

# Budget 2007 capital taxation issues for Clients of the Private Wealth Department

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## Budget Highlights

After the seismic changes to the taxation of trusts introduced in the 2006 Budget, the Chancellor opted for a tinkering Budget, making no substantial changes to the personal tax regime, tightening up various anti-avoidance provisions, amending the rules regarding filing, enquiries and penalties and also giving some comfort to taxpayers, particularly those with homes abroad.

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

### 1. Overseas properties

In a welcome announcement that will have owners of holiday homes in France and Spain breathing a sigh of relief, the Government announced that Finance Bill 2008 will contain legislation (having retrospective effect) confirming that where UK residents own foreign property through overseas companies, the benefit in kind tax charge for use of those properties by directors (or shadow directors) will not apply. Subject to any changes made during the consultation period, the exemption will only relate to companies owned by individuals, where the property is the only or main asset of the company, the activities of the company are incidental to the ownership of the property and the property is not funded by a loan from a connected company.

This will be of comfort to those persons who own French properties through SCIs and Spanish properties through local companies. The risk of the rules applying in respect of UK properties held by companies remains.

### 2. Residence and domicile

The Government continues to review the UK residence and domicile rules as they affect individuals. It appears unlikely that any imminent changes will be made in this regard.

### 3. Status of shares listed on the Alternative Investment Market ('AIM')

At present, shares in trading companies listed on AIM are treated as unquoted for the purposes of business asset taper relief and business property relief for inheritance tax, which generates significant tax advantages.

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There has been growing concern that the Government will change this treatment and treat shares listed on AIM in the same way as shares listed on the London Stock Exchange. Currently, this would require primary legislation. However, legislation announced today to be included in the Finance Bill 2007 will allow HMRC to make this change by order. There is no indication that a change in AIM's status is currently proposed.

**4. Self-assessment filing dates, enquiry windows and penalties**

As expected following the Carter Report, changes will be made to the self-assessment income tax return filing dates for individuals, trustees and partnerships.

For 2007/08 tax returns, and those in subsequent years, there will be two separate filing dates.

For paper returns, the new date will be 31 October (i.e. 31 October 2008 for 2007/08) although the date for online returns will remain 31 January (31 January 2009 for 2007/08). A calculation of tax liability is provided automatically where returns are filed online. For paper returns, the cut off date for those wishing HMRC to calculate their tax liability for them will move to 31 October from 30 September.

An "enquiry window" is the period during which HMRC can enquire into a self-assessment tax return. Presently, where a return is received on time, the enquiry window runs until the anniversary of the filing deadline, 31 January after the end of the tax year to which the return relate. For income tax self-assessment returns for 2007/08 and in subsequent years, the enquiry window will close on the anniversary of the date the return was filed, sooner than it would have previously done if the return was submitted before the deadline.

A single penalty system will be introduced for inaccurate tax returns, claims and accounts relating to income tax, corporation tax, PAYE, National Insurance and VAT. The new provisions will apply penalties based on (1) the amount of tax understated and the (2) circumstances of the inaccuracy. There will be no penalty where a taxpayer has made a genuine mistake and moderate penalties where the taxpayer took reasonable care. An unprompted disclosure by a taxpayer should substantially reduce the penalty.

**5. Pre-owned assets - late elections**

As an alternative to the pre-owned asset income tax charge, taxpayers can elect for property that would otherwise be within the pre-owned asset income tax charge to be subject to inheritance tax in their estates. The deadline for making such an election is 31 January after the tax year in which the taxpayer would be liable for the income tax charge, with the first deadline having arisen on 31 January 2007 (for the tax year 2005/06).

The Finance Bill 2007 will include provisions allowing HMRC to accept late elections for that first deadline and subsequent deadlines.

## 6. Capital gains tax: a targeted anti-avoidance rule

As announced in the Pre-Budget Report, Finance Bill 2007 will extend the restriction on allowable capital losses, which was introduced for companies in Finance Act 2006, to individuals, trustees and personal representatives for disposals on or after 6 December 2006. The new section 16A TCGA 1992 (which will replace section 8 TCGA 1992 which applied only to companies) will provide that where a person enters into arrangements and the main purpose of those arrangements is to gain a tax advantage by creating an artificial capital loss, any resulting loss will not be an allowable loss for the purposes of capital gains tax, income tax or corporation tax.

The provision aims to restrict allowable capital losses to those arising from genuine commercial transactions. HMRC have issued today revised guidance on how this rule will operate.

## 7. Changes to Alternatively Secured Pensions ('ASPs') rules

The Chancellor has again confirmed his opposition to ASPs being used as a mechanism to avoid the compulsory purchase of an annuity at the age of 75, or to leave a tax-free capital sum that can be passed onto future generations.

At the age of 75 instead of being forced to purchase an annuity with a pension fund, an individual can still enter into an ASP and draw income directly from that fund. In the Pre-Budget Report the Chancellor announced that the minimum income draw down requirement would be 65% of a comparable annuity bought with the ASP fund for a 75 year old. In response to a consultation process, the minimum income requirement will be reduced to 55%.

The maximum annual income draw down is to remain 90% of the annual amount of a comparable annuity bought with the ASP fund for a 75 year old.

In the Pre-Budget Report it was announced if, that on the death of an individual in ASP, or on the death of a dependant who has inherited the benefit of an ASP fund from such an individual, any remaining funds are transferred to the pension funds of other members of the same scheme, there will be an immediate tax charge of up to 70%, called an unauthorised payment charge. The rules on how the unauthorised payment charge interacts with inheritance tax are to be clarified.

There will be an inheritance tax charge at 40% and an unauthorised payment charge of up to 70% on the same ASP funds, but where the unauthorised payment charge is deducted before inheritance tax is paid, the inheritance tax due is calculated by reference to the net value of the ASP funds and vice versa. Although inheritance tax will not be due on the ASP funds that are used to pay the unauthorised payment charge, and vice versa, the overall tax burden on ASP funds on death is severe.

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Specific inheritance tax legislation will be introduced to deal with individuals who die leaving property chargeable to inheritance tax net of their ASP funds worth less than their nil-rate band (£300,000 after 6 April 2007). The aim of this legislation is to ensure that where there is an unauthorised payment charge and an inheritance tax charge on ASP funds, the aggregate of the two tax charges is the same regardless of the order in which the taxes are charged.

The above changes will come into effect on 6 April 2007.

HMRC have today announced a consultation 'on measures that will be introduced to prevent ways of inheriting tax-privileged pension savings'. It is likely that there will be further changes to limit the use of UK registered pensions as a means of transferring capital to future generations.

### **8. Life insurance policies and commission arrangements**

Under an amendment to the taxation of medium-term life insurance, capital redemption policies and life annuity contracts, commission which is passed on to the policyholder or reinvested in the policy will be subject to tax in certain circumstances.

Previously, it was possible for the amount of any rebated or reinvested commission to be outside the charge to tax with respect to gains arising on the surrender, maturity or assignment of a policy or annuity. Under an amended definition of 'premium' for these purposes, the amount of any premium deductible in calculating the gain arising on surrender, maturity or assignment will be reduced by the amount of any commission passed on to the policyholder, or the amount of any commission waved by an intermediary and reinvested in the policy.

The amended definition of premium will apply in cases where the premiums paid are in excess of £100,000 in a tax year and the policy or annuity matures, is surrendered or assigned before the end of the third tax year after that in which the premium threshold is exceeded. The changes will have effect for all policies and contracts made on or after 21 March 2007, and to all existing policies or contracts where the benefits secured are increased on or after today either by a variation of the policy or contract or by the exercise of an option.

It will be important to carefully review the implications of any changes to existing policies in light of the potential application of the new rules to existing policies from today.



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## 9. Changes to the offshore funds regime - restrictions on tax efficient fund structures

HMRC announced today a series of changes to the taxation of offshore funds. Offshore funds are specifically defined in TA 1988 and include the great majority of non-UK collective investment schemes which do not distribute approximately 85% of their income each year, including hedge funds. Returns on the disposal of a material interest in an offshore fund are subject to income tax at 40%. This compares unfavourably with investments which benefit from the application of taper relief, under which the effective rate of tax can be as low as 10%.

It has been possible to structure a fund to fall outside the regime by imposing a six month lock up during which investors could not realise their interest. Where such a lock up applied investors could benefit from taper relief and were no longer subject to income tax on the disposal of their interest. Under changes announced today this will no longer be possible and with effect from 1 January 2007 a seven year lock up will instead be required. This is far less commercially viable and raises an interesting question as to whether existing funds with six month lock up periods will be affected by these changes. This should be clarified when draft legislation is available.

Under a further amendment to the offshore funds regime announced today, the current restriction, which effectively limits the capacity to be certified as a distributor status fund to two layer fund of fund structures, will be removed. Additionally, losses arising on the disposal of interests in offshore funds will only be capital losses and not income losses.

## 10. Taxation of personal dividends - alignment of taxation of dividends paid by UK and non-UK resident companies

HMRC today announced a change in the treatment of dividends received by UK residents from non-UK resident companies.

Under the present regime dividends paid by UK resident companies carry a non-refundable one ninth tax credit, which results in an effective 25% income tax rate for higher rate taxpayers. By contrast, dividends paid by non-UK resident companies carry no tax credit, and are subject to income tax at 32.5% for higher rate taxpayers.

With effect from 6 April 2008, this mismatch will be corrected, and dividends from non-UK resident and UK resident companies will be subject to income tax at 25% for a higher rate taxpayer. This will be achieved by the creation of a non-refundable one ninth tax credit for foreign dividends.

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The aligned treatment is subject to restrictions. It will only apply to investors with an interest smaller than 10% in the non-UK resident company, and only where they receive less than £5,000 foreign dividend income a year. The Government is considering whether the alignment can be extended so that certain other individuals can benefit from the non-refundable tax credit, without giving rise to abuse.

The aligned treatment may be in part a response to the Manninen case. In that case the European Court of Justice held that where entitlement to a dividend credit was restricted where the paying company was not established in the state in which the recipient was resident, this was contrary to EU legislation. The ruling was not against the UK, but was subject to much scrutiny as it was of direct relevance to the UK dividend regime.

It is not clear whether the proposed changes fully address the position. Nevertheless, the changes will enable offshore investment structures such as SICAVs to compete on a more equal footing with UK resident investment companies.

**11. Islamic finance - sukuks**

Sukuks are a type of investment bond that replicate the economic effect of debt securities on which interest is payable so as to satisfy the Shari'a law prohibition on paying or receiving interest.

Legislation will be introduced in Finance Bill 2007 to ensure that sukuks are taxed on a par with equivalent conventional debt securities. The changes will apply to amounts received or paid on or after 6 April 2007 for income tax purposes and 1 April 2007 for corporation tax purposes.

Amounts paid by the issuer to the holder will be deductible by the issuer under the tax rules on loan relationships, and taxable as if they were interest where the holder is subject income tax, or under the loan relationship rules where the holder is subject to corporation tax. For non-corporates any gain on the disposal of a bond by a person will be taxable under the capital gains tax rules, unless treated under the new rules as a qualifying corporate bond, and for companies will fall within the loan relationship rules. Bonds that are convertible into, or exchangeable for, shares will be taxed in the same way as conventional convertible or exchangeable securities.

**12. Charities**

The key provision in the 2007 Budget affecting charities and charitable donors is a relaxation of the upper limit on the value of benefits that a donor may receive in consequence of a Gift Aid payment to charity. Under the current rules, a charitable donation will be ineligible for Gift Aid if the donor receives a benefit as a result of the donation in excess of a prescribed upper limit. In the case of donations in excess of £1,000, this upper limit is at present 2.5% of the value of the donation, but for donations made on or after 6 April 2007 this will be doubled to 5% of the value of the donation, subject to an overriding maximum limit of £500 (previously £250) per donor in any one tax year.

The proportional limits on donations less than £1,000 will remain the same.

The change applies to both individual and corporate donors, and will also apply to donations made to Community Amateur Sports Clubs.

### 13. Employee benefit trusts ('EBTs')

Draft legislation has been issued which, if enacted, will have the effect of closing a perceived loophole in the anti-avoidance regime applicable to EBTs. At present, Schedule 24 FA 2003 and sections 38 to 44 Income Tax (Trading and Other Income) Act 2005 restrict the level of deductions that an employer can claim against its taxable profits for contributions made to an EBT. These provisions currently only apply where the employer has transferred money or assets to a third party (usually an independent trustee). HMRC have become aware of schemes which involve the employing company itself acting as trustee of an EBT, rather than a third party. The draft legislation amends the existing rules by removing the reference to third parties, so catching contributions to all EBTs, whoever the trustees may be. The amendments will have effect for contributions made to EBTs on or after 21 March 2007.

It should be noted that contributions made before that date to an EBT of which the employer company is trustee will not necessarily be allowed as deductions against taxable profits. HMRC may still seek to argue, for example, that general accounting principles will restrict their deductibility.

### 14. Trust modernisation - taxation of capital receipts

As previously announced, the Finance Bill will contain amendments to the rules regarding capital receipts by trustees on the purchase of a company of its own shares and the interaction of the tax pool rules with the chargeable events legislation, to correct omissions.

### 15. Stamp duty land tax ('SDLT')

A number of minor changes have been made to the SDLT regime including:

New zero carbon homes costing up to £500,000 will be exempt from any SDLT liability on purchase and any liability to SDLT for purchases in excess of that amount (taxable at 4%) will be reduced by £15,000. The definition of a zero carbon home has yet to be set out, but will include a stringent heat efficiency standard and the ability to provide onsite renewable (i.e. non-fossil fuel) heat and power. The relief will only apply to newly built homes and will not apply on second or subsequent sales.

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The Finance Bill 2007 will provide that land transaction returns will no longer have to be accompanied by the payment of the SDLT due. However, SDLT due will still have to be paid by the filing date. Self-certificates (declaring that no SDLT is payable) will be amended to include provision for the declaration to be made by the purchaser's agent.

Exchanges of property between connected persons will no longer be linked and so property values will no longer be aggregated for the purposes of determining the rate at which SDLT is payable.

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*Taken from commentary issued by the Society of Trust and Estate Practitioners (STEP) STEP Worldwide, 26 Grosvenor Gardens, London, SW1W 0GT, United Kingdom. [www.step.org](http://www.step.org).*

*STEP is the professional body representing the trust and estate profession worldwide. All of the qualified staff in the Private Wealth Department of Mundays LLP are either full or student members of STEP.*

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