

Prosper - Newsflash

2007 Pre-Budget Report Special

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 (CGT) of 18%; and
- changes to the taxation of non-UK domiciled individuals 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 measures 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.

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and both indexation allowance (which currently applies to assets held before 6 April 1998) and taper relief will be withdrawn for all assets, including those already held.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

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.

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

The test for UK residence

The Government has made some major changes to the test for UK 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 UK resident purely on the basis that they are excluding days of arrival and departure in their test for residence.

Taxation of UK resident but non-UK domiciled individuals

Following the announcement of a review of the taxation of non-UK domiciled individuals in 2003, the Government will make some major, although not entirely unexpected, changes to the taxation of UK resident but non-UK domiciled individuals. 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 want to continue using the remittance basis of taxation. The seven year time limit runs from the first year of residence in the UK, i.e. if the individual has already been UK resident for five years, the new rules will apply after a further two years.

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 their 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 to the UK tax-free in the following tax year.
- It will no longer be possible to remit income arising in one year, tax-free the following year, by claiming the remittance basis in the first year but not the second.
- Further changes will mean an extension to 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-UK domiciled individuals.
- 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 by way of the additional tax charge.

Irish investment and employment income: taxation on the remittance basis

From 6 April 2008 restrictions on the remittance basis of taxation for Irish income are to be removed. Non-UK domiciled or not ordinarily resident individuals are usually taxed on foreign investment income and employment income from an overseas employer (when no duties are performed in the UK), only if it is remitted to the UK. These rules do not currently apply to Irish investment and employment income, which remains taxable on the arising basis. These restrictions will be lifted from 6 April 2008 so that the same rules apply to all foreign investment and employment income regardless of the country of origin.

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 frozen at the percentage of the unused allowance at the time of his or her death as applied to the nil rate band at the time of the second death. Any claims for relief will be made by the personal representative of the last spouse or civil partner to die.

This relaxation will be welcomed by many and may make it unnecessary 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.

Inheritance tax provisions for pensions

The IHT provisions for alternatively secured pensions (ASPs) will change in line with the new proposals for transferring the balance of the unused nil rate band on the death of a surviving spouse or civil partner. Legislation will also be introduced in Finance Bill 2008 to ensure that tax-relieved pension savings that are diverted into pensions and lifetime annuities in order to achieve IHT savings will be subject to additional tax costs. This can include both income tax and, where appropriate, IHT charges. The aim is to catch cases where a member surrenders part of their entitlement in certain circumstances thereby boosting the entitlement of a connected person.

Husband and wife companies and partnerships

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 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.

Despite confirmation of the effectiveness of such structures by the House of Lords, 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 6 April 2008 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.

Restriction on loss relief for individuals paying interest in advance on qualifying loans

Legislation will be introduced in Finance Bill 2008 to block a disclosed avoidance scheme whereby individuals seek to accelerate tax relief for interest payments made on certain qualifying loans. From 9 October 2007, interest on qualifying loans (for example, those invested in partnerships or certain small companies) will only be eligible for relief in the tax year to which the interest relates regardless of when it is paid.

Discussion paper on offshore funds

A discussion paper on offshore funds was issued on 9 October 2007. The discussion period ends on 9 January 2008. The Chancellor's objectives are to simplify the tax regime for offshore funds, provide certainty to UK investors and strengthen anti-avoidance rules.

The main feature is to propose a new method of defining offshore funds for UK tax. The result should be of little material impact for most investors in retail type funds.

The status of funds in umbrella structures, including protected cell companies, will be tested at the fund or cell level, in line with current rules in order to ascertain whether they are 'reporting funds' - broadly equivalent to 'distributor' funds.

The Government intend to close a loophole in respect of the taxation of offshore income gains. This is the basis of taxation for non-distributor funds at present, and will apply to non-reporting funds in future. At the moment, income gains arise on 'rolled up' gains. An investor can be non

UK-resident for as little as one complete tax year to avoid tax on these gains. In future it is intended that investors will need to be non-resident for five complete tax years, bringing the tax position in to line with the taxation of capital gains.

VAT and housing

With effect from 1 January 2008 renovations and alterations to residential properties that have been empty for at least two years will be eligible for a reduced VAT rate of 5%. This measure currently applies where properties have been empty for three years.

Income tax self-assessment: increase in payment on account threshold

Individual tax payers are currently required to make two payments on account (POAs) towards their tax liability for a tax year, unless:

- their income tax bill for the previous year was less than £500; or
- 80% or more of the tax due was deducted at source.

From 2009/10 an individual will not have to make POAs if their income tax bill for the previous year was less than £1,000. The deduction at source test has not been altered.

Tax rates and allowances

Tax rate tables have not been prepared as many of the applicable 2008/09 tax rates were pre-announced in the 2007 Budget, whilst a number of others have not yet been published.

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