contributions/accrual for those individuals whose present benefits are close to but do not currently exceed the SLA. These individuals may well have made an assumption that the SLA would be increased each year by the Treasury. They may now be worried that the Treasury may extend the freezing of the SLA beyond tax year 2015/16, which could result in their benefits exceeding the SLA.

The standard lifetime allowance and the annual allowance will increase in tax year 2009/10 to the already announced levels of £1.75 million and £245,000 respectively.

2. Open market option

The Government is to publish a review of the operation of the open market option shortly after the publication of the Pre-Budget Report (PBR). This will review the progress made against the recommendations of the open market consultation set out in the 2007 PBR.

3. State benefits

The Basic State Pension will increase in line with the increase in the RPI to £95.25 per week (single person) and £152.30 per week (married couple) from April 2009. In addition a one-off £60 payment will be made to all pensioners early in 2009. This will have the effect of bringing forward the increase in the Basic State Pension to January 2009.

An above indexation increase will be made in the minimum income guarantee element of the pension credit from April 2009 raising this to £130.00 per week for a single person and £198.45 per week for a married couple.

As already announced in the 2008 Budget the winter fuel payments will be increased this year to £250 for each household with a person aged over 60 and to £400 for each household with a person aged over 80.

As announced in October, the Government will change the Class 3 voluntary national insurance contribution rules to allow those reaching state pension age between 6 April 2008 and 5 April 2015 with 20 qualifying national insurance years to purchase up to six additional years from 1975/76. The package is intended to be cost neutral overall and the Class 3 rate will therefore rise accordingly from £8.10 a week to £12.05 a week in April 2009.

4. Tax and national insurance

The payment of pension contributions by salary sacrifice will become even more attractive in the future. This is because of:-

- the significant increase in the upper earnings limit for national insurance contributions from April 2009 to align this with the rate at which people start to pay higher rate income tax (i.e. from £40,040 to £43,888)

- the increase in NIC rates for employer and employees from April 2011 and

- the reduction in the personal allowance for individuals with gross income before the allowance of over £100,000 from April 2010.

However, individuals who already have large pension benefits may be reluctant to increase their contributions if they fear that this will result in their aggregate benefits exceeding the SLA (see our comment in 1. above).

10. FOREIGN DIVIDENDS

Subject to appropriate anti-avoidance provisions there are proposals to allow exemption from tax for most foreign dividends received by large and medium-sized companies from overseas subsidiaries regardless of the size of the shareholding in the overseas subsidiary. This change will enable multi-nationals to repatriate foreign dividends (from non-resident group companies) tax free from next April.

Comment

It is hoped that this provision will stem the flow of corporate "emigrations". However, there is also concern that this relaxation could lead to significant avoidance through companies shifting the earning of profits abroad to avoid tax. In view of this the Government has announced that it will continue to consult on reform of the anti-avoidance rules. As a result of consultation, to date the Government appears happy not to tax profits "genuinely earned abroad".

It remains to be seen whether this considerable relaxation will result in a substantial repatriation of cash currently held abroad by multi-national groups.

11. QUALIFIED INVESTOR SCHEMES (QIS)

The current QIS tax rules effectively limit most investors to a 10% share of any one fund by a "substantial holding" test.

QIS are a type of authorised investment fund (AIF) that can only be marketed to sophisticated investors. QIS generally have wider investment powers than other types of AIF. A harsher taxation regime on substantial investors (those with a 10% or greater holding) applies than under the ordinary AIF regime.

From 1 January 2009 this harsher regime will cease to apply and the normal AIF rules will apply provided that investment in the QIS will not be limited to specific individuals or companies ie satisfies a "genuine diversity of ownership" rule. The test will thus be less rigid than it is at present.

Comment

Under the rules as they stand for QIS, broadly speaking, the increase (albeit unrealised) in the value of the investor's investment will be assessed to tax each year – thus denying deferral. If the yearly calculation produces a loss – then this will be allowable.

12. OFFSHORE FINANCIAL CENTRES

Especially in the light of the recently experienced difficulties and uncertainties over financial services compensation in connection with the UK's crown dependencies and overseas territories, a review into their long-term opportunities and challenges has been announced.

The review will cover financial supervision and transparency, fiscal arrangements, financial crisis management and resolution arrangement. Interim conclusions are to be produced for the 2009 Budget.

Comment

Given the increasing levels of investment made by UK investors into bank accounts, collective investments and insurance products offered by businesses resident in these locations this review will be important.

Until this year the major focus (and investor incentives) was the tax attraction of products issued from these jurisdictions – there will be few advisers unaware of offshore accounts, offshore funds and offshore bonds. All of these have become real choices for many UK investors.

As has been the case for many investments investors have, of late, been more concerned about a return ***of*** *capital than a return* **on** *capital. And this has led to greater focus on and scrutiny of the investor compensation rules for the jurisdictions from which the various products have been issued – including the UK.*

13. OFFSHORE DISCLOSURE

It has been announced that HMRC will be giving offshore account holders a new opportunity in 2009 to disclose if they have unpaid tax or duties and to settle debts. Advisers need to ensure that their clients are fully aware of the need to disclose offshore income- regardless of whether the income is brought to and spent in the UK.

14. AVOIDANCE

The Government has re-stated its intent to continue to act to prevent what it considers to be unacceptable tax avoidance. Consultation will take place on "principle based anti-avoidance legislation". Amendments will be made to the Disclosure of Tax Avoidance Schemes to simplify and improve the way users report schemes and scheme reference numbers back to HMRC.