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2007 PRE-BUDGET REPORT SUMMARY

Chancellor Alistair Darling presented his first Pre-Budget Report on Tuesday 9 October 2007.

The speech itself may have seemed short but the detail was in the accompanying press releases and other documents. The main proposals, which included some major changes, are set out below.

- The abolition of taper relief and indexation allowance for capital gains tax (CGT)
- The introduction of a flat rate of CGT for individuals of 18%
- A significant change in inheritance tax relief for married couples and civil partners
- Non domiciles to pay an annual charge of £30,000 for their tax advantaged status
- Proposals to stop the tax savings available to businesses by income shifting between family members
- An increase in the car fuel scale charge

You will find more detail in the following summary. Please do get in touch if you have any questions.

PERSONAL TAX

Tax rates for 2008/09

As previously announced the government proposes to radically change the tax rates for 2008/09 onwards when the 10% starting rate will be abolished for earned and pensions income and the 22% basic rate of tax will be reduced to 20%. The higher rate of tax will continue at 40%.

The starting rate will continue to be available for savings and investment income. There are no changes to the tax rates applicable to dividends. However the rate of tax applicable to capital gains will change significantly to a flat rate of 18% for 2008/09 (see Capital Taxes section).

The income tax bands for 2008/09 were not announced in the Pre-Budget Report. Details of these are normally made available in the main spring Budget.

Comment

Gordon Brown had previously announced the reduction of the basic rate of tax by 2% in the Budget earlier this year. He also announced that the point at which people start paying the higher rate of tax will be increased significantly to £43,000 from 2009/10.

There is, however, a significant sting in the tail for some of those with earned income. The changes in the upper earning limit for NIC (see Employment Issues) will largely negate the income tax savings for many.

Allowances

The Chancellor did not announce the level of income tax allowances for 2008/09. The current personal allowance for those under the age of 65 is £5,225.

Tax Credits

There are two types of Tax Credits; Working Tax Credit (WTC) and Child Tax Credit (CTC). The CTC is potentially available to families who have responsibility for one or more children. There are several elements to the credit but broadly the maximum is an annual amount for 2007/08 of £1,845 per child together with a family element (generally one per family) of £545 per annum. The amount per child has been increased but the family element has been frozen since the introduction of the credit.

Some credit is likely to be payable for 2007/08 if a family's income is less than £58,175 a year, or £66,350 if there is a child under one year old.

The government announced that from April 2008:

- the child element of Child Tax Credit will increase by £25 above earnings indexation, in addition to the £150 increase earnings indexation already announced in the Budget

- the income threshold for Working Tax Credit will increase to £6,420

- a higher rate of taper will apply for those in the fast taper band (up from 37% to 39%).

Pensioners

The Chancellor has announced that from April 2008 the Pensions Credit will be increased to a minimum of £124 for single pensioners and £189 for couples.

Payments on account (POA) threshold

Individuals who complete a self assessment tax return have to make direct payments to HMRC of their income tax and Class 4 national insurance contributions. The POA are made on 31 January and 31 July each year with a balancing payment for the tax year being made by 31 January following the end of the tax year. The POA are broadly made by reference to the previous year's liability. POA are not due where more than 80% of the previous year's liability was met by tax deductions at source from income such as employment or savings.

Currently where the previous year's liability is less than £500 no payments on account are due and the taxpayer just makes one payment on 31 January following the end of the tax year of their full liability.

From 2009/10 the £500 threshold will be doubled to £1,000. The first POA affected by this change will be those due on 31 January and 31 July 2010.

Comment

This measure is expected to remove 367,000 taxpayers from POA most of which have business income.

Residence and domicile

The government has announced the completion of the residence and domicile review with a package of reforms which will take effect from April 2008.

The main proposal is that UK residents who are non-domiciled, who wish to continue to be taxed on a 'remittance basis' rather than on their worldwide income and gains, will have to pay an annual charge of £30,000. This measure is being introduced to ensure that they contribute in respect of the foreign income and gains which they keep abroad and on which they do not pay UK tax. The charge will apply if they have been resident in the UK for more than seven years.

Other proposals include:

- users of the remittance basis will lose their automatic entitlement to the personal allowance, currently £5,225, subject to a de minimis

- to ensure that when determining if an individual is resident in the UK, days of arrival and departure are counted

- to amend the current rules to remove flaws and anomalies that allow individuals who are assessed only on a remittance basis to sidestep UK tax where it is due on income and gains.

The government will consult on the detail of these proposals and on a wider range of options, including an option to make those individuals who are resident in the UK for more than ten years contribute more.

Pensions

The government proposes to extend the existing rules to prevent the abuse of pensions tax reliefs through members surrendering rights under registered pension schemes during their lifetime or through reallocation of assets after a member's death.

The measures will have effect for surrenders made on or after 10 October 2007 and for increases in pension rights attributable to the death of a member when the member dies on or after 6 April 2008.

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EMPLOYMENT ISSUES

Company cars and the fuel scale charge

Where a car is provided for an employee's private use, a taxable benefit arises which is based on the list price of the car and its CO2 emissions. The percentages range from 15% to 35% for most cars. There are currently discounts available for environmentally friendly cars and from 6 April 2008 there will be a 2% discount for cars that have been manufactured to run on E85 fuel.

If free fuel is provided for private motoring then a fuel benefit tax charge arises based on the percentage used for the car benefit and a 'multiplier', which is currently £14,400. For 2008/09 the figure will increase to £16,900.

Comment

The fuel scale charge figure has not changed since it was introduced in 2003. This rise, combined with an increase in the car benefit percentages for 2008/09, means that many employees will see a substantial increase in their tax bills from next April.

Employers should seriously consider whether the fuel benefit is worth maintaining, as the associated Class 1A payable by employers on benefits in kind will also go up.

National Insurance Contributions (NICs)

In the last Pre Budget Report, all of the NIC rates were announced for the forthcoming year but, this year, no rates at all were announced!

In this year's Budget, significant proposed changes to the limits between which NICs are payable were announced. For 2008/09 the upper earnings limits (UEL), above which employees continue to pay contributions of 1% on earnings, will be increased by £75 per week above indexation.

The upper profits limit for Class 4 national insurance for the self-employed will also be increased in 2008/09 by £75 per week above indexation.

In the following year the upper earnings limits will be aligned with the point at which the higher rate of income tax becomes payable.

Comment

The government claims the increases in national insurance are aimed at simplifying the tax system but it comes at quite a cost to employees and the self-employed.

Other NIC changes

Under an exemption that has existed since at least the 1960s, employers in the construction industry can pay into a third-party pooled holiday pay scheme, from which employees receive their holiday pay. There is no liability to deduct employer and employee NICs on that payment.

HMRC have become aware that this exemption is being used by large employers of workers outside the construction industry, putting significant amounts of revenue at risk. From 9 October 2007, the exemption is withdrawn for all businesses but the construction sector. For the construction sector, a five year transitional period will be introduced before the exemption is withdrawn completely on 30 October 2012.

CORPORATE AND BUSINESS TAX

Income shifting

In July 2007 Mr and Mrs Jones won their case in the House of Lords. The profits of Arctic Systems (their company) which were paid equally to them by means of dividends would be taxed on each of them rather than solely on Mr Jones. The government believes it is unfair for one person to arrange their affairs so that their income is diverted to a second person, subject to a lower tax rate, to obtain a tax advantage.

The government has announced that draft legislation to take effect from 2008/09 to address income shifting will shortly be issued for consultation. The legislation will work alongside the existing rules on businesses deductions and settlements, and will seek to remove the tax advantage obtained from income shifting. It would only apply when the income is in the form of distributions from a company (dividends) or partnership profits.

HMRC will provide ‘practical guidance’ on the legislation as to the circumstances which may not be caught by the legislation. Relevant factors to consider when establishing whether or not income shifting has taken place could include the work done by the individuals in the business, the investments made and the risks to which they are subject through the business.

Income from employment, interest on savings and any other source will not be affected.

Comment

Legislation was widely expected following the Arctic Systems case. We await the publication of the draft legislation with interest!

Tax simplification reviews

The government has announced the start of a 'significant programme of tax simplification'. Three reviews will be started in the autumn where HM Treasury and HMRC will work in partnership with business to evaluate how a range of tax policies could be simplified. These initial reviews will cover:

- how to simplify VAT rules and administration in the UK and the EU
- how anti avoidance legislation can best meet the aims of simplicity and revenue protection
- how to simplify the corporation tax rules for related companies.

VAT rules and administration

Areas where simplification will be of most significance to all VAT registered business include:

- Partial Exemption and the Capital Goods Scheme
- the frequency with which businesses submit returns
- VAT retail schemes.

Comment

There are 1.9 million VAT registered organisations in the UK. The VAT system already contains a wide range of schemes and methods, many targeted at smaller businesses, designed to simplify administrative requirements. However business has told the government that it would like to see further simplification.

Corporation tax rules for related companies

Areas where simplification will be of most significance to UK companies include:

- associated company rules for small companies corporation tax rate
- group aspects of corporation tax on chargeable gains
- corporation tax self assessment filing and payment for groups
- the burden of the transfer pricing rules.

Comment

There are over one million active companies in the UK, many of which have related companies, either as part of a wider company group, or because of association through common ownership. These relationships may complicate their tax affairs, and simplifying the corporation tax treatment of related companies could help reduce administrative and compliance burdens.

Spreading of tax relief for pension contributions

Employers generally get tax relief against their taxable profits for contributions paid to a registered pension scheme. Relief is given for the accounting period in which the contributions are paid. Tax relief for some large contributions above £500,000 maybe spread over a period of up to four years.

Legislation will be introduced in Finance Bill 2008 to ensure that the rules that spread tax relief for large employer pension contributions relative to their contribution in the previous year cannot be circumvented. This measure will have effect for payments made on or after 10 October 2007 under binding obligations entered into on or after 9 October 2007.

The measure will ensure that the spreading of contributions cannot be avoided by routing them through a new company.

Other anti-avoidance measures

Action is being taken to counter various avoidance schemes:

- financial products - disguised interest (and thus taxable) as dividends (which are exempt from tax for companies)
- abusing the availability of interest relief through the payment of interest in advance
- avoidance involving the sale and finance leaseback of plant or machinery and attempts to exploit long funding leases to create a tax loss where there is little or no commercial loss.

Company gains on life policies

Legislation will be introduced in Finance Bill 2008 to bring all life insurance policies and life annuity contracts to which a company is a party, other than protection-type policies, within the loan relationships legislation that is used to tax debts and debt-like instruments.

The special legislation that currently applies to such policies held by companies (‘the chargeable events’ rules) will therefore be repealed.

Comment

In practice very few companies own life policies and annuity contracts partly because of the archaic chargeable event rules. Where such policies and contracts are used for investment, economically they resemble debt-like instruments. Under this measure they will be taxed as such under the loan relationships legislation which is a far more sensible taxation system.

Tax relief for business cars

In March 2007 the government issued a second discussion document about business expenditure on cars.

The proposals are that:

- the existing 100% first year allowances for cars with CO_2 emissions up to 120g/km be retained
- the general plant and machinery capital allowances pool will be used for cars with CO_2 emissions between 121 and 165g/km
- a new car pool would be introduced with a lower writing down allowance than the general plant and machinery pool for other cars.

As a consequence there would no longer need to be a specific distinction between cars costing more or less than £12,000.

The government has issued a summary of the responses to the proposals. The majority of the respondents supported reform of the current system but views were divided as to what would be a preferable system. In the light of this, the government has not indicated its next steps to modernise the tax relief system.

Fire safety capital allowances

Legislation extending capital allowances to expenditure on building alterations, made in response to a notice from a Fire Authority, is to be repealed for expenditure from April 2008.
Relief for expenditure on fire safety equipment such as fire alarms and sprinkler systems will continue to be available for all businesses.

Comment

The repeal sounds more severe than it actually is. The rules giving relief for fire safety alterations were introduced in 1974 to encourage businesses to ensure that existing buildings met fire safety standards. But since that date fire safety legislation has been reformed and now operates on a self-assessment basis. The tax relief provision applies only to those who have not complied with fire safety requirements and, as a result, are issued with a prohibition notice by a Fire Authority. To ensure that this does not encourage businesses to delay vital safety improvement work, the relief is being removed.

VAT and housing

Currently VAT is chargeable at 5% on renovations or alterations to residential properties that have been empty for at least three years.

Eligibility for this reduced VAT rate will, on and after 1 January 2008, apply to renovations or alterations carried out to residential properties that have been empty for at least two years.

CAPITAL TAXES

Capital gains tax (CGT) reform

The Chancellor surprised everyone with major changes to the CGT regime. Legislation will be introduced next year to give effect to a new single rate of charge to CGT at 18%. A number of changes will be made for disposals made on or after 6 April 2008 to simplify the capital gains tax regime, including:

- the withdrawal of taper relief
- the withdrawal of indexation allowance
- simplification of the share identification rules.

CGT annual exemption

The annual exemption allows the first element of chargeable gains made in a given tax year to be exempt from CGT. An annual exemption will remain in place and for 2007/08 this is currently £9,200.

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CGT rates of tax

Individuals making capital gains currently treat those gains as the top slice of income. This means that, currently, tapered gains are charged at 10% where gains plus taxable income do not exceed £2,230; 20% between £2,231 and £34,600; and 40% on any balance. For trustees the rate of CGT is 40%.

For 2008/09 there will be a single rate of capital gains tax set at 18%, which will apply to individuals, trustees and personal representatives.

CGT reliefs

Taper relief was introduced for disposals on or after 6 April 1998 and can reduce the amount of the gain chargeable to CGT. The amount of relief available depends on whether the asset is classed as a business or non-business asset and, also, on the length of time an asset has been held since 1998.

For disposals on or after 6 April 2008 and any held over gains coming into charge on or after that date, taper relief will no longer be available. The chargeable gain will be liable to tax at 18%, after deducting allowable losses, any other reliefs and the annual exemption.

Indexation allowance was, for individuals and trustees, the precursor to taper relief and gave relief for the effect of inflation on the costs incurred on assets. Indexation was frozen as at 5 April 1998. Currently, where an asset was held at 6 April 1998 and is disposed of after that date, any gain on the disposal may be eligible for indexation and taper relief.

For disposals on or after 6 April 2008 indexation allowance will no longer be available.

Simplification of the share identification rules

The current rules for the identification of shares and securities for CGT purposes require a complex order of identification, which is dependent upon the dates when the assets were acquired.

Due to the changes to taper relief and indexation allowance, all shares of the same class in the same company will be treated as forming a single asset from 6 April 2008, regardless of when they were originally acquired. However certain anti avoidance rules will remain.

Comment

The major changes announced will mean that CGT calculations will become a lot simpler. However although an 18% rate of CGT sounds low, there will be many losers.

Consider a higher rate taxpayer who makes a gain on £1m on a business asset. Business asset taper relief is available at 75%, so, in simple terms, only £250,000 is chargeable at 40%, a bill of £100,000.

Under the new rules, the whole of the £1m is chargeable at 18% a bill of, £180,000. Simplification may come at quite a price!

Inheritance tax (IHT) threshold

The IHT nil rate band was increased to £300,000 with effect from 6 April 2007.

Transfers of property between spouses or civil partners are generally exempt from IHT. This means that if an individual dies and leaves some or all of their property to their spouse or civil partner, they may not have fully used their nil-rate band.

The new rules will allow any nil-rate band unused on the first death to be used when the surviving spouse or civil partner dies. The transfer of the unused nil-rate band from a deceased spouse or civil partner, irrelevant of the date of death, may be made to the estate of their surviving spouse or civil partner who dies on or after 9 October 2007.

The amount of the nil-rate band available for transfer will be based on the proportion of the nil-rate band which was unused when the first spouse or civil partner died.

For example, on the first death none of the original nil-rate band was used because the whole of the estate was left to the surviving spouse. If the nil-rate band is £350,000 when the surviving spouse dies, it would be increased by 100% to £700,000.
Comment

This is an interesting way of addressing a problem that has arisen over recent years, namely that house price increases have meant that many people have been dragged into the IHT net. Certainly the change will help address this issue.

Stamp Duty and Stamp Duty Land Tax (SDLT) changes

To continue the theme of simplification, further changes are proposed from next year.

Firstly for transactions involving residential and non-residential property where the chargeable consideration is less than £40,000, there will no longer be a need to notify HMRC about the transaction.

Secondly transfers that currently attract stamp duty not exceeding £5 will be exempt and will not have to be presented for stamping.

Finally for transactions that occurred on and after 19 July 2007, where there is a transfer of an interest in a property within an investment partnership, there will be no charge to SDLT.

Planning Gain Supplement (PGS)

The PGS has been the subject of consultation since 2004 and, although no definite start date has yet been announced, it is expected to be introduced where planning permission is granted after 31 March 2009. The following principles have been established:

- the PGS will be levied at a flat rate on the difference in the value of land without planning permission and the freehold value with full planning permission
- both residential and commercial developments will be included
- there is unlikely to be any exemption for small scale developments such as building a single house in a back garden
- the developer will pay the PGS within 60 days of the date the development commences
- the developer will have to self assess the PGS and obtain the necessary valuations.

Comment

The PGS is designed to encourage landowners to release land for development, although how a tax on this action will achieve this aim remains to be seen. Landowners and developers need to consider the impact of the PGS on proposed developments that may not commence until after 31 March 2009.

OTHER MATTERS

Aviation tax

The government has announced that it intends from 1 November 2009 to replace Air Passenger Duty (APD) with a tax payable per plane rather than per passenger. The government will consult with the industry on the detail of this tax.

It was also announced that amendments will be made to the current definitions to determine the class of travel for APD. The change will remove an anomaly whereby passengers on 'business class only' flights are currently liable for reduced rates of APD. The government proposes using seat pitch, more commonly referred to as leg room, to help determine classification. This measure will take effect for journeys on or after 1 November 2008.

Vehicle Excise Duty (VED)

The government has announced inflation only increases on motorcycle VED rates in 2008/09.

VED rates for special types of vehicles, combined transport vehicles and all vehicle categories linked to the basic goods rate will be frozen.

It announced on 1 October 2007 that VED rates for heavy goods vehicles will be frozen in 2008/09.

All changes take effect for licences commencing from 1 April 2008.