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Stop Press - Budget 22 March 2006 - Personal Tax Highlights

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The Chancellor in his Budget speech today announced a number of changes affecting the private client world.

The key points of interest that individuals, trustees and their advisers should be aware of are set out below.

Inheritance Tax – Taxation of Trusts

Introduction

HMRC's Press Release BN25 is titled 'Aligning the Inheritance Tax Treatment for Trusts'. A more accurate title would be 'Penalising Families for Using Trusts to Hold their Assets'.

In December 2003, HMRC announced their approach to the reform of the taxation of trusts was essentially to create a 'level playing field' between assets held in trusts and assets held personally by individuals (from 'Modernising the tax system for Trusts overview of the proposals' 17 December 2003.)

"4. The Government recognises the important role trusts play in society. As far as possible it wants a tax system for trusts that does not provide artificial incentives to set up a trust but, equally, avoids artificial obstacles to using trusts where they would bring significant non-tax benefits".

HMRC have spent more than two years consulting with professional bodies in the context of income and capital gains tax where this has been their core message. The measures announced today in relation to inheritance tax **completely contradict** that stated objective. They unfairly penalise the holding of property through trusts to an extraordinary extent.

Accumulation and Maintenance Trusts ('A&M Trusts')

A&M Tusts are special trusts for children/grandchildren which, until today, qualified for special inheritance tax status provided the beneficiaries became entitled to income by the age of 25 at the latest. They have been used to a significant extent by 'middle England' as a way for parents and grandparents to fund the needs of their children/grandchildren in a wholly legitimate way for the last 31 years.

From today, except in very limited circumstances, anyone establishing a new A&M Trust will be subject to an inheritance tax charge at 20% on the value of chargeable assets gifted to that trust in excess of the nil rate band (£275,000 at the moment, £285,000 from 6 April 2006) – furthermore, these trusts will be taxed on a ten yearly basis at 6% on the excess value over the nil rate band.

Even more extraordinary, unless existing trusts (ie those established prior to 22 March 2006) are, or are converted by 6 April 2008, into ones where the children concerned receive the property outright at age 18, they will also be subject to the 6% ten yearly charge inheritance tax rule even though these rules had no application at the time the settlement was created.

The inability to make new lifetime trusts for children and grandchildren without a 20% charge on the value in excess of the nil rate band, means that families will be forced either to make outright gifts at a point where the receipt of wealth could seriously deflect children and young adults from their studies, or to make no gifts at all – it is difficult to see what fiscal objective this actually achieves.

Life Interest Trusts

These trusts are commonly used by parents to provide for their adult children. Often the motivation behind parents creating trusts in these circumstances, is to protect family assets in the context of the potential divorce of children and to enable the property to be managed on behalf of the children eg family companies where voting control may need to be kept in a 'pooled' vehicle. These trusts will now become subject to the discretionary trust regime when the life tenant's interest comes to an end unless, on the death of the existing life tenant, the property passes outright to another individual.

This seriously restricts the ability of families to undertake careful planning for the gifting of family assets – the current inheritance tax treatment of trusts, other than discretionary trusts, is the same as that applicable to outright gifts and there is no evidence that this has been used other than for non-tax reasons.

Adding to Existing Settlements

Care should be taken in relation to any additions to existing settlements as well as the establishment of new settlements, as the new rules will apply equally to both.

Divorce Settlements

One immediate problem area which springs to mind is in the context of divorce settlements where one spouse may be required to settle property on to trust for a former spouse for a fixed period until children obtain a specified age. We have some initial concerns that this type of arrangement, which is currently tax neutral, might fall foul of the new rules.

Implications for Will Planning

The changes could have important implications for will planning – it would seem that multi-generational trusts and those with flexible overriding powers could be treated unfavourably and that choices may need to be made between accepting the discretionary regime with 10 yearly charges at 6% or outright gifts unless property continues to qualify for 100% relief from inheritance tax as business or agricultural property.

Conclusion

With no consultation whatsoever, the existing rules on the inheritance tax treatment of trusts have been turned upside down and the current beneficial regime afforded to all but discretionary trusts, will be limited going forward to a very narrow category of trusts for the disabled or trusts where children receive property outright at age 18.

The changes provide substantial disincentives for families to create trusts as holding vehicles for assets except in relation to property which qualifies for 100% relief from inheritance tax. They are ill thought through and constitute an attack on the use of trusts as an accepted planning tool which completely contradicts HMRC's previous acceptance of trusts as a legitimate holding vehicle for assets.

We will need to await the publication of the Finance Bill 2006 to assess more fully the detailed implications of these changes. It is anticipated that STEP and other professional bodies will undertake some vigorous lobbying in order to modify some of the more unfair consequences of the proposed changes.

Modernising the Tax System for Trusts

HMRC confirmed today that they will introduce most of the income tax and capital gains tax provisions covered by the draft legislation issued on 31 January this year (see our February Stop Press). It is not clear at this stage whether any amendments will be made to the wording of the draft legislation as a result of comments made by various professional bodies during the consultation period which ended on 17 February.

However, having been advised that it would constitute a State Aid, HMRC have decided not to introduce the proposed regime which would have allowed certain UK based professional trustees to elect to be treated as non-UK resident in relation to trusts created by non-domiciled and non-resident and not ordinarily resident settlors. This is an unfortunate development for the UK trust industry given that the common residence test applicable from 6 April 2007 will be based on the current income tax definition and so the current capital gains tax provisions allowing certain UK based professional trustees to be treated as non-UK resident will now cease to apply.

One new measure announced today is the increase of the standard rate band, which applies to the income of all trusts otherwise chargeable to the rate applicable to trust from £500 to £1000.

The new rules, other than the rules on trustee residence, will take effect from 6 April 2006.

Residence and Domicile

The Government continues to review the UK residence and domicile rules as they affect individuals, and has announced that in taking the review forward it will proceed on the basis of evidence and in keeping with its principles. A Consultation Paper on these issues has yet to be published and it therefore appears unlikely that any imminent changes will be made in this regard.

Pensions and Inheritance Tax

Death of pension scheme member before age 75

The 2006 Budget contained welcome clarification of the inheritance tax treatment of pension death benefits. The Chancellor has decided to bring into legislation the current concessionary practice relating to pension death benefits which dates from 1992. Under the old concessionary regime if a member fails to take pension benefits, e.g. he fails to annuitise his pension fund prior to his death, no inheritance tax is charged where the beneficiary of the pension death benefits is the taxpayer's spouse, civil partner or person who is financially dependant on him. In addition, no inheritance tax is charged where a member chooses not to exercise his rights to take an annuity, or another form of pension benefit, while he is in good health, and does not subsequently vary that choice, even when a reduction in his life expectancy would technically trigger an inheritance tax charge.

Death of pension scheme member after age 75

Under the new regime for UK registered pensions from 6 April 2006 it is no longer necessary for individuals to take an annuity at the age of 75. However, HMRC have made it clear that the ability to continue in income draw down after the age of 75, known as Alternative Secured Pension (**'ASP'**), was specifically designed for those taxpayers who have a principled religious objection to annuitisation. ASP is not intended to be used as a vehicle to pass capital down to the next generation.

When a member dies in ASP with remaining pension funds, where these funds are used to provide pension benefits to someone who is **not** his spouse, civil partner or financial dependant, the funds will be subject to an inheritance tax charge taxable on the deceased member's estate. Any leftover ASP funds paid to charity will be exempt from inheritance tax, as will funds used to provide pension benefits to the deceased's members spouse, civil partner or financial dependant, and on such person's death any remaining funds will be subject to inheritance tax. These leftover funds will be treated as if they were an addition to the original deceased member's estate.

Where there is a potential double charge on ASP funds, such as when ASP funds are paid back to an employer or where on the death of a dependant under age 75 any remaining funds are paid out as a lump sum other than to a charity, the inheritance tax charge takes priority over any pension scheme tax charge which is then applied to the net fund after deduction of inheritance tax. Where any inheritance tax is due it is the responsibility of the ASP pension scheme administrator to pay the tax due out of the remaining ASP fund. The above measures will be effective on the death of a scheme member on or after 6 April 2006.

Estate Planning

Where pension death benefits form a sizeable part of a person's estate, it may be sensible to review the existing planning in the light of these proposed announcements to ensure that the way in which the pension death benefits are dealt with continues to be appropriate.

Recycling Tax-Free Lump Sums

The 2005 Pre-Budget Report announced measures to stop individuals from reinvesting tax free lump sums from UK pension schemes into other UK pension schemes, thus obtaining tax relief on the contribution. Following comments on draft legislation the anti recycling rule, which effectively removes any tax advantages from recycling tax-free lump sums, will not be triggered where no more than 30% of the lump sum is recycled. In addition, the de minimis threshold under which lump sums are ignored for the anti avoidance rule will be linked to 1% of the Standard Lifetime Allowance, which in 2006/2007 will be £15,000.

Real Estate Investment Trusts ('REITs')

The 2006 Budget sets out the regime that will apply to REITs. As announced previously, companies coming within the REIT regime will be exempt from corporation tax on their income and capital gains. Distributions made by REITs will be treated as property income in the hands of the shareholders and will be subject to corporation tax or income tax as appropriate.

The charge to convert to REIT status has been set at 2% of the market value of the properties held by the company.

Stamp Duty Land Tax ('SDLT')

A number of minor changes have been made to the SDLT regime including:

- The threshold for SDLT on residential property has been raised to £125,000.
- As widely expected, the relief for the transfer of land to a newly formed unit trust (seeding relief) has been withdrawn.
- The relief from SDLT for Shari'a law compliant mortgages has been extended to apply to purchases by all persons (companies, clubs, trusts, etc) not just individuals.

Changes to Venture Capital Schemes

HMRC today announced various changes to the law affecting enterprise investment schemes, (**'EIS'**) corporate venturing schemes (**'CVS'**) and venture capital trust (**'VCT'**) schemes.

The rate of income tax relief available for VCT shares issued on or after 6 April 2006 has been increased to 30% and the minimum period for which those shares must be held to qualify for relief has been increased to 5 years. In addition the meaning of 'investment' for the purposes of section 842AA TA 1988 has been amended so that any money held by or on behalf of a VCT after 6 April 2007 will be treated as an investment.

In relation to EIS shares issued on or after 6 April 2006, the investment limit to which income tax relief is subject has been increased to £400,000 and the maximum carry-back figure for the purposes of section 289 TA 1988 has been increased to £50,000 from 6 April 2006.

In relation to all three types of scheme, the gross assets test (the maximum size limit of companies able to raise money under these schemes) has been reduced to £7 million immediately before the investment and £8 million immediately afterwards. These changes will not apply to funds raised by VCTs prior to 6 April 2006 or to EIS or CVS shares subscribed for before 22 March 2006, nor will they apply to EIS investments made by Approved Investment Funds approved before 22 March and which have started raising money before 6 April 2006.

Employment Remuneration

As announced in the 2005 Pre-Budget Report, the Government is legislating to close down certain 'contrived' income tax and National Insurance avoidance schemes. The schemes involve awards of securities options and have come to the notice of HMRC as a result of the operation of the tax scheme disclosure rules.

The effect of the legislation is that securities options (that is, options to acquire shares or other securities) will be treated as securities rather than options for tax purposes where the main purpose (or one of the main purposes) of the grant of the option is the avoidance of tax or National Insurance. Under Chapter 5 of Part 7 ITEPA 2003, securities options are not taxed on receipt but rather on exercise. By treating certain options as securities rather than securities options, these options will become taxable on receipt and will also be capable of being subject to the additional tax charges imposed by Chapters 2 to 4 of Chapter 7 (such as the charges which apply to restricted securities and convertible securities).

The legislation will have effect for options acquired on or after 2 December 2004 and also to options acquired before that date 'where something is done on or after that date as part of the arrangements under which it was made available'. It is not clear what this means and whether the mere exercise of an option after 2 December 2004 may be sufficient to bring it within the new provisions. This is an example of HMRC's stated policy of introducing legislation with retrospective effect where tax avoidance is undertaken in relation to employment schemes.

Where, as a result of the new rules, an employer must account for income tax under the PAYE system in relation to any retrospective charge, the employer will not have to do so until the date the Finance Bill receives Royal Assent.

Film Tax Relief

It was announced today that a new tax relief for the production of British films would be available for films intended for release which commence principal photography on or after 1 April this year. The legislation is now available.

This replaces the existing regime, which was extended to apply until 31 March 2006 in the 2005 Budget, and which treats certain capital expenditure as revenue expenditure.

The new regime will be underpinned by a new treatment for film production companies (**'FPCs'**) producing British films. FPCs will be treated as companies responsible for principal photography, postproduction and delivering the completed film. A maximum of 80% of total qualifying UK expenditure may benefit from tax relief where at least 25% of the total production expenditure is qualifying UK expenditure. Enhanced relief is available for films with total qualifying production expenditure of less than £20m.

Where the enhanced relief gives rise to a tax loss the FPC can either receive a payment of part of the loss or carry the loss forward to set against future income against the film. The carried forward loss may also in some cases be transferred and set against another film.

The definition of a 'British film' will be based on a revised version of the test set out in the Films Act 1985, and 'qualifying UK expenditure' will refer to expenditure incurred with respect to pre-production, principal photography and post production activities which take place in the UK. Expenses on other production activities will be outside the new regime and subject to normal rules.

Tackling Tax Avoidance – Disclosure Requirements

HMRC today announced amendments to the direct tax disclosure regime, which will have effect from 1 July 2006.

The current Disclosure Regime, which was introduced in the 2004 Budget, operates so that promoters and, in some cases, users, of tax planning arrangements which might be expected to obtain a tax advantage have an obligation to notify HMRC of those arrangements. The rules are directed at two classes of arrangements, namely those that contain certain specified 'financial products' and those which refer to 'employment arrangements'.

At present, a series of 'filters' are in place so that arrangements do not have to be notified if they do not fall foul of any of the 'filters'.

The filter tests have effect so that where:

1. hypothetically a premium fee could be charged for the advice provided; or
2. a promoter would wish to keep those elements of the arrangements which gives rise to the tax advantage confidential; or
3. the terms on which a financial product is available are not directly comparable by with the terms on offer by other providers, the arrangements must be disclosed.

HMRC today announced that the regime is to apply to the whole of income tax, corporation and capital gains tax, and that the filter tests are to be replaced by a series of 'hallmarks'. Therefore, financial products and employment arrangements seem likely to cease to be relevant concepts within the regime.

It was announced that there will be three groups of hallmarks:

1. three generic hallmarks will target new and innovative schemes. These are to be derived from the existing filters;
2. one hallmark will target mass marketed products; and
3. certain hallmarks will target areas of particular risk. There will be specific hallmarks concerning capital gains tax and certain leasing schemes.

In addition, the timetable within which in-house schemes must be disclosed is to be reduced to 30 days, and a de minimis provision will be introduced to exempt certain individual and small businesses from the requirement to disclose in-house schemes.

This appears to be an attempt to ensure that all innovative tax planning across the direct tax spectrum is disclosed, rather than that which relates only to financial products and employment arrangements, whilst simultaneously seeking to ensure that everyday tax planning is not caught by the disclosure rules. It will be interesting to see the detail of the new hallmarks in this context.

Miscellaneous

- ***Capital gains tax 'bed and breakfasting' rules:*** This measure amends the capital gains tax 'bed and breakfasting' rules to counter tax avoidance schemes, such as the one used in the case of ***Davies v Hicks,*** __ whereby the person disposing of the relevant shares or securities ceases to be resident or ordinarily resident in the UK after the disposal but before acquiring identical shares within thirty days of the disposal and therefore falls outside the scope of the rules as currently drafted.

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