

# PRE-BUDGET STATEMENT 2007

## PRIVATE CLIENT BRIEFING

### EDITORIAL COMMENT

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This briefing note concentrates on the radical changes affecting the capital taxation of private clients and the taxation of the non-domiciled. These are of profound significance to the majority of our clients.

The new Chancellor has taken full advantage of the limelight afforded by his first Pre-Budget Report. While his speech may have been delivered without charisma, several of his proposals seemed designed to steal the Opposition's clothes and address the groundswell of popular concern – particularly over the burden of Inheritance Tax on middle Britain. A radical change to Capital Gains Tax was announced with a flourish, whereas the results of the long awaited review of the taxation of foreign domiciliaries were presented against a more detailed critique of recent Conservative proposals – while strangely adopting the underlying principle of an annual tax “fee” where foreign income and gains are taxed only by reference to remittance. The finer details of these proposals remain obscure – the Press Release describing only the broad principles – but there is to be consultation over the proposed revisions, which will apply from 6 April 2008. Foreign domiciled clients already resident here and those planning to arrive will need to review their affairs over the next five months and will await the consultative document with keen interest.

The intention to consult is to be welcomed – though expected in the light of previous assurances – but the scarcity of details given in the HMRC Press Releases is regrettable and perhaps indicates a hasty adoption of an Opposition idea.

The introduction of transferable nil-rate bands for Inheritance Tax (IHT) is likely to be generally welcomed. It is a long overdue reform, as recognised by the fact that the new rules will come into force immediately, and will apply to those previously widowed whenever their spouse (or civil partner) died. There will, however, be rules limiting the amount of additional nil-rate bands available where a spouse has been widowed more than once and the transferability of bands is to be available only on death – and not, for example, to allow a larger lifetime transfer into trust. It is regretted that the opportunity to introduce graduated tax bands has not been taken, although the absence of any measures to restrict potentially exempt transfers is welcome.

The changes to Capital Gains Tax (CGT) are far-reaching, and more fundamental than might have been expected as a reaction to press comment on gains from private equity. Taper relief and (finally) indexation relief will disappear for individuals, and disposals of business assets will no longer be taxed at a favourable rate (although hold-over, roll-over and EIS and VCT reliefs will continue). Instead a flat rate of 18% will apply for all disposals from 6 April 2008, seemingly without transitional provisions. This may seriously affect those who have held assets for many years and may have expected their allowable expenditure to have been significantly increased by indexation and taper relief. Despite some concern, the exemption for principal private residences remains. Again it is surprising that such changes are announced well in advance of draft legislation. Rules for companies remain unchanged and indexation relief will continue to be available.

All in all, this statement may be seen as both radical and a hasty response to matters of current debate. It is to be hoped that the Government will take seriously their commitment to consultation and publish draft legislation in good time for such a process to take place.

Briefing

October 2007

## • DOMICILE AND RESIDENCE:

The Government has finally decided to reform the basis of taxation for foreign domiciled residents. The proposals are announced in outline only and will apply from 6 April 2008. This will permit those affected to consider their position and plan for the new regime and there will be an opportunity for consultation on draft legislation when published.

The headline proposal is for an additional tax charge of £30,000 to be levied on those who elect for the remittance basis of taxation to apply to their foreign income and gains, if they have been resident in the UK for more than seven years. The qualifying period of residence will be retrospective – so individuals who will have been resident for seven years or more as at 6 April 2008 will have to choose whether to accept this charge before 31 January 2009. There is to be consultation on whether a higher charge should apply to those individuals resident for more than 10 years.

The charge will be additional to any tax computed by reference to actual remittances. It will neither be a flat rate tax nor allowable as a credit against any tax calculated on such remittances. Consequently if the charge is paid out of remitted income, the actual cost of the charge to a 40% taxpayer will be £50,000, ignoring other remittances. The charge can be avoided by electing to be taxed on an arising rather than remittance basis. It appears that it will be possible to elect annually between the remittance and the actual basis – though, if confirmed, it seems clear that it will not be possible to avoid tax on subsequent remittances of foreign income or gains which have not been subject to tax on the arising basis.

Furthermore, if an individual chooses to be taxed on remittances, he or she will not be eligible for personal income tax allowances (no mention is made of the CGT annual exempt amount). This restriction will be subject to a de minimis limit that will enable those with unremitted foreign income of less than £1,000 p.a. to claim such allowances. It is unclear whether the de minimis level is also to apply to the additional charge.

The Government also proposes to introduce changes to abolish the “source ceasing” rule and to extend definitions of remittance – presumably introducing a common definition for savings, employment income and capital gains. Techniques for remittance involving gifts offshore may be affected and the value of imported items acquired out of foreign income or gains may have to be taken into account. Irish income will no longer be excepted from the remittance basis.

The Press Release states that changes will reduce the scope for alienation of income and gains through offshore structures and extend anti-avoidance measures. It is therefore possible that

foreign domiciliaries who currently avoid liability on gains realised within trusts will be exposed to tax in the future.

There will be both the need and (apparently) the scope for extensive tax planning between now and 5 April, although some of the changes likely to be introduced (such as the abolition of the ceasing source principle) may limit planning opportunities. Thought will, no doubt, be given to advancing the realisation of income and gains before the imposition of the fixed charge and further consideration may need to be given to remitting gains eligible for full Business Asset Taper Relief in the current tax year. (See below).

The rules for determining residence are to be changed – but only, apparently, to the extent of requiring both days of arrival and departure to be taken into account when determining the length of time spent by an individual in the UK in any tax year. Previously, HMRC’s practice has generally been to ignore these, although recent cases have demonstrated their wish to limit this concession. Such a change is likely to result in more people being regarded as UK resident – and, if not domiciled, qualifying for the additional charge. It is regrettable that the opportunity has not been taken to introduce a comprehensive statutory definition of residence.

Finally, in a discussion document on offshore funds (referred to below), it is proposed that individuals who cease to be resident in the UK and dispose of interests in offshore funds, chargeable to Income Tax, will no longer be able to escape a charge to UK tax should they resume residence within five years.

## • CAPITAL GAINS TAX (CGT):

While some amendment to Business Asset Taper Relief was expected, a major reform of the CGT regime as it applies to individuals, trustees and personal representatives, was not. Companies are not affected by the changes and the paragraphs below do not apply to corporate entities.

There is to be consultation on the proposed changes: draft legislation is not yet available and is not expected until the end of the year.

According to the announcement capital gains will be taxed from 6 April 2008 at the single fixed rate of 18%. Taper relief, only introduced in FA 1998, will no longer be available. Similarly, indexation, first introduced in FA 1982 (and, frozen when taper relief was introduced) will no longer apply to reduce the chargeable gain. The abolition of taper relief and indexation applies to all assets disposed of on or after 6 April 2008 regardless of when they were acquired. Apparently there are to be no transitional provisions.

The abolition of the indexation relief, in particular, may cause hardship to certain taxpayers who have owned assets for long periods before 1998. Further hardship may result from the adoption of 31 March 1982 values for all assets held at that date, even if the original base cost was greater. These changes appear more expedient than equitable.

However, as a consequence, the share identification rules are to be simplified. From 6 April 2008 all shares of the same class in the same company will be treated as forming a single pool. The "same day" and "bed and breakfasting" rules will remain and have priority.

The annual exemption and the capital losses rules will remain unchanged as will other CGT deferral reliefs (such as business asset roll-over, gift relief, Enterprise Investment Scheme CGT deferral relief) and exemptions (such as private residence relief, and relief for qualifying Enterprise Investment Scheme and Venture Capital Trust shares).

All taxpayers, regardless of whether they are individuals, trustees or personal representatives, will pay tax on capital gains at 18%. There will be no relief for inflationary gains and the tax system will provide no incentive to retain investments for the long term/or favourable treatment for gains arising on the disposal of business as opposed to investment assets.

The current CGT rates and provisions will apply to disposals undertaken prior to 6 April 2008.

## • INHERITANCE TAX (IHT) NIL-RATE BAND:

Rather than responding to pressure for an increase in the nil-rate band, the Chancellor has focused on the position of married couples and civil partners. Until now, the nil-rate band of the first to die has often been lost as all assets have been left to the survivor (such a transfer being exempt from IHT). This has led to a "bunching" of estates with only one nil-rate band being available to reduce the ultimate IHT bill.

Where someone who dies:

- is survived by either a spouse or a civil partner; and
- has not fully utilised their nil-rate band

the nil-rate band available on the death of the surviving spouse or civil partner will (subject to certain conditions) be increased by the unutilised percentage of the nil-rate band of the first to die. The actual size of the net estate of the first spouse or civil partner to die is irrelevant.

Draft legislation, notes and guidance are all available on the HMRC website with the promise of more to follow. The legislation will apply where the surviving spouse or civil partner dies on or after

9 October 2007. The date of death of the first to die is irrelevant. Furthermore, no claim is necessary on the first death. The executors will, however, need to record the proportion of the nil-rate band that is unused and retain adequate records to support this figure. Penalties will be applied if a false claim is made.

There are specific rules where an individual survives more than one spouse or civil partner. These provisions ensure that the additional relief due is limited to the value of the nil-rate band on the survivor's death. In other words, relief can be claimed with respect to all the partners the individual has outlived (separate claim forms must be completed for each partner) but the enhanced nil-rate band cannot exceed twice the standard nil-rate band in the tax year of the survivor's death.

The changes should not adversely affect current wills though they will make nil-rate band trusts redundant. Individuals whose wills have been drafted so as to ensure full use of nil-rate bands may wish to consider whether in the light of these changes they would prefer the assets to go absolutely to, or on an interest in pos-session trust in favour of, their surviving spouse or civil partner.

Importantly and surprisingly, the transferability provision will apply regardless of whether the first spouse died before 9 October 2007 – although there are specific rules where the death of the first spouse occurred prior to 18 March 1986. There are also special provisions with respect to the interaction between the transfer of the nil-rate band and certain IHT and capital transfer tax deferred reliefs (such as on heritage assets and woodlands) and also clauses in the draft legislation providing for the unutilised portion of a nil-rate band to be available against Alternatively Secured Pensions, where the IHT charge on the first death has been deferred.

The exemption for transfers between spouses and civil partners is unaffected by the changes.

The combined nil-rate band for 2007/08 will be £600,000, increasing to £700,000 in 2010.

## • PENSIONS AND IHT:

The IHT protection already available to UK registered pension schemes will be extended to UK tax relieved pension savings held in overseas pension schemes.

However, there is also an extension to existing anti-avoidance rules which prevent individuals from using their tax relieved pensions savings to provide inheritances for others. The rules can apply unauthorised payment tax charges where:-

- a scheme member surrenders annuity (or dependant annuity) rights;

- a connected person becomes entitled to an increase in his pension rights under the scheme which is attributable to the member's death.

An IHT charge may also be imposed where a member with a pension scheme or annuity (or a dependant's scheme or annuity) dies aged 75 or over and there is an increase in pension rights attributable to the death of the member or an unauthorised lump sum payment in respect the deceased's pension scheme arrangement.

## • OFFSHORE FUNDS:

A discussion paper on the offshore funds regime has been published. The aim is to simplify the rules which currently distinguish between "distributor" and "non-distributor" status funds. Responses to the paper are required by 9 January 2008.

The terminology will be changed and funds will be designated either as "reporting" or "non-reporting". Reporting funds will be approved by HMRC (as distributor status funds are currently) but it will be possible to obtain approval in advance, so giving investors greater certainty. Inadvertent breaches of the rules will be capable of being remedied.

Rules limiting investment by reporting funds in non-reporting funds will be relaxed but such investments will require either the computation of annual income (as if the fund was reporting) or will need to be valued annually on a marked-to-market basis and income gains recognised accordingly.

"Non-reporting" funds will, broadly, be subject to the Income Tax regime currently applying to non-distributor status funds.

It is also proposed that the test of "material interest" be simplified and that (as mentioned above) individuals who cease to be UK resident for less than five tax years will remain liable to tax on disposals of non-reporting funds.

## • ANTI-AVOIDANCE:

Measures are to be introduced to combat schemes allowing an income tax loss to be claimed on accelerated or up-front interest or a loan that is subsequently repaid. These measures are in response to tax schemes disclosed to HMRC.

## • PAYMENTS ON ACCOUNT:

The level of annual Income Tax liability at which payments on account are required will be increased from £500 to £1,000, but not until the payments on account due for the 2009/2010 tax year, and following.

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