

Pre-Budget briefing

Entrepreneurial Business

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INTRODUCTION

The first Pre-Budget Report from Alistair Darling contained two major surprises:

- the complete abolition of taper relief (both for business and non-business assets held by individuals), and its replacement with a single rate of capital gains tax of 18%; and
- changes to the taxation of non-UK domiciliaries including the levying of an annual fee of £30,000 for those who have been resident in the UK for more than seven years and wish to retain the remittance basis of taxation.

HM Treasury estimates that both these measure will be revenue raising. Over the next three years, the capital gains reforms are estimated to generate £2bn and the domicile (and other residence) changes will bring in £1.3bn.

There were no specific proposals relating to the private equity industry although the above changes will have an impact. However, there appeared to be a note of warning in the speech that suggests that further announcements might be made.

PERSONAL AND EMPLOYMENT TAXES

Capital gains tax reform

The Chancellor made a number of sweeping changes to the CGT regime which will come into effect for disposals made on or after 6 April 2008 or held over gains coming into charge after this date. The current CGT rules will continue to apply for disposals made up to 5 April 2008.

A flat rate of CGT of 18% will apply to all disposals after that date and both indexation allowance (which currently applies to assets held before 6 April 1998) and taper relief will be withdrawn. This new rate of CGT will apply to all assets, both business assets and non-business assets, including those already held.

In addition, a number of other existing provisions have been simplified, including rules applying to assets held at 31 March 1982 and the share identification rules, although the 'bed and breakfasting rules' remain unchanged.

The CGT annual exemption will remain, as will Principal Private Residence relief, business asset roll over relief, business asset gift relief and CGT reliefs available under the Enterprise Investment Scheme and Venture Capital Trusts. Unused capital losses will continue to be available to carry forward to set against future gains.

In depth, in context.

Draft legislation will be published later this year after further discussion with interested parties.

Taxation of UK resident but non-UK domiciliaries

Following the announcement of a review of the taxation of non-UK domiciliaries in 2003, the Government will make some major, although not entirely unexpected, changes to the taxation of UK resident non-UK domiciliaries. The new rules – outlined below – will take effect from 6 April 2008.

The changes include an annual 'additional tax charge' of £30,000 for individuals who have been resident in the UK for seven years or more and who wish to continue using the remittance basis of taxation. The seven year time limit takes into account periods before the change.

Where an individual decides not to use the remittance basis (and not to pay the additional tax charge), he or she will be taxed on worldwide income and gains whether or not they are remitted to the UK.

Entitlement to personal allowances will be removed for individuals resident in the UK who are using the remittance basis, subject to a de minimis level of unremitted foreign income of less than £1,000.

In addition, a number of alterations will be made to the remittance basis of taxation:

- The 'source ceasing' rule is to be removed with effect from 6 April 2008. This means it will no longer be possible to cease a source of income in one tax year and remit funds tax-free in the following tax year.
- It will no longer be possible to remit income tax-free by claiming the remittance basis in the year the income arises but not in the year it is remitted.
- Further changes will extend the definition of 'remittance' of relevant foreign income.
- There will also be a tightening of the rules relating to the use of offshore trusts and companies to convert taxable income and gains to non-taxable payments in the hands of non-domiciliaries.
- There will be a general extension of anti-avoidance legislation, which currently does not catch individuals taxed on the remittance basis.

There will be consultation on the detail of the changes based on draft legislation due to be published later this year. The Government also intends to consider whether individuals who have been resident in the UK for more than ten years should be charged an even higher amount in future by way of the 'additional tax charge.'

The test for UK residence

The Government has made some major changes to the test for UK tax residence.

When deciding an individual's tax residence status, days of arrival in and departure from the UK will be counted as days of presence in the UK with effect from 6 April 2008. This will affect those who are not currently considered UK resident purely on the basis that they are excluding days of arrival and departure.

Inheritance tax changes: transferable nil rate bands

The Chancellor announced that legislation will be introduced in Finance Bill 2008 to allow a claim to be made to transfer any unused inheritance tax (IHT) nil rate band on a person's death to the estate of their surviving spouse or civil partner who dies on or after 9 October 2007. This will enable tax savings to be achieved where the IHT nil rate band of the first deceased spouse or civil partner was not fully used in calculating the IHT liability of their estate. The amount that can be transferred is based on the percentage of the unused allowance at the time of the first death as applied to the nil rate band at the time of the second death.

This relaxation will be welcomed by many and may make it unnecessary for taxpayers to consider undertaking estate planning through their Wills. However, it does not mean that nil rate band discretionary trusts under existing Wills no longer have any role to play as they may still shelter future growth from the charge to tax.

Income shifting

Following HMRC's defeat in the Arctic Systems case, the Government's intention to bring in amending legislation to reverse the decision has been confirmed. The case involved a company owned by a husband and wife where each owned one share, enabling profits to be distributed as dividends to both of them despite the fact that the husband was the income earner for the company. Due to recent changes in tax and national insurance rates, significant tax savings can be made using 'husband and wife' companies or partnerships.

Following confirmation of the effectiveness of such structures by the House of Lords in the Arctic Systems case the Chancellor has announced that the legislation will be amended to remove the tax advantage from such income shifting arrangements.

The new rules will take effect from 2008/09 and will apply when income is distributed as dividends from a company, or arises as partnership profits.

There will be a consultation process to ensure the new rules are clear and provide certainty.

Inheriting tax-relieved pension savings

From 10 October 2007 the Government has further tightened the anti-avoidance rules aimed at preventing pension scheme members from avoiding inheritance tax by passing benefits to their relatives after their death. The legislation imposes an 'unauthorised payments charge' at an aggregate 70% for the member and the scheme. It does not apply to schemes with 20 or more members where the pension increase caused by the arrangements affects all members equally. There is a secondary inheritance tax charge, with offset for the unauthorised payments charge, where the benefitting member dies after reaching age 75, raising the aggregate rate of charge to 82%.

HM Treasury's review of aligning income tax and national insurance

The Treasury has published the findings of its review into the possibility of aligning income tax and NICs. The review has concluded that the costs and limited benefits of moving the calculation of Class 1 NICs to an annual basis, as is the case for income tax, mean that this is not worthwhile.

There will now be a consultation in the Autumn on a number of simplification proposals which could reduce the administrative burden for business and include:

- collecting tax on benefits-in-kind and expenses through the payroll,
- withdrawing the requirement for P11Ds and P9Ds, and
- removing the £8,500 threshold for taxing benefits in kind.

CORPORATE TAX

Corporation tax: simplification and anti-avoidance

The Government intends to consult on the areas where it believes that simplification will be of most significance to UK companies, including:

- group aspects of corporation tax on chargeable gains (including the treatment of assets transferred, offsetting of gains and losses, and the treatment of companies joining and leaving a group);
- associated company rules for small companies corporation tax rate;
- CTSA filing and payment for groups; and
- transfer pricing rules.

They are also consulting on simplifying anti-avoidance legislation by:

- ensuring new anti-avoidance legislation is clear, effective and well targeted;

- simplifying areas of existing anti-avoidance legislation.

Leasing Plant and Machinery

Certain sale and finance leaseback transactions which fell within section 222 CAA 2001

New draft legislation is intended to counter arrangements that exploited section 222 which limits the disposal value of plant and machinery. The arrangements avoided triggering a full claw back of capital allowances on the disposal of valuable plant or machinery to a non-UK resident.

The new legislation will apply to sale and finance leaseback transactions entered into on or after 9 October 2007. Section 222 will be repealed so that a full disposal value will be brought into account (in accordance with the usual rules where a company sells and finance leases back plant or machinery).

The 'transfer' of capital allowances will now be prevented by a different measure. In future finance leasebacks under a sale and finance leaseback will be treated as long funding leases. Accordingly the lessor will not be entitled to capital allowances except where the plant & machinery is 'new' (less than 4 months old).

Transactions which create tax losses where there is a commercial profit

Anti-avoidance provisions will affect arrangements where a sub-lessor in a lease chain realises a tax loss (and there is either a commercial profit or a smaller commercial loss) either by:

- obtaining a trading deduction for the cost of an asset but only being taxed upon the finance element of rentals received under a long funding lease; or
- entering into arrangements where over the lease term there is a substantial difference between the GAAP profits and the tax result; that difference being to some extent a result of the 'ceiling' in the Long Funding Lease rules applying; and that difference being a main purpose of the arrangements.

In each case the new rules remove the 'ceiling' in the Long Funding Lease rules which would otherwise apply to restrict the lessor's taxable income.

The changes take effect in the case of (i) if deductions arise after 9 October 2007 (with just & reasonable adjustment) and in the case of (ii) if arrangements are entered into on or after that date.

Spreading of tax relief for pension contributions

With effect from 10 October 2007, HMRC are reinforcing the current rule that disproportionately large employer pension contributions should be spread for tax deduction purposes for up to four years. Under existing rules spreading could be required where, for instance, a large contribution exceeds 210% of the previous year's amount. However, if the previous year's amount is nil, spreading is not required. It appears that some groups have exploited this anomaly to avoid spreading by routing contributions through a newly-established participating employer with no previous record of paying contributions. This will no longer be effective.

Fire safety capital allowances

Specific legislation granting plant and machinery allowances for expenditure on building alterations made in response to a notice from a fire authority has been repealed. Fire safety equipment such as fire alarms and sprinkler systems will continue to qualify for plant and machinery allowances.

STAMP DUTY LAND TAX (SDLT)

Changes to partnership anti-avoidance rules

The Chancellor has announced a review of the controversial SDLT anti-avoidance rules introduced in Finance Bill 2007, which charge deemed transfers of interests in property-

investment partnerships.

The anti-avoidance rules currently apply whenever a person acquires or increases a share in a property-investment partnership, regardless of whether consideration is given. The Government appear to have been persuaded by submissions made by interested parties (including Deloitte). The new rules adversely affect (both disproportionately and retrospectively) genuine property-investment partnerships, catching many benign transactions. The review is also likely to have been prompted by news that two £1 billion funds have suspended admissions and withdrawals due to the SDLT changes. We understand that the proposed relaxation in the rules, which will be retrospective and apply to transactions that occurred post 19 July 2007, will target funds of this nature rather than all property-investment partnerships *per se*. The announcement will be welcomed by the real estate sector but until the publication of Finance Bill 2008 uncertainty as to the application of the rules will continue.

INDIRECT TAXES

Tax simplification reviews: VAT

Government have announced a review, working in partnership with business, on how to simplify VAT rules and administration in the UK and the EU. They are seeking views (including through an on-line questionnaire) by the end of November 2007 from businesses and other stakeholders.

Five areas prioritised for simplification include the 'option to tax'; partial exemption (including the capital goods scheme); frequency of return submission; VAT retail schemes; and complexities requiring simplification at an EU level.

An update on progress will be reported at Budget 2008.

VAT and housing

From 1 January 2008 the reduced VAT rate of 5% will apply to renovation work on residential properties where those properties have been empty for two years (the current qualifying period being three years).

For detailed coverage of and comment on the Pre-Budget Report, visit our dedicated website at <http://www.ukbudget.com>

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