APT

Whatever happened to the 2008 Budget?

Some readers have asked us whether we propose to do a Budget summary this year. So far we've rather "picked at" some of the more important changes, here and there, but we certainly haven't done an overall review.

So the purpose of this piece is, as we have done in previous years, to highlight the tax proposals that we think are likely to be of most interest to Schmidt Report readers, and leave to the daily newspapers the question of whether a family with 2.4 children, a Mondeo and a dog are 50p a week better off or worse off.

Things that have caught our eye in the monster collection of Budget notes (thicker than a telephone directory), which have subsequently been translated into legislationese in the Finance Bill, in no particular order, are:-

- Capital gains tax "Entrepreneurs' Relief"
- The changes for non-domiciliaries
- A new window of opportunity for inheritance tax saving using trusts
- The irritating tinkering with capital allowances
- Lower tax for dividends received from non UK companies
- The kicking into touch of "Isle of Man partnerships"

A Year's Reprieve

One of the more interesting announcements in the Budget, though, isn't in that list at all. The fact is they have deferred the introduction of the so called "income shifting" rules until next year, probably because the more they thought about how these rules worked, the more problems came to light. Those who follow the news in the tax area will know that there was a notable victory by David over Goliath last year, when the "Arctic Systems" case was decided in favour of the taxpayer in the House of Lords. It's worth spending a little time on the

history of this case, which sheds no favourable light on the two-faced hypocrisy of HM Revenue & Customs.

We start off in 1990 or 1991 when the then Chancellor of the Exchequer, Norman Lamont, was introducing the independent taxation of husbands and wives. Following this new move towards women's' equality, wives income that they enjoyed in their own right was to be taxed separately, rather than being taxed on the husband as had always been the case up to then. Good old Norman made it clear that the government, in introducing this legislation, knew that this meant that assets would be passed over from husband to wife so as to use the wife's personal tax allowances, and accepted that this was a natural result of independent taxation.

A mere ten or so years later, HM Revenue & Customs start attacking this as an "abuse" (one of their favourite words which occurs again later in this article) and put forward a convoluted argument that the legislation doesn't actually have the effect that Norman Lamont wanted after all. The taxpayer picked on was poor Mr Jones of Arctic Systems Limited, an IT services company based in West Sussex, whose raison d'etre was principally providing Mr Jones's own services. He arranged for half of the shares in the company to be owned by his wife, and these shares then paid dividends to her. It was accepted that she received more money than would be a fair recompense to her for the work she put in to the company.

At first, the Revenue went for six back years of tax on the basis that the income should be chargeable on Mr Jones rather than his wife. This sent shock waves through the whole owner managed business sector, but particularly the one man service company part of that sector. A lot of people faced the spectre of bankruptcy.

For reasons that are obscure to us, the Revenue later withdrew their claims or threats on the previous five years, and just concentrated on the one year, which became a test case.

After losing in the lower appeal stages, Mr and Mrs Jones were finally triumphant in the House of Lords, that took a comparatively "no nonsense" and straightforward view of the legislation.

Before the ink was wet on the Lords judgement, HMRC were, typically, threatening reprisals in the form of a moving of the goalposts.

The basic idea is that legislation is going to be introduced whereby non arms-length diversions of income are made ineffective. The

trouble is, the goalposts are now so wide they arguably cover the whole pitch! Because these new rules cover an awful lot more situations than have ever been within the scope of anti tax avoidance legislation before.

It also introduces fundamental uncertainty in almost all owner managed business situations. Instead of a relatively (!) straightforward process of drawing up accounts and paying tax on profits, we've now got a situation where grey areas abound as to who should actually be treated as receiving that income. How they get round this problem is anybody's guess.

Entrepreneurs' Relief

This is another U turn in a government with a history of U turns. Until 5 April 2008, all those who sold businesses or business assets had an effective 10% capital gains tax rate, providing they had owned the assets concerned for at least two years. Out of the blue, though, last October, the Chancellor announced that this was being scrapped in favour of a flat 18% rate for everyone. Whether they were trading or just passively investing made no difference.

Leaving aside the baffling question of what the policy for this change was, it was an example of the most terrible PR from the government's point of view, who pay lip service to helping small business but, many small businesses feel, do nothing in the real world except kick them in the teeth.

To cut a long story short, "entrepreneurs' relief" was invented at the last minute as a sop to the small business lobby.

The relief consists of up to £1 million of gains, realised over an individual's lifetime, chargeable at the 10% rate rather than the new 18%. Gains qualifying for relief are those arising where a partnership or sole trader business is sold, shares in the trading company that the individual owns more than 5% in are sold (providing the individual works for the company) and "associated disposals" of assets used by the partnership or company concerned which are sold around the same time as the sale of the overall business.

There is a similar relief for trustees. Gains made on business assets prior to 6 April 2008 are not counted towards the £1 million limit, which is available in full to everyone from that day onwards.

The introduction of entrepreneurs' relief reminds us old stagers of the rules which used to apply for retirement relief before it was abolished.

One big problem with retirement relief was that you only got it if you sold a business or “part of a business”. That didn’t include individual assets of a business, so that, for example, farmers selling a few fields didn’t qualify for any relief at all even though the fields had been used for the business.

One of the biggest casualties of the change, though, is the landlord of commercial property let to trading tenants. Under the old business asset taper relief rules, which are no more, these landlords enjoyed a 10% CGT rate. They will not qualify for entrepreneurs’ relief, though, and their tax rate has effectively therefore almost doubled overnight.

Non UK Domicilaries

The promised £30,000 a year tax charge for the privilege of using the “remittance basis” has been confirmed. This means it’s only those non UK domiciliaries with large income or gains who are going to find it worthwhile to claim the remittance basis in future. To take a simple example, if funds can be deposited at an interest rate of say 6%, and assuming the UK resident but non UK domiciled person is a 40% taxpayer, that taxpayer will need to have non remitted interest of more than £75,000 on which tax at 40% is more than £30,000, before claiming their remittance basis is worthwhile. To get £75,000 of interest income at a 6% interest rate you will need £1.25 million. If an account is joint between husband and wife, you either need to have £2.5 million to make it worthwhile, or you need to put the deposit in the name of one of the spouses only, so that only one of them needs to claim the remittance basis.

It’s no use, either, claiming the remittance basis in a year in which a large item of investment income arises, and then remitting it in a subsequent year when the remittance basis isn’t being claimed. The income will still be taxed on remittance in this situation.

Interestingly, though, there is both good and bad news for offshore trusts where non UK domicilaries are involved. The government seems to have decided that offshore trusts should continue to be available for use as tax avoidance vehicles, because they have reaffirmed, in the Budget, that offshore trusts will continue to be on a remittance basis, if the non UK domiciliary concerned claims it, both in respect of UK and non UK assets. So offshore trusts as a way of saving capital gains tax even on UK property still live. It’s just that, now, in order for a settlor who has an interest in an offshore trust and is non domiciled not to be taxed on any gains the offshore trust makes, he will have to claim the remittance basis and pay his £30,000 in the year the gain arises.

But there is a penalty for claiming the remittance basis in addition to having to pay the £30,000. This is that no personal allowances or capital gains tax annual exemptions are available to such individuals.

And they've changed the rules about periods spent in the UK and the effect this has on a person's residence status. Last October it was suggested that days of arrival and days of departure from the UK should count towards your 91 days a year that is the maximum you can spend in the UK, on average, and remain non resident. This has now been modified in the taxpayers' favour so it is only days of arrival that count. If an individual is present in the UK at midnight, that's counted as a day of presence in the UK for the residence test purposes.

Inheritance Tax: A New Window of Opportunity

Over the last few years, and specially the last few months, we have come to the belief that Gordon Brown must have some kind of random tax law change generator in his garage. He switches this on, and some major change to the way the UK tax system works pops out. The fact that this is completely random can be proved by the way the changes knock on the head previous changes that Gordon Brown himself has made, like with taper relief.

But one particularly random, and vicious, change was that made to inheritance tax in the Finance Act 2006. It's no exaggeration to say that inheritance tax planning is twice as difficult now as it was before.

Before 2006, you could make a gift to a trust for someone, usually the next generation or generations, and there was no inheritance tax on that gift, providing the trust had a "life interest", because the gift was treated as a potentially exempt transfer. That is, you had to live seven years after making the gift.

A person who had a life interest in a trust was treated for inheritance tax purposes as if he or she owned the trust capital, so it was all quite fair and symmetrical. The only difference between a gift absolutely to your child or grandchild, and a gift into a trust where he had a life interest, was the fact that the trustees had discretion over whether they had to pay out capital to the son or grandson.

When a parent or grandparent had some doubts or worries about the financial stability of the proposed beneficiary, therefore, this sort of trust was the perfect solution.

Not any more. Following 22 March 2006, if you make a gift to a trust like this it's chargeable to inheritance tax, so that, if you have a cumulative total of more than the nil band (just over £300,000) of such gifts, you have a 20% lifetime inheritance tax charge to pay. This is almost back to the bad old days before capital transfer tax was emasculated by Sir Geoffrey Howe in 1986 and renamed inheritance tax.

Trusts which were set up with a life interest before 22 March 2006 continue to enjoy the old, favourite treatment, though. And there was another opportunity introduced in a slight sugaring of the pill, which was that life interests in trusts could be transferred to other people at any time before 5 April 2008 and the new life interest beneficiaries would qualify for the old treatment as well. This is ideal planning in situations where, for example, the life tenant of the trust is himself starting to think about inheritance tax planning, bearing in mind that the trust assets are treated as part of his estate for inheritance tax purposes. Without triggering a tax charge, creating this transitional serial interest in favour of, say, his own children, is a good way of preserving the assets in trust, and thus protecting them from financial disaster striking the beneficiaries themselves, but taking the value out of the person's estate (providing the person survives seven years, of course).

The window for creating transitional serial interests was meant to close on 5 April 2008, but it has been announced in this Budget that a further six month period of grace will apply, ending on 5 October 2008.

Anyone with trusts with life interests which existed pre 22 March 2006 (which is likely to most or all of them) should be seriously considering whether to take advantage of this opportunity.

Capital Allowances

Hot off the tax change generator is a change to the way businesses get relief for investment in "plant and machinery". Out (from April 2008) goes the "first year allowance" of 50% or 40% for small or medium sized businesses, and in comes the "annual investment allowance". This is basically an allowance of up to £50,000 or the amount the business has spent on buying new plant and machinery in the period, whichever is the lower. Oh, and the main rate of capital allowance relief has been randomly reduced from 25% to 20%.

Dividends from Foreign Companies

The effect of the notional “tax credit” which shareholders get when they receive a dividend from a UK company is that basic rate taxpayers pay no tax at all on a dividend, and higher rate taxpayers pay 25% of the net dividend received. So if you receive a dividend of £100 net and you are a top rate taxpayer, you have to pay £25 in your self assessment.
For some reason the RTCG (the random tax change generating machine we spoke about) has decided to extend this treatment to dividends from foreign companies as well, even though those companies haven’t paid any UK corporation tax which was meant to be the rationale between the tax credit. (Perhaps the government is afraid of being taken to the cleaners by the EU).

But as always there are conditions and stings in the tail. In this case it is the fact that this is only available if you have less than 10% of the shares in the foreign company.

Double Tax Treaty “Abuse”

A lot of people are very angry about this one. A very clever scheme existed, which we won’t go into the technicalities of as it seems to have been wiped off the face of the earth by the 2008 Budget, where you set up a partnership in the Isle of Man consisting of a reasonably complicated structure of trusts and companies. This trust, which had a UK based settlor and beneficiary, then entered into profitable trading (almost always in property development) and the scheme worked so that the profits accrued to the Isle of Man partnership could be remitted straight to the beneficiary in the UK with no tax, either in the UK or the Isle of Man.
Rumour has it that there were several hundreds of £millions leaking out of the UK’s tax net as a result of these schemes, but the way they stopped them is distinctly below the belt.
The Budget notes promise legislation in the Finance Act 2008 to “clarify, retrospectively, legislation introduced in 1987, which itself was retrospective, so that it has effect as intended.”

You can always be sure that where those introducing legislation in this country use the word “clarify”, what they really mean is “change”, and the word is always used where the subject is being kicked in the teeth by the civil servants.

Presumably because this new measure is aimed at those wicked people who “abuse” the rules, the legislators are not being as coy as they usually are about admitting that they are bringing forward retrospective legislation.

Retrospective legislation, that is where law is introduced now which is treated as having been effective from before it was introduced, is effectively the death of legislation. On our shelves as we write this, are four very fat tomes printed on very thin paper which contain most of the UK's tax legislation. We might as well take those books off the shelf and throw them in the bin, if retrospective legislation is going to be allowed, because the government can, it seems, turn round to us and say that the law wasn't how it was actually written in the books at the time we entered into transactions relying on it. So you wonder what the point is in having it written in the books in the first place.

More positively from the point of view of this magazine, the tax avoidance industry, always good at rolling with the punch, is thought to be busily at work on replacements to the Isle of Man scheme. You can't keep a "good" man down!

Alan Pink FCA ATII is a specialist tax consultant for APT. Based at their Tunbridge Wells office, Alan advises on a wide range of tax issues and regularly writes for the professional press. Alan has experience in both major international plcs and small local businesses and is recognised for his proactive approach to taxation and solving tax problems. Please send an email to info@aptpartner.com if you would like to contact Alan.

The information contained in this article is for general guidance on matters of interest only. The application and impact of laws can vary widely based on the specific facts involved. As such, it should not be used as a substitute for consultation with professional accounting, tax, legal or other competent advisers. Before making any decision or taking any action, you should consult an APT professional. You can contact an APT consultant on (01892) 539000.