Election Tax Update

May 2010

WHEN TWO WORLDS COLLIDE

Tax under the new Coalition Government

"We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle" ~ *Winston Churchill*

"Any coalition has its troubles, as every married man knows" ~ *Arthur H. Sulzberger*

The announcement of an Emergency Budget on 22 June 2010 by the new Chancellor, George Osborne, follows hot on the heels of the indecisive election result, and the dramatic events which led to the Conservative-Liberal Democrat Coalition Government. As has already been widely reported in the Press, some major tax reforms are on the way.

Whilst we do not know the details of these changes, there are indications in the election manifestos of the two parties, and in the Full Coalition Agreement (the "Agreement") which brings together their sometimes widely differing proposals, as to what these may be. The purpose of this Election Tax Update is to review some of the likely changes which have already been signposted in these documents.

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Capital Gains Tax

Capital Gains Tax ("CGT") has featured heavily in recent headlines. The UK has enjoyed a relatively benign regime for taxing gains on investment assets for a number of years now and, although the abolition of Taper Relief and introduction of Entrepreneurs' Relief two years ago resulted in a less generous regime for business assets, non-business assets were actually taxed more lightly following these changes.

The fundamental issue is that, with a top rate of tax of 50% now applying to annual income in excess of £150,000, the disparity between Income Tax and the 18% CGT rate for investment gains has never been greater. It is therefore not surprising that CGT is a target for change. Indeed, Mr Osborne has recently insisted that an increase in CGT is needed to crack down on Income Tax avoidance due to an *"enormous amount of income shifting"*.

Although the Conservatives did not make any specific pledges about CGT in their election manifesto, the Liberal Democrats stated that it was their intention to tax capital gains at the same rate as income. This was echoed in the Agreement in which the parties state that capital gains on non-business assets should be taxed "at rates similar or close to those applied for income", but with the proviso that there would be "generous exemptions for entrepreneurial business activities".

As a result, it is likely that CGT on non-business assets, such as quoted stocks and shares, second homes and investment properties, will increase to up to 50% for those with annual income in excess of £150,000. Whether this rate increase will apply from Budget Day on 22 June 2010, from 6 April 2011, or even, as some anticipate, is back-dated to 12 May 2010 when the proposal to increase in CGT was first announced, remains to be seen. However, it is certain that CGT on non-business gains will be increased substantially.

As far as business entrepreneurial activities are concerned it is not clear whether the existing rules on Entrepreneurs' Relief will remain in place, or whether they will be amended or superseded by a different relief. Again, we will have to wait for the announcement on Budget Day.

One of the major issues with Entrepreneurs' Relief is that certain assets, such as shareholdings of less than 5% and properties let to trading entities, which had qualified as business assets under the old taper relief provisions, are no longer eligible for relief. Whether the proposed "generous exemptions" will include these types of assets is uncertain.

The Lib-Dems have stated that they would like the CGT annual exemption for individuals (currently £10,100) to be cut to a more modest £2,000, although the Conservatives have indicated that they favour a reduction to £5,000. Either way this could significantly increase the number of individuals who are required to complete a tax return due to relatively small investment asset disposals.

CGT Increase - Window Of Opportunity

The proposed increase in the CGT rate on non-business assets from 18% to up to 50% is likely to hit some taxpayers very hard. However, there remains a small window of opportunity before Budget Day on 22 June during which swift action should be considered in order to mitigate this increase. You should therefore consider action if you are:-

- A UK resident individual or partnership who owns a non-business asset that is standing at a gain, including a second home, an investment property or quoted shares;
- A UK resident individual who previously sold his company in exchange for loan notes which remain outstanding;
- An employee who owns less than 5% of the voting shares in his employer, where these shares are standing at a gain;
- A UK resident individual who owns an overseas company that owns a non-business asset standing at a gain, including an investment property or quoted shares;
- A UK resident, non-domiciled, individual who is considering remitting gains to the UK over the next few years;
- A UK resident, non-domiciled, individual who is funding UK expenditure from a "segregated" or "income-free" offshore trust; or
- A UK domiciled settlor or beneficiary of a trust.

If your circumstances are as set out above, then please contact the Rawlinson & Hunter partner who normally acts for you as soon as possible to discuss taking urgent action.

Corporation Tax

The Conservative election manifesto included a pledge to cut the main Corporation Tax rate from 28% to 25%, and the small companies' rate from 21% to 20%, with further cuts to be made "over time", and to reduce "complex reliefs and allowances". There was also a pledge to announce in the first Budget a "5-Year Road Map" setting out the direction of Corporation Tax reform and simplification.

However, the Agreement states that there will be a reform of the Corporate Tax system in order to "reduce headline rates". This will be achieved by "simplifying reliefs and allowances, and tackling avoidance" with the aim of making the UK "the most competitive corporate tax regime in the G20". It therefore seems likely that a cut in the Corporation Tax rate will be announced on Budget Day, although it is not clear how much the cut will be, or when it will take effect.

The Chancellor has also stated that he intends to reform the complex Controlled Foreign Companies rules that seek to tax the profits of certain overseas subsidiaries of UK parented groups, although no further details have been announced as yet.

IR35

There is reference in the Agreement to a review of "IR35" as part of a "wholesale review of small business taxation". Broadly, this complex legislation seeks to prevent the avoidance of PAYE using disguised employment through a service company, where payments made directly to the individual would have been subject to PAYE. This has been much criticised for the additional administration it places on "one-man" companies, and the uncertainty of its application in certain circumstances.

Personal Allowances

Another Lib-Dem manifesto pledge, which has been adopted in the Agreement, is an increase in the individual personal allowance, with the long term aim of increasing it from £6,475 to £10,000. The Agreement stated there would be a "substantial" increase in the personal allowance announced in the first Budget to take effect from 6 April 2011, but with the benefits "focused on those with lower and middle incomes". It is therefore likely that the current restrictions on personal allowances for those with income over £100,000 will remain in place, and that these restrictions could be extended to those with incomes above a new limit set below £100,000.

The Lib-Dems intended to use their proposed 1% "Mansion Tax" on properties worth more than £2 million to help pay for the increased personal allowance. However, this tax was scrapped during Coalition negotiations, so alternative funding measures have had to be found.

The Conservative manifesto pledge to introduce a transferable tax allowance for married couples remains a sticking point for the Lib-Dems. As a result, the measure has been included in the "To Do" list in the Agreement, but the Lib-Dems have been granted the right to abstain from voting on this issue in future.

Pensions

The previous Government announced restrictions on both the amount of pension contributions which can be made, and the levels of tax relief available. Although the Agreement makes no specific reference to tax relief on pension contributions, the Lib-Dem manifesto included a pledge to abolish higher rate tax relief for pensions contributions, and the appointment of Lib-Dem Steve Webb as pensions minister makes a change here look more likely. Any change could perhaps be achieved by gradually reducing the income level above which higher rate relief is given - initially perhaps from £150,000 (the current upper limit) to £100,000.

Both parties' election manifestos pledged to remove the obligation to purchase a pension annuity at age 75, and this has been carried over into the Agreement. It also states that the default retirement age at 65 will be phased out, presumably to coincide with the phased increase in the age at which entitlement to the state pension begins.

National Insurance Contributions ("NIC")

The manifestos of both parties made reference to the previous Government's plan for a 1% increase in both Employees' and Employers' NIC from 6 April 2011. However, whereas the Conservatives favoured scrapping the plan altogether for those earning less than £35,000, the Lib-Dems favoured reversing the increase "when resources allow". As a compromise, the Government has agreed that the increase in Employees' NIC will take effect in full, but that the increase in Employers' NIC will not affect employers whose employees earn less than around £35,000 per annum.

In practice, this means that, from 6 April 2011, Employees' NIC and Class 4 NIC on the self-employed will increase by 1% with no upper limit. This is equivalent to a 1% increase in Income Tax on all earned income. In addition, from 6 April 2011, Employers' NIC will increase by 1% with no upper limit, although the threshold below which no

Employers' NIC is due has been increased by around £1,600. Therefore despite the political rhetoric, there will be a very significant increase in employment taxation from 6 April 2011.

Income Tax Rates

Taking all of the proposals on Income Tax, personal allowances and NIC together, the position from 6 April 2011 is that there will be a 52% tax rate on income for those earning more than £150,000. Those earning between around £44,000 and £150,000 will suffer a 42% tax rate, with the exception of those individuals earning between £100,000 and £112,950 who will suffer a 62% tax rate on their earnings above £100,000 (due to the tapering away of their personal allowances).

Consequently, from next tax year, the UK will have very high marginal tax rates on earned income and, in particular, those earning above £150,000 will be paying away more than 50% of their earnings in income taxes. 50% has always been recognised as a psychologically important barrier for taxation as it can cause taxpayers to change their behaviour by taking more steps to reduce their tax liabilities, often causing a Government's Income Tax revenues to actually go down.

This issue has been recognised by the new Prime Minister, David Cameron, who said on the day after the Agreement was published, "*We will always be looking at the yields from different taxes to see whether they are effective and efficient. I have always had my doubts that 50p will yield a lot of money. But the great thing about being in office is we can give you the figures now. Let's have a look and see. We don't like high marginal rates of tax. They are not good for the country, but we always had a queue and the (front of) the queue is cutting tax for the low paid.*"

Inheritance Tax ("IHT")

The Conservative pledge to increase the IHT threshold to £1 million is another casualty of the Coalition negotiations. Although this was opposed by the Lib-Dems, the proposal has not been completely abandoned. However, the Agreement acknowledges that there are other priorities before this is implemented.

VAT

VAT is the "elephant in the room" as it has been ignored by all concerned to date. Neither party made any pledges about VAT in their manifestos, nor in the Agreement. It is therefore widely expected that VAT will increase from the current rate of 17.5% to at least 20% in the Budget. This would bring the UK more in line with the majority of other EU countries (the UK currently has the fourth lowest standard VAT rate after Cyprus, Luxembourg and Spain), although the maximum permissible rate under EU law is 25% (currently in force in Sweden).

In addition, items which are currently zero-rated for VAT purposes (such as food, books, newspapers and magazines, and children's clothing and footwear) could be re-categorised so that they are also subject to VAT at the standard rate or a reduced rate. Again this would bring the UK into line with the position in many EU countries for certain goods and services.

Stamp Duty Land Tax ("SDLT")

The Conservatives pledged in their manifesto to abolish SDLT for first time buyers on house purchases up to £250,000. However, the Agreement has removed this pledge and instead promised to "review the effectiveness of the raising of the stamp duty threshold for first-time buyers".

Furthermore, the previous Government's proposal to increase SDLT from 4% to 5% on the sale of residential property for more than £1 million from 6 April 2011 has now become law in the 2010 Finance Act. This is not mentioned in the Agreement, and it therefore appears that this rate increase will go ahead on 6 April 2011.

Anti-Avoidance

The Lib-Dems made it clear in their manifesto that they intended to tackle tax evasion and avoidance "with new powers for HM Revenue & Customs", in order to raise an extra £4.6 billion per annum. The Agreement states that the Government will make "every effort to tackle tax avoidance including detailed development of the Lib-Dem proposals".

The Lib-Dems have previously stated that they are in favour of a General Anti-Avoidance Rule ("GAAR"), and it is therefore possible that the new Government could introduce such a rule despite previous misgivings about how this would work in practice.

One of the specific anti-avoidance areas mentioned in the Lib-Dem manifesto was to introduce new rules to prevent the avoidance of SDLT on UK property using offshore trusts. It is therefore expected that this rule will be introduced in the Budget.

Non-Domiciled Status

The Lib-Dem manifesto pledged they would reform the taxation of non-UK domiciled individuals so that after seven years they would become subject to UK tax on all overseas income. On the other hand, the Conservative manifesto contained no new proposals on this issue. The Agreement states the Government will "review the taxation of non-domiciled individuals". Some may take encouragement from this announcement given that the previous Labour

Government also announced a review of the non-domicile rules, and it took them six years, and a change in Prime Minister, before they announced any changes.

Air Passenger Duty

Another Lib-Dem manifesto pledge which has been adopted in the Agreement is to switch from a "per passenger" duty for air travel to a payment "per plane". This will mean that air freight is taxed for the first time.

It is also a stated intention that the additional revenues which arise from this change will be used to help fund the increase in the personal allowance. This proposal is therefore likely to prove a significant revenue-raising measure for the Government.

Banking Reform

The Conservative and Lib-Dem manifestos both pledged that they would introduce a bank tax, and promised measures to curb the bonus system. The Agreement reflects this, and states that as well as introducing a banking levy, detailed proposals will be announced to "tackle unacceptable bonuses" in the financial services sector with the aim of reducing the associated risks, whilst creating a more competitive banking industry.

Conclusion

A new Government's first Budget is always subject to careful scrutiny, but in the current economic circumstances not only the electorate, but the markets, will see this Budget as an indication of the Coalition's stance on tackling the unprecedented deficit, and bringing the UK's finances back on track.

Whatever changes are introduced in the Budget, it is certain that taxes will be increased, and that these will inevitably hit entrepreneurs and their businesses, as well as shareholders and individual taxpayers. However, there remains a small window of opportunity for those who may be affected to review their affairs before Budget Day, and to take any appropriate action to avoid the tax increases - in particular in relation to CGT planning.

If you are interested in any of the issues raised in this Election Tax Update, please speak to your usual R&H contact to discuss how we may assist you.

What to do next...

If you are interested in any of these issues and wish to discuss them in more detail, please call the Rawlinson & Hunter partner who normally acts for you. If you are not one of our regular clients but would like more information or advice, a full list of partners is provided on this page and any of them will be delighted to help you.

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