Technical Connection

BUDGET ISSUE CONTENTS

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INTRODUCTION

The first Budget of the Coalition government was heavily trailed as being the Budget of necessity and austerity and it largely did not disappoint.

The Chancellor was at pains to stress that he believed that the majority of the deficit reduction plan that this Government was committed to undertake should be concentrated on spending reduction rather than taxation increases. Despite this, the Budget contained proposals to consolidate and build on the tax raising measures implemented by the last Labour government.

In this bulletin we look at all of the main changes taking place for this tax year, based on the newly proposed changes in this Budget and those we already know about (a number of which were confirmed in this Budget).

INCOME TAX

The three important Labour government Budget changes for 2010/11, involving the 50% income tax rate, the reduction in the basic personal allowance for those with income in excess of £100,000 and the freezing of personal allowances and the higher rate tax threshold, were confirmed.

By way of a new change, from tax year 2011/12 the personal allowance for those aged under 65 will be increased by £1,000 to £7,475. There will be a reduction in the basic rate limit so that higher rate taxpayers will not benefit from the increase in the personal allowance. The exact figure will be confirmed when September's Retail Prices Index figure is known.

CAPITAL GAINS TAX

The possible changes to capital gains tax were among the most extensively debated ahead of this Budget. The Coalition Agreement made explicit reference to increasing the rate of CGT. Most expected some form of linkage to income tax and possibly some amelioration through the introduction of taper relief or indexation allowance, or both. There had even been suggestions that individuals might be able to carry forward any unused annual exemption.

What we actually got was an increase but not in the format that was widely expected.

The key changes that were proposed:

- Legislation will be included in Finance Bill 2010 to introduce a new rate of CGT of 28 per cent. For individuals, the rate of CGT remains at 18 per cent where total taxable gains and income are less than the upper limit of the basic rate income tax band (£37,400 for 2010/11). The 28 per cent rate applies to gains (or any parts of gains) that fall above that limit. For trustees and personal representatives of deceased persons, the rate of CGT is increased to 28 per cent (previously 18 per cent).

- The rate of CGT for gains qualifying for entrepreneurs' relief remains at 10 per cent but as a real 10% rate rather than an effective rate as previously. The lifetime limit on gains qualifying for entrepreneurs' relief is increased from £2 million to £5 million.

- The annual exempt amount (AEA) for 2010/11 remains at last year's level of £10,100.

- The new rates of CGT and lifetime limit for entrepreneurs' relief have effect for disposals taking place on or after 23 June 2010.

The new rates – in a little more detail

Between 6 April 2010 and 22 June 2010 net gains chargeable to CGT (after deduction of reliefs, losses and the CGT AEA) were taxed at 18 per cent.

The Finance Bill 2010 will include a provision to change the rates of CGT for gains arising on or after 23 June 2010.

For individuals, where their total taxable income and gains after all allowable deductions (including losses, the income tax personal allowance and the CGT AEA) are less than the upper limit of the basic rate income tax band, the rate of CGT will be 18 per cent. For gains (and any parts of gains) that fall above that limit, the rate will be 28 per cent. For trustees and personal representatives of deceased persons, the rate will be 28 per cent for gains arising on or after 23 June 2010.

Gains arising in 2010/11, but before 23 June 2010, will continue to be liable to CGT at 18 per cent and will not be taken into account in determining the rate (or rates) at which gains of individuals arising on or after 23 June 2010 should be charged.

Certain CGT reliefs allow gains on disposal of an asset to be deferred until some time after the disposal. For instance, a gain can be reinvested in shares under the Enterprise Investment Scheme (EIS) and, subject to conditions, can be deferred until the EIS shares are disposed of. The CGT rate(s) on a gain deferred in this way will be the rate(s) at the time the deferral ends and the gain becomes liable to tax. Gains on disposals before 23 June 2010 which are deferred until 23 June 2010 or later will therefore be liable to CGT at the 18 or 28 per cent rates (or the rates that then apply), in the same way as gains arising on disposals on or after that date.

In working out the CGT payable, taxpayers will be able to deduct losses and the AEA in the way which minimises the tax due.

Example

In 2010/11 X's taxable income, after all allowable deductions and the personal allowance, is £27,400. The upper limit of the income tax basic rate band is £37,400. X sold an asset in May 2010 and realised a chargeable gain of £17,000. In November 2010 X sells another asset, realising a chargeable gain of £25,100. X has no allowable losses to set against these gains, and the AEA for 2010/11 is £10,100. Neither of the gains qualifies for entrepreneurs' relief.

X's taxable income is £27,400, £10,000 less than the upper limit of the basic rate band of £37,400. X sets the AEA against the later gain (because part of that gain is liable to tax at the higher CGT rate), leaving £15,000 taxable (£25,100 – £10,100).

The first £10,000 of the £15,000 is taxed at 18 per cent and the remaining £5,000 is taxed at 28 per cent. The £17,000 chargeable gain X realised in May 2010 before the change of rates on 23 June 2010 is taxable at the old 18 per cent rate.

For trustees and personal representatives of deceased persons, the CGT rate will be a flat 28 per cent for gains arising on or after 23 June 2010, except where entrepreneurs' relief applies (see below).

Entrepreneurs' relief – in a little more detail

Subject to satisfying certain conditions, including the lifetime limit, gains on disposals of entrepreneurial businesses by individuals and certain trustees qualify for entrepreneurs' relief. Between 6 April 2010 and 22 June 2010 entrepreneurs' relief reduced qualifying gains by 4/9 and the remaining 5/9 were then charged at the single 18 per cent rate. This resulted in qualifying gains being taxed at an effective rate of 10 per cent.

The changes to CGT rates from 23 June 2010 would mean the 4/9 reduction no longer achieves an effective rate of 10 per cent. The Finance Bill 2010 will therefore include provision to charge gains on disposals that qualify for entrepreneurs' relief on or after 23 June 2010 at a 10 per cent rate. The previous 4/9 reduction will cease to apply from that date.

The previous amount of an individual's gains that could qualify for entrepreneurs' relief was subject to a lifetime limit of £2 million (£1 million for disposals before 6 April 2010). For trustees, the £2 million limit was that of the beneficiary of the settlement who met the conditions for the trustees to claim the relief.

The Finance Bill 2010 will include a provision to increase that limit to £5 million from 23 June 2010.

Where individuals or trustees made qualifying gains above the previous £2 million limit before 23 June 2010 (£1 million limit before 6 April 2010), no additional relief will be allowed for the excess above the old limit. But if they make further qualifying gains on or after 23 June 2010, they will be able to claim relief on up to a further £3 million of those additional gains (or up to £4 million where the earlier £1 million limit applied), giving relief on accumulated qualifying gains up to the new limit of £5 million. In determining at what rate(s) an individual should be charged to CGT on any other gains, those gains qualifying for entrepreneurs' relief are set against any unused basic rate band before non-qualifying gains (but the AEA can still be used in the way that produces the best tax savings for the individual).

Example

Y has previously used £1 million of his lifetime entrepreneurs' relief limit. In 2010/11 Y's taxable income, after all allowable deductions and the personal allowance, is £17,400. The upper limit of the income tax basic rate band is £37,400. In May 2010 Y realised a chargeable gain of £3 million on the disposal of a business. In December 2010 Y sells another business, realising further chargeable gains of £7 million. Both disposals qualify for entrepreneurs' relief (subject to the lifetime limits). Y has no allowable losses to set against these gains, and the AEA for 2010/11 is £10,100.

The £3 million gain realised in May 2010 is subject to the £2 million lifetime limit for entrepreneurs' relief (for qualifying disposals from 6 April 2010), of which Y has previously used £1 million. £1 million of the gain is reduced by 4/9, added to the rest of the gain and charged to CGT at the single rate of 18 per cent.

The increase in the lifetime limit from 23 June 2010 means that £3 million of the £7 million gain from December is chargeable at the 10 per cent rate of CGT. Y's taxable income is £17,400, £20,000 below the basic rate band of £37,400. But the £3 million of the gain charged at 10 per cent is taken into account in priority to other gains in determining whether total income and gains exceed the basic rate band. So the remaining £4 million of gains, less the AEA, are charged at the higher rate of 28 per cent.

CORPORATION TAX

The rates of corporation tax from 1 April 2010 are those proposed by the previous government.

The rates of corporation tax for the financial year starting 1 April 2011 will be as follows:

- The small companies' rate of corporation tax for companies with profits up to £300,000 will be reduced to 20% and renamed the "small profits rate".

- The main rate of corporation tax for companies with profits of £1,500,000 or more will be reduced to 27%.

- 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 profits rate of 20% and the main rate of 27%. Profits in excess of £300,000 will effectively bear tax at the marginal rate of 28.75%.

- It has also been announced that the main rate will reduce by 1% annually until it is 24% for the financial year starting 1 April 2014.

INHERITANCE TAX

- The Coalition Government made no announcements on inheritance tax. Previously the Conservative Party had stated they would increase the nil rate band to £1 million per person but, following the formation of the Coalition government, it now seems that this change has been shelved and the nil rate band will remain at £325,000 until 5 April 2015 as proposed by the previous government.

- The Government announced that it will consult over the Summer on the possibility of bringing the saving of inheritance tax by using trusts within the Disclosure of Tax Avoidance Schemes regime.

CAPITAL ALLOWANCES

It was indicated ahead of the Budget that capital allowances may be a necessary casualty in the light of the Government's aspiration to reduce the corporation tax rates. This has indeed "come to pass" so to speak.

Legislation will be introduced to make the following changes:

- To reduce the rates of writing-down allowances (WDAs) for new and unrelieved expenditure on plant and machinery:

  - from 20 per cent to 18 per cent per annum for expenditure allocated to the main rate pool; and

  - from 10 per cent to 8 per cent per annum for expenditure allocated to the special rate pool.

  The changes will have effect for the calculation of WDAs for accounting periods ending on or after 1 April 2012 for businesses within the charge to corporation tax and on or after 6 April 2012 for businesses within the charge to income tax.

- To reduce the maximum amount of the annual investment allowance from the current limit of £100,000 to a new limit of £25,000. This will have effect from April 2012.

NATIONAL INSURANCE

The changes for 2011/12 announced by the previous government will still go ahead, including the 1% increase in the rate of employers' NICs to 13.8%.

Two new changes, effective from 6 April 2011, were announced:-

- In order to maintain the previously proposed alignment of the Upper Earnings/Profits Limit (UEL/UPL) with the higher rate threshold (the total of the personal allowance for those aged under 65 and the basic rate limit) the UEL/UPL will be reduced.

- The secondary threshold, which is the point at which employers start to pay Class 1 NICs, is to be increased by an extra £21 per week above indexation. The Government stated that this measure is to offset the 1% increase in employers' NICs, coming into effect in April 2011.

TRUST TAXATION

The Coalition government announced that with effect from 23 June 2010 trustees of all trusts other than bare trusts will be subject to a flat rate of CGT of 28%. Trustees of such trusts were previously subject to a flat CGT rate of 18%.

Discretionary trusts will, from 6 April 2010, also be suffering income tax at 50% (42.5% on dividend income) on income above the £1,000 standard rate band.

It was also announced that where a settlor of a settlor-interested trust receives a repayment of tax:

(a) this tax repayment must be paid to the trustees, and

(b) the payment to the trustees will be disregarded for IHT purposes

SAVINGS AND INVESTMENTS

(i) ISAs

There were no new proposals on ISAs but given the 50% additional rate of income tax and 28% capital gains tax for higher/additional rate taxpayers, it is worth repeating the changes introduced in the last Budget which have been confirmed.

The maximum subscription for all eligible investors is £10,200 for the 2010/11 tax year, with the maximum subscription to a cash ISA being £5,100. From 6 April 2011 the ISA subscription limits will be increased in line with the Retail Prices Index (RPI) on an annual basis using the RPI figure for the previous September. The new limits will be rounded to the nearest multiple of £120.

Whilst £10,200 as an upper subscription limit may seem low, this equates to £20,400 for a married couple each year and over 10 years equates to £204,000!

(ii) Real estate investment trusts (REITs)

The Chancellor announced proposals which will allow UK REITs to issue stock dividends in lieu of cash dividends in meeting the requirement to distribute 90% of the profits from the property rental business of the REIT. Currently, stock dividends do not count as property income distributions and so are not able to be used by UK REITs to meet the distribution requirement.

(iii) Venture capital trusts (VCTs) and enterprise investment schemes (EISs)

The Chancellor announced the final five changes to the EIS and VCT schemes agreed with the European Commission as a condition for their approval by the Commission as approved State aids.

The Government intends to legislate for this in a Finance Bill to be introduced as soon as possible after the Summer recess. The changes generally will have effect on and after a date to be appointed, with the exception of the definition of eligible shares for VCTs, which will not affect monies raised by the VCT before that date.

In summary, the changes are:-

- An increase in the minimum amount VCTs must hold in "eligible shares". At present eligible shares in unlisted companies must represent at least 30% of a VCT's qualifying investments (which in turn have to be at least 70% of the VCT). The eligible shares minimum holding will more than double to 70%.

- Revision of the definition of VCT 'eligible shares' to include shares which may carry certain preferential dividend rights.

- Allowing a VCT to be listed on any EU/EEA investment market rather than be restricted to a UK listing.

- Preventing shares in companies that are 'in difficulty' from qualifying for the purposes of the VCT and EIS rules.

- For both EISs and VCTs, the existing requirement that an EIS company or a company in which a VCT invests must have a qualifying trade carried out wholly or mainly in the UK is changed to one that it need only have a permanent establishment in the UK.

LIFE POLICYHOLDER TAXATION

In its March 2010 Budget, Labour proposed changes to how deficiency (loss) relief was to be given following the introduction of the additional 50% rate of income tax. Broadly, deficiency relief was to be available against income taxed at 50% as well as 40%. This change has been dropped.

It is likely (but not known for certain) that the entitlement to deficiency relief will continue to be subject to a targeted anti-avoidance provision effective for termination chargeable events occurring on or after 6 April 2010 which give rise to a deficiency. This provision was a proposal of the previous Labour government and would apply where the main purpose, or one of the main purposes, of arrangements made on or after 22 April 2009 is to secure a tax advantage.

FURNISHED HOLIDAY LETTINGS

The Government has confirmed that FHL will continue to be treated as a trade for tax purposes. From tax year 2009/10 the FHL rules were widened to include properties in the EEA so such properties will also continue to benefit from the current FHL rules. However, the Government did announce that it would consult over the Summer on the FHL rules.

DOMICILE AND RESIDENCE

There were no new proposals as such but the Government confirmed that it will launch a review on the taxation of non-UK domiciled individuals.

PENSIONS

The first Budget of the new Coalition government has introduced a number of important pension changes, as well as reaffirming a number of policy statements that had already been made. The main changes are:

- The proposed repeal of the high income excess tax relief charge and its replacement by a new restriction designed to deliver the same potential tax return to the Treasury. This will most likely be by a reduction in the annual allowance to between £30,000 and £45,000.

- The extension of the effective age at which benefits need to be annuitised under a money purchase scheme.

- Confirmation that the basic state pension will be increased each year by the greater of the increase in inflation, the increase in national average earnings and 2.5% per annum. (For April 2011, inflation will be as measured by RPI but, from April 2012 onwards, it will be as measured by CPI).

- Confirmation of a review of the date the State Pension Age will rise to age 66 and consideration of future increases to State Pension Age in light of increasing longevity.

- Confirmation that the default retirement age of 65 will be removed from April 2011.

- Confirmation of a fundamental structural review of public service pension provision to be undertaken by the Public Service Pensions Commission.

- The introduction of legislation in a Finance Bill to be laid shortly after the Summer recess to enable the National Employment Savings Trust to be treated as an occupational scheme and therefore able to benefit from the favourable pension tax reliefs under the current pension tax regime.

1. Pension tax relief

The previous government had laid the initial legislation in the Finance Act 2010 for the introduction of the 'high income excess relief charge' that would have taken effect from 6 April 2011 and would have restricted the pension tax relief available to high income individuals with 'relevant income' of £150,000 or more.

There had been much criticism of this new tax charge by the pension industry in view of its administrative complexities and the potential difficulty in explaining this to affected individuals. This measure was, however, seen as extremely important by the then Government as it was estimated to raise around £3.5 billion in additional tax.

There was much trepidation prior to this Budget that higher rate tax relief on pensions may be abolished altogether as this had been a manifesto commitment of the Liberal Democrats. Fortunately this is not the case. The Coalition government has listened to the industry's concerns about the 'high income excess relief charge' and it will bring forward legislation to repeal it. The Government, however, cannot afford to lose the potential tax return that this would have provided, and it is considering introducing changes to the existing pension savings allowances, which provide a comparable tax return and simplify the position. This will principally be achieved by lowering the annual allowance from its current £255,000, to in the region of £30,000 to £45,000. This may require amendments to other aspects of the existing tax regime: any final agreed level of annual allowance would "be influenced by a number of policy design features in the revised regime, including the appropriate level of the lifetime allowance". The Government will be discussing these changes further with interested parties.

These changes mean:

- Those individuals with 'relevant earnings' of less than £130,000 in tax year 2010/11(and in the two immediately preceding tax years) should consider maximizing their pension savings in tax year 2010/11. Such savings will not be subject to any special annual allowance tax charge, although account will need to be taken of the impact of such contributions/accrual on the individual's annual allowance and lifetime allowance.

- Those individuals with 'relevant earnings' of £130,000 or more in any of tax years 2008/09 to 2010/11 will be subject to a special annual allowance tax charge on any pension savings in 2010/11 that exceed the greater of their special annual allowance and any protected pension input. Full advantage should be taken of their special annual allowance (ie. normally £20,000 but potentially up to £30,000 where sufficient 'infrequent money purchase contributions' have been paid in tax years 2006/07 to 2008/09) and protected pension input.

  If they want to pay substantial pension contributions which exceed their special annual allowance consideration should be given to whether these would best be paid in the current tax year, where the effect of the special annual allowance will bring the effective relief on excess contributions down to 20%, or to pay these in 2011/12 when any excess over the annual allowance, as set, would result in a tax charge of at least 40% (see below). Such a charge could negate all tax relief for a 40% taxpayer.

There are many uncertainties that need to be resolved concerning any reduction in the annual allowance. These include:

- Will the annual allowance tax charge be retained at 40%? If it is, how will this be reconciled with tax relief at 50% on pension contributions for 50% taxpayers? If there is no change in the tax rate to allow for this 50% taxpayers may still feel pension contributions over the annual allowance will be attractive as there is still effectively 10% relief.

- Will the existing rules regarding the annual allowance continue to apply? If so, this will provide substantial opportunities for pension accrual/pension contributions in respect of a member of a scheme who will be drawing all his retirement benefits from that scheme in the same tax year as the one in which the contributions/accrual are tested for annual allowance purposes. This is because accrual/contributions paid in these circumstances are currently excluded when determining whether the member's benefits have exceeded the annual allowance.

- At present a member's pension savings accrue in respect of a pension input period under each scheme of which he/she is a member. The total pension savings in respect of all the pension input periods ending in a tax year are set against the member's annual allowance for that tax year. If the new rules are introduced it will be important for individuals to ensure that any pension contributions/accrual made in 2010/11 are in a pension accrual period ending on or before 5 April 2011 to avoid such contributions/accrual being set against the substantially reduced annual allowance in 2011/12. This will particularly be the case where an individual is maximising pension savings in 2010/11 as he is not subject to the special annual allowance tax charge.

How will the new rule affect members of DB schemes? Assuming the current 10:1 conversion factor is used this would mean that should the annual allowance be set at £30,000 a member could only receive an increase of up to £3,000 in their pension entitlement during a pension input period without triggering an annual allowance charge. If there was a move to age related factors this may further reduce the scope for increased pension accrual without a tax charge. If the annual allowance is set at £30,000 this could impact on DB scheme members with pensionable salary as low as £40,000 to £50,000 where they have significant accrued pensionable service.

2. Change of annuitisation date

Up until now a member has effectively had to 'annuitise' their benefits at age 75. The Government has now announced its intention to remove such a requirement with effect from tax year 2011/12. Pending implementation of the necessary changes, legislation will be introduced in the Finance Bill 2010 to increase to 77 the age by which members have to buy an annuity or otherwise secure a pension income.

Although the wording of the Budget press release is open to interpretation (which may only become clear once the Finance Bill has been published) we believe that the following changes will only, at this stage, apply to any member of a money purchase pension scheme who has not yet secured an annuity or scheme pension, and **who reach age 75 on or after 22 June 2010.**

- The ASP minimum and maximum income limits will not apply until their 77th birthday.

- Immediately before they reach their 75th birthday they will become entitled to income withdrawal and can take a PCLS alongside this, from any uncrystallised funds. It should be noted that if no PCLS is taken before age 75, as under current rules, there will be no opportunity to take a PCLS subsequently.

- In the period up to 2011/12, when the main changes take effect, a tax charge of 35% will be levied in respect of any lump sum death benefit. The specific IHT death charges on members who die in drawdown while aged 75 or over will not apply in these circumstances, nor will any lump sum death benefit be subject to unauthorised payment charges. It should be noted that although the specific IHT charge on death after age 75 will not apply an IHT charge could still arise in normal circumstances and this can be avoided by paying the lump sum death benefits at the discretion of the scheme administrator/trustees.

It is important to note at this stage that there is no change to the position for those individuals who reached age 75 prior to 22 June 2010. Should they die while in receipt of ASP benefits, any lump sum death benefit paid other than as a charity lump sum death benefit will continue to potentially be subject to aggregate IHT and unauthorised payment charges of up to 82%.

The Government will be consulting shortly on the detail of the changes to be introduced in 2011/12. The above is a substantial improvement for those individuals reaching age 75 on or after 22 June 2010 and it is hoped that even more flexibility will be introduced in the 2011/12 changes.

3. State pension benefits

The Government will uprate the Basic State Pension by a triple guarantee of earnings, prices or 2.5 per cent, whichever is highest, from April 2011. CPI will be used as the measure of prices in the triple guarantee, as for other benefits and tax credits. However, to ensure the value of a Basic State Pension is at least as generous as under the previous uprating rules, the Government will increase the Basic State Pension in April 2011 by at least the equivalent of RPI.

To ensure the lowest income pensioners benefit from the triple guarantee, the standard minimum income guarantee in Pension Credit will increase in April 2011 by the cash rise in a full Basic State Pension.

The Government will review the date at which the State Pension Age rises to 66. It has already indicated this will not be before 2016 for males and 2020 for females. The Government will also consider future increases to State Pension Age and how best to manage the ongoing challenge posed by increasing longevity.

4. Default retirement age

The Government will be consulting shortly on how it will phase out the default retirement age from April 2011.

5. Public sector pensions

The Government has appointed the independent Public Service Pensions Commission to undertake a fundamental structural review of public service pension provision and to make recommendations to the Chancellor and Chief Secretary on pension arrangements that are sustainable and affordable in the long term, fair to both the public service workforce and the taxpayer and consistent with the fiscal challenges ahead, while protecting accrued rights.

In reaching its recommendations, the Commission is to have regard to:

- the growing disparity between public service and private sector pension provision, in the context of the overall reward package – including the impact on labour market mobility between public and private sectors and pensions as a barrier to greater plurality of provision of public services;
- the needs of public service employers in terms of recruitment and retention;
- the need to ensure that future provision is fair across the workforce;
- how risk should be shared between the taxpayer and employee;
- which organisations should have access to public service schemes;
- implementation and transitional arrangements for any recommendations; and
- wider Government policy to encourage adequate saving for retirement and longer working lives.

As part of the review, the Commission will produce an interim report by the end of September 2010. This should consider the case for delivering savings on public service pensions within the spending review period – consistent with the Government's commitment to protect those on low incomes - to contribute towards the reduction of the structural deficit. The final report is to be available in time for the 2011 Budget.

The official value of all unfunded public sector pension promises is £770 billion, although most independent estimates put it at £1,000 billion or more. The Office for Budget Responsibility indicates that additional unfunded liabilities are accruing at £26 billion a year. These figures highlight the drastic need for an effective solution in respect of public sector pensions.

6. National Employment Savings Trust

Legislation will be included in a Finance Bill to be introduced as soon as possible after Parliament's Summer recess to allow the National Employment Savings Trust (NEST) to be treated as an occupational pension scheme for the purposes of Part 4 of the Finance Act 2004. This will mean that members of NEST and contributing employers will be able to benefit from the tax reliefs available to registered pension schemes on contributions and investment growth and to be subject to the same tax rules as other tax-registered pension schemes.

As usual, the contents of this Bulletin are based on the proposals put forward by the Chancellor in his June 2010 Budget and need to be approached with caution as details may change during the passage of the Finance Bill through Parliament.