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Stop Press - Pre-Budget Report 9 October 2007 - Personal Tax Highlights

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The Chancellor in the Pre-Budget Report today announced a number of changes affecting the private client world.

The proposals represent something of a patchwork quilt of good and bad news for taxpayers. There is no single underlying strategy that can be discerned. The chief examples of the somewhat contradictory nature of the proposals can be found by contrasting those on capital gains tax with those relating to inheritance tax and non-domiciliaries.

In the area of capital gains tax, the abandonment of taper relief with its fundamental distinction between business and non-business assets will certainly contribute to the simplification of the tax system. However, it will impact negatively on entrepreneurs who are likely to suffer a near doubling of the rate of tax payable on their gains.

The proposals relating to inheritance tax are sensible, positive and appear to signify a policy decision to modify the existing rulebook rather than to embrace more radical proposals for its complete replacement. The absence of any specific proposals bringing to an end the ability to make potentially exempt transfers is also welcome news for the present.

Whether the proposal for a flat rate charge of £30,000 on UK resident non-domiciliaries will manage to raise significant revenue without driving some of the more productive contributors to the UK economy offshore remains to be seen and further clarification is urgently needed.

The narrow proposal relating to residency is a specific response to the *Gaines-Cooper* decision on the significance of days of arrival and departure counting as days of presence in the UK. There will be continued uncertainty on the application of the rules and a failure to move to a clearer statutory day count test in all cases is a missed opportunity.

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

1. Residence and domicile

It is proposed that legislation will be introduced to take effect from 6 April 2008 to cover the following provisions affecting non-UK domiciled persons living in the UK.

- Introduce an additional charge for individuals claiming the remittance basis of taxation.
- Ensure that when determining if an individual is resident in the UK in any tax year, days of arrival and departure are counted.
- Address a range of "anomalies" in the remittance basis:
    - closing a loophole enabling income to be remitted without tax by claiming the remittance basis in one year and not the next;
    - preventing taxpayers from relying on the source closing rule to remit income tax free;
    - reducing the scope for the alienation of income and gains through the use of offshore structures; and
    - extending the existing anti-avoidance provisions to the remittance basis and the definition of the remittance basis.
- End the automatic entitlement to certain personal allowances for individuals resident in the UK who are using the remittance basis.

UK residents who are not domiciled in the UK can currently claim the remittance basis of taxation i.e. they pay income tax and capital gains tax in the UK in respect of foreign income and gains only to the extent that they are remitted to the UK.

Flat rate charge

The new rules will introduce a flat rate charge so that individuals seeking to use the remittance basis after they have been resident in the UK for seven years will have to pay an additional charge of £30,000 a year. An individual who elects not to claim the remittance basis will pay income tax and capital gains tax on an arising basis on their worldwide income and gains. For individuals already resident in the UK the seven year period will already have started running although the additional tax will only be payable from 6 April 2008.

There will be further consultation on whether people who have been resident in the UK for longer than ten years should make a "greater contribution". This will add to continued uncertainty for long-term residents.

Residence rules

Under the current rules, an individual will be resident in the UK if he spends a sufficient number of days in the UK. Previous HMRC practice was to ignore days of arrival and departure when calculating the number of days present in the UK. This rule enabled some individuals to spend a significant amount of time in the UK without becoming tax resident here by travelling in and out of the UK on a regular basis. From 6 April 2008 days of arrival and departure will be counted as days present in the UK for this purpose.

Other changes

A number of further changes are being made to ensure that where foreign income and gains are remitted to the UK then tax is charged on those remittances. These are regarded as "anomalies" to the present system and the following changes have been proposed:

- **Preventing tax-free remittances of income**
    - Currently, if an individual claims the remittance basis of taxation in respect of foreign income arising in one tax year he can remit that income in the following tax year without paying tax if he does not claim the remittance basis in that year. Legislation is to be introduced to close this loophole.
    - At the moment it is possible to take advantage of the source-closing rule. This rule enables an individual claiming the remittance basis to remit investment income to the UK as if it were tax-free capital. Income currently is only taxable if, when the income is remitted to the UK, the asset or the bank account giving rise to that income is held by the taxpayer. If the asset has been sold or the bank account closed in the tax year before the year in which remittance takes place, the income is not taxable in the UK when remitted. Some taxpayers have becoming increasingly more aggressive in relying on this rule by opening and closing accounts on an annual basis. New legislation is to be introduced to tax such remittances.
- **Alienation of income and gains through the use of offshore structures**

It is proposed that new rules will be introduced to reduce the scope for the alienation of income and gains through the use of offshore structures, such as companies and trusts, which convert taxable income and gains into non-taxable payments. Currently non-domiciled residents who benefit from offshore trusts pay no capital gains tax in respect of trust gains even where those gains are remitted to the UK. In addition, it is possible to avoid the application of income tax anti-avoidance provisions by ensuring that no UK source income arises and by paying away the income out of the trust to a beneficiary who is not subject to UK taxation. In this way capital benefits can be received in the UK without any UK tax charge. No information currently is available as to how these new rules will apply.

There will be consultation on the detail of the changes and we understand that draft legislation will be available in the next few weeks.

2. The Republic of Ireland

Responding to pressure from the European Commission, the Government has announced that from 6 April 2008 it will no longer tax investment and employment income that arises in the Republic of Ireland to persons resident but not domiciled (or not ordinarily resident) in the UK on an arising basis. Instead such income will be taxable on the remittance basis.

This will be good news for Dublin based offshore funds which have hitherto been taxed on an arising basis for UK resident non-domiciliaries.

3. Capital gains tax reform

Fundamental changes to the way in which capital gains tax is charged on the disposal of assets by individuals, trustees and personal representatives also have been announced. The taxation of chargeable gains accruing to companies is unaffected.

A flat rate of 18% capital gains tax will be introduced for the disposal of any chargeable asset after 5 April 2008. Taper relief and indexation relief will be withdrawn. This will affect different taxpayers in different ways.

Entrepreneurs

Currently individuals who have held business assets (for example shares in unquoted companies) can benefit from an effective rate of tax on capital gains of 10%. From 6 April 2008 disposals of these assets will be taxable at 18%. Taxpayers in this position will want to consider realising gains in the current tax year to secure the lower tax rate.

Investors/Long-term holders

By contrast under the current taper relief rules investors who hold non-business assets (such as quoted shares, second homes and buy-to-lets) currently can only reduce their effective rate of tax to 24% after a ten-year period. Taxpayers in this position will benefit from an immediate reduction in their tax rate from 6 April 2008 and may want to consider delaying any disposals until after 5 April 2008.

However, the withdrawal of indexation allowance will affect persons who acquired assets before March 1998. They will face an immediate increase in their chargeable gains (up to an amount approximately equal to their acquisition cost). Taxpayers in this position will want to carefully compare the tax charge before and after 6 April 2008 to decide the optimal timing of a disposal.

Share identification rules

In circumstances where a person owns shares in a company which have been purchased in several batches over a period of time, the share identification rules presently apply to identify the shares being disposed of. HMRC plan to simplify these provisions such that all shares of the same class in the same company will be treated as forming a single asset (a "share pool") regardless of when they were acquired. The rules which apply to "bed and breakfasting" (the 30 day rule) and shares which are disposed of and reacquired on the same day will be preserved.

4. Inheritance tax reform

From today unused nil rate bands will be capable of being transferred to the estate of deceased spouses and civil partners.

Previously, where assets passed outright to the survivor, the spouse/civil partner exemption meant that no charge to inheritance tax arose on the first death, but also meant that the nil rate band was effectively wasted, with only the survivor being able to utilise their nil rate band. Although this could be addressed relatively simply by the inclusion of nil rate band trusts within wills, simple estate planning ran the risk of wasting up to £120,000 (being the inheritance tax saving provided by the current nil rate band of £300,000). Commentators have urged for some time for the possibility for a surviving spouse or civil partner to make use of any portion of the nil rate band not used on the first death.

The changes

It would appear that the transferability will work as follows:

- Married couples and civil partners will be able to benefit from a combined nil rate band of £600,000 based on current rates, increasing to £700,000 in 2010, by allowing the transfer of any unused portion of the nil rate band so that the surviving spouse or civil partner will be entitled to "double up" that nil rate band and claim a double exemption against chargeable gifts on his or her death.
- Where only part of an individual's nil rate band was used on a first death, the pro rata equivalent in current values will be made available. In practical terms this means if someone died five years ago but used half of the then nil rate band of £250,000, 50% of the current nil rate band will be available to their surviving spouse.
- Where a survivor remarries or enters into a civil partnership and survives their new partner, the maximum relief he/she can claim will be twice the nil rate band at the time of his/her death.
- The relief will also apply to widows, widowers and surviving civil partners whose spouses died on or before today.

Application

The main beneficiaries of these proposals will be:

- Those whose principal asset is the family home where using the nil rate band on a first death proved too complex or costly.
- Surviving spouses/civil partners who were reluctant to alienate control of part of the first to die's estate to a discretionary nil rate band trust because of concerns over access to funds in the event of nursing home fees etc.
- Those who did not take professional advice to incorporate a nil rate band discretionary trust or effect a Deed of Variation within two years following the first death.

5. Offshore funds

The Government has also issued a discussion paper today concerning proposed changes to the offshore funds regime. The offshore funds rules set out the way in which investors who dispose of investments in certain types of non-UK funds are taxed and can mean that disposals of investments give rise to a charge to income tax, rather than capital gains tax. Where an offshore fund has "distributor status", there is no charge to income tax and the disposal is charged to capital gains tax. Where a fund does not apply for distributor status, any gains realised on a disposal by investors gives rise to a charge to income tax.

The stated aim of the Government's review of the offshore funds rules is to simplify them and provide greater certainty for investors.

It is proposed to amend the definition of an offshore fund – it will no longer rely on the definitions set out in the Financial Services and Markets Act 2000 and there will be welcome clarification on certain issues including the fact that the offshore funds regime does not apply to contractual arrangements, such as partnerships.

The concept of distributor status will be abolished and replaced by funds which are either "Reporting Funds" or "Non-Reporting Funds". If a fund does not elect to be a Reporting Fund, it will automatically be a Non-Reporting Fund and will be taxed broadly in the same way as at present. The current requirement to apply for distributor status is criticised as creating uncertainty for investors, since approval can only be given retrospectively and investors can not be certain that it will be given. The new proposals provide that a fund can elect to be a Reporting Fund in advance, so giving investors greater certainty when deciding whether or not to make investments in a particular fund.

There is greater flexibility proposed for funds which inadvertently breach the conditions for Reporting Fund status and remedy the breach without delay – no adverse consequences will arise to investors. The proposals are also designed to ensure that in the event that a fund does lose its Reporting Fund status, investors will have sufficient notice to decide whether or not to realise their investment, rather than hold an investment in a Non-Reporting Fund, with the potentially adverse consequences which that could entail.

It is proposed that the requirement to physically distribute income be amended, to recognise the fact that it may not be commercially attractive to distribute income. It is therefore suggested that income may be either physically distributed or deemed to be distributed (although tax remains payable on physical and deemed distributions).

It is presently a condition that an investor holds a "material interest" in an offshore fund for the provisions to bite (broadly, this means that they should reasonably expect to be able to realise their investment within seven years at an approximate market value). It is proposed that this requirement will be abolished, to simplify the rules and provide greater certainty.

The Government has also stated its intention to close a "loophole" relating to individuals who become non-resident and dispose of investments. In general, individuals who cease to be resident in the UK are subject to clawback provisions on gains made on the disposal of their investments while non-resident in the event that they return to the UK within 5 years. These provisions do not apply to disposals of investments in non-distributor status funds, since they do not give rise to a charge to capital gains tax. The Government intends to address this anomaly in the new rules.

Responses to the paper are invited by 9 January 2008.

6. Changes to Alternatively Secured Pensions ('ASPs') rules

In the 2007 Budget the Chancellor confirmed that, on the death of an individual in an ASP, if any remaining funds are transferred to the pension funds of other members of the same scheme there will be a potential inheritance tax charge. However, this inheritance tax charge can be deferred on the death of the original "owner" of the ASP funds if the funds are used to provide relevant dependant pension benefits, such as to the surviving spouse or civil partner. On the death of the relevant dependant, or the earlier cessation of their pension benefits, any left over ASP funds would be subject to inheritance tax at the rates of tax applying at that date.

Where the inheritance tax nil rate band was not fully used when the original "owner" of the ASP funds died, the unused portion will be applied to the nil rate band in force at the date of death of the relevant dependant, or the earlier cessation of their pension benefits. This is consistent with the introduction of transferable nil rate bands between spouses and civil partners.

7. Taxation of derivatives

HMRC today clarified the tax treatment of transactions involving financial derivatives in the context of what is and what is not trading. Existing advice on the general distinction between investment and trading remains relevant as regards general commercial activities.

Given the increasing use of derivatives by individuals this clarification could be seen as helpful in the context of active portfolio management where there is a desire to avoid the risk of capital returns on derivatives being classified as trading income, as it may be taken to indicate that where the derivative positions are conceptually similar to long only positions the returns will be treated as capital and not income. This will be especially attractive in the context of the new capital gains tax flat rate of 18% which will shortly apply.

8. Anti-avoidance

Measures have been announced to combat artificial anti-avoidance schemes including:

- a scheme that created an income tax loss by accelerating the payment of interest due under a loan that is subsequently then repaid; and
- a scheme that allowed taxpayers to claim capital allowances for plant and machinery leased to operating businesses where no economic risk was taken.

However, in response to the concerns of industry the Government has relaxed certain anti-avoidance measures that were brought in earlier this year to charge to SDLT on partnerships.

Authors

John Riches

CONSULTANT | LONDON

Private client and tax

+44 20 7597 6109

john.riches@withersworldwide.com

Christopher Groves

PARTNER | LONDON

Private client and tax

+44 20 7597 6127

christopher.groves@withersworldwide.com