McKie&Co

TAX PLANNING BULLETIN

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Introduction

We are sending this bulletin just 39 days before major upheavals in Capital Gains Tax and the taxation of non-domicillaries come into effect. Those changes were announced almost five months ago and yet we still await draft legislation for significant parts of the new regime. It now appears likely that draft legislation will not be available until Budget Day on the 12th March.

Taxpayers are faced with the difficulty of making significant decisions on the basis of Government statements which are, at best, imprecise and in some particulars, deliberately misleading. As advisers we must formulate plans for our clients and be prepared to adjust them quickly when the new legislation is available.

As always, we shall be happy to help in that planning process.

Sharon McKie **Simon McKie**

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INDEX

SECTION NO.	SECTION
I	**Residence and Domicile**
II	**Capital Gains Tax**
	1. Draft Legislation Published
	2. Entrepreneur's Relief
	3. Qualifying Corporate Bonds
III	**Inheritance Tax**

SECTION I

RESIDENCE AND DOMICILE

As you will no doubt have read the draft legislation in respect of the proposed amendments to residence and domicile has now been published together with explanatory notes (if you can call them that) and a number of frequently asked questions. Since then there has been widespread criticism of the legislation and its effects which has resulted in a letter from Dave Hartnett, Acting Chairman of HMRC, dated 12th February 2008, designed to defuse this unfavourable publicity. Unfortunately, the letter is so vague that, until revised draft legislation is published, the scope of the changes will be very uncertain.

The draft legislation which we do have makes a series of changes which are discussed below.

Days of Arrival and Departure

From 6th April 2008 days of arrival in and departure from the UK will count in determining whether an individual has spent at least 183 days in the UK so making him UK resident (under ITA 2007 s.831). There is an exemption for transit passengers. Any day where presence in the UK is solely as a passenger in a part of an airport or port which is not accessible to members of the public unless they are arriving or departing from the UK is not counted so the exemption will not cover unexpected delays or a medical emergency necessitating an overnight stay. In addition, there are concerns that the legislation does not accord with airline practices. Representations have been made to HMRC on this matter. The Government has also announced its intention to amend its practice of ignoring days of arrival and departure in applying the non-statutory tests in IR20. It is difficult to see how it can properly do so. IR20 is supposed to represent guidance on HMRC's application of the law of residence which is primarily to be found in case law. It is not said to be concessionary. If that was HMRC's view of the law before the PBR, the PBR cannot possibly have changed that view simply because the Government wishes that the law were harsher than it is. It would be interesting if, when a revised version of IR20 is to be published, one of the professional bodies were to make an application for judicial review, in an attempt to restrain its publication on the grounds that it is ultra vires for a public body to publish guidance on the law which it knows to be misleading.

The Remittance Basis

From 2008/2009 a non-UK domiciled individual who has been UK resident in at least 7 of the 9 tax years immediately preceding the relevant year must pay a charge of £30,000 per annum if he wishes to retain the remittance basis. By retaining the remittance basis the taxpayer will have no entitlement to either the Income Tax personal allowance or the CGT annual exemption. That is rather petty. There is a *de minimis* limit of £1,000 per annum, so if unremitted income and gains are less than £1,000, the charge need not be paid and personal allowances and the CGT annual exemption are retained. Representations have been made for this limit to be increased.

Although 3 consecutive years of non-UK residence will break the 7 out of 9 year test, the proposed ITTOIA 2005 s.832A provides that a period of non-UK residence of less than 5 years following residence for at least 4 of the preceding 7 tax years will catch a remittance to the UK in the intervening period so that it will be treated as remitted to the UK in the year of return. Section 832A effectively adopts the CGT s.10A rule for temporary non-residence.

Although the £30,000 charge is treated as Income Tax for various limited administrative purposes it is not Income Tax. It is understood that it is unlikely that this impost will be creditable against US Tax on the unremitted income. Mr Hartnett's letter states that "we will continue to discuss with the US authorities how the £30,000 charge can become creditable against US tax." The same principle may well apply in other countries; each Treaty needs to be examined carefully for its application.

Where moneys were brought to the UK to pay the charge, that in itself could be a remittance increasing the effective cost of the impost to up to £50,000. HMRC had published Q&A's confirming that such remittances will be chargeable in addition to the £30,000 impost. Mr Hartnett's letter says that "I want to make it clear that the Government's intention … has always been to ensure that … money brought into the UK to pay the £30,000 charge will not itself be taxable." That is a clear contradiction to the earlier Q&A produced by Mr Hartnett's department.

Meaning of 'Remitted to the UK'

The new statutory test of whether an amount has been remitted applies both to income and to gains. Both conditions A and B must be satisfied.

Condition A is that:-

(a) any money or other property is brought to, or received or used in, the United Kingdom by or for the benefit of a relevant person; or

(b) any service is provided in the United Kingdom to or for the benefit of a relevant person.

Condition B is that:-

(a) the property or consideration for the service is (wholly or in part) the income or chargeable gains;

(b) the property or that consideration derives (wholly or in part, and directly or indirectly) from the income or chargeable gains;

(c) the income or chargeable gains are used outside the United Kingdom to satisfy (wholly or in part, and directly or indirectly) a debt which is (wholly or in part, and directly or indirectly) in respect of the property or service; or

(d) anything deriving (wholly or in part, and directly or indirectly) from the income or chargeable gains is used as mentioned in paragraph (c).

The proposed legislation introduces a much wider definition of remittance than we currently have and will catch many transactions unconnected with tax. For example, consider the situation of a UK resident individual who wears a valuable watch purchased overseas with overseas income. There would be a remittance under the draft legislation if he wears his watch in the UK. Similarly, works of art sent from overseas owners to museums and galleries in the UK could constitute a remittance. In his letter of the 12th February 2008 Mr Hartnett states "it will continue to be possible to bring art works into the UK for public display without incurring a charge to tax." How careful HMRC are with their commitments: careful reading of this passage reveals that its statement is literally true even of the draft legislation.

Unfortunately, it will be possible, under the draft legislation, to lend art works to galleries in the UK and by doing so to trigger a tax charge. Whether the draft legislation will be amended in this respect remains to be seen.

The new definition of remittance closes a possible loophole not previously mentioned, viz paying for services provided in the UK by crediting the offshore bank of the provider.

A relevant person is an individual or a person connected with the individual. Such a connected person need not be UK resident or indeed an individual. Therefore, the import by an offshore trust or company of money into its own UK bank account could be a remittance if it derives from the UK resident taxpayer's offshore income or gains.

Relevant Person

As to the meaning of 'relevant person' the proposed legislation includes what is often loosely, although incorrectly, called a 'common law spouse' or 'common law civil partner' for these purposes. This catches both heterosexual couples living together 'as husband and wife' and homosexual couples living together 'as civil partners' with no formal marriage or civil partnership. Apparently this is a standard social security definition but what meaning it has is uncertain. A civil partnership is a legal status – it does not require any particular form of behaviour on the part of the parties. So how can one live together as civil partners without actually being such?

Perceived Anomalies

The legislation deals with what HMRC claim are anomalies. For example, the *Carter v Sharon* arrangement will no longer be possible. Therefore, where a non-UK domiciled mother gives to her daughter outside the UK cash representing offshore income which the daughter brings into the UK, that is caught. Of course, it raises difficult compliance issues: how is the mother to know of her UK tax liability, for example? Those accustomed to effecting arrangements along the lines of *Carter v Sharon* might consider accelerating such transfers to take place before 6th April 2008 in order to forestall the new regime to that extent.

A significant change is introduced in relation to foreign chargeable gains accruing to an individual on the disposal of an asset where he does not receive consideration equal to market value, for example, a gift to a trust. In such situations the asset is treated as deriving from the chargeable gains. Where it is unclear as to whether or not a sale is at market value it will be advisable to obtain valuations at the time.

Planning Opportunities and Traps

While the source closing rules are to be abolished, it would still seem possible to allow the remittance of pure capital to the UK with no tax charge by proper segregation of income and capital.

The remittance basis election is made in relation to individual fiscal years. So, by aiming for capital growth rather than income, it could be possible to pay the charge only in years when gains are realised. This of course will need careful planning.

Spouses and civil partners may consider amalgamating assets (subject of course to other considerations such as the security of the marriage or civil partnership) so that only one of them pays the £30,000 charge.

In some cases offshore bonds or other investment wrappers may be attractive to enable tax deferral without the £30,000 charge. This will unfortunately come at a cost, namely 40% Income Tax (with no remittance basis) on encashment rather than a potential 18% of rate of CGT. Although it may be possible for some clients to become non-UK resident before encashment of a bond so as to avoid a charge arising.

Compliance with the new rules will require the taxpayer to have information concerning years before the rules' introduction which he will have had no reason to have kept at the time concerned.

An unfair feature of the proposed legislation is that there is no ability to make an error or mistake claim in respect of the £30,000 tax charge. For example, if a person pays the £30,000 tax charge on the basis that he is non-UK domiciled and then discovers years later that he is not, he will not get a credit of the £30,000 paid against the tax now being assessed on an arising basis.

Another grossly unfair feature of the current regime which is to remain, is that a loss made by a non-UK domiciliary on non-UK assets will still be unallowable even if he opts to pay CGT on an arising basis.

Attribution of Gains to Members of Non-UK Resident Companies

Currently TCGA 1992 s.13 applies where a UK resident and domiciled participator with an interest of more than 10% in a non-UK resident company which would be close if UK resident is charged to tax on an apportioned part of the gain made by the offshore company. From 6th April 2008 s.13 will also apply to a non-UK domiciled individual participator. Where the gain arises on the disposal of UK situs assets, the gain attributable to a non-UK domiciled participator will be taxed on an arising basis. Where the gain arises on an overseas asset, the gain attributed to such a participator will be taxed on an arising basis if the participator has not claimed the remittance basis for the year in which the gain arose. Where the participator has claimed the remittance basis, the gain is taxed when the proceeds from the gain are remitted to the UK by the company.

There is an unfair disapplication of s.13(7) which allows a credit of the s.13 tax against the CGT computation of a gain subsequently accruing on the disposal of the share, so there could be double taxation. This could be relieved only by s.13(5A), but here there is a 3 year time limit from the end of the accounting period (or from 12 months after the date of the gain), though at least there is a credit of tax against tax.

Attribution of Gains to Settlors with Interests in Non-Resident Settlements

From 2008/2009 a UK resident but non-UK domiciled settlor of an offshore trust will be charged to CGT in respect of gains accruing to the trustees. Currently, such a charge under TCGA 1992 s.86 applies only to UK domiciled settlors. Where the gain relates to an asset situated in the UK the settlor will be taxed on an arising basis. Where the gain arises on an asset situated overseas the gain is treated as a foreign chargeable gain as if the consideration received by the trustees were actually received by the settlor. Where the settlor has not claimed the remittance basis for the relevant year he will be assessed on an arising basis.

Attribution of Gains to Beneficiaries

These changes to TCGA 1992 s.87 represent perhaps the worst news of the new regime. Section 87 applies a CGT charge to UK resident beneficiaries of overseas trusts where the beneficiary receives a capital payment in respect of a gain accruing to the trust. From 6th April 2008 the charge will also apply to capital payments made to non UK domiciled beneficiaries after 5th April 2008 even if they relate to capital gains arising before 6th April 2008. This means that trust gains made since 1981 or, where the settlor was non-UK domiciled, 6th April 1998, are potentially caught, with horrendous compliance issues if trust gains are to be matched with capital payments. There is no remittance basis and so all charges are on an arising basis. On 12th February 2008 Mr Hartnett said that “there will be no retrospection in the treatment of trusts and the tax changes will not apply to gains accrued or realised prior to the changes coming into effect.”

Again, it is not clear whether this is actually a commitment to change the draft legislation in a way which answers the difficulty. Gains will accrue to beneficiaries under s.87 in the current year but, under the draft legislation, they can be computed by reference to gains realised by trustees in 2007/2008 and before. Was Mr Hartnett referring to the gains accruing under s.87 or the trust gains by reference to which the gains were calculated?

Practical advice

If an offshore trust is likely to be caught by the extension to s.87 in a significant way, it may be advisable to wind up the trust before 6th April 2008 unless no beneficiary receiving capital will become UK resident. The danger applies especially in cases where the trustees have ‘over-distributed’ so that future trust gains will be caught.

This could be done by a capital advance to a beneficiary who is the original settlor (who is domiciled and deemed domiciled outside the UK for IHT purposes), and he could consider resettling the trust. Alternatively, perhaps because the settlor had become domiciled or UK deemed domiciled and it is important to retain the IHT status of the trust, there could be a loan of assets back to the settlor or other beneficiaries (but consider any possible UK Income Tax or other implications). The first suggestion at least assumes that the settlor is a beneficiary, which of course he might well not be. The danger of making a capital advance to some other beneficiary with the intention that he should resettle is of course that his hands cannot be tied (as if so the assets would still be treated as forming part of the original settlement) and so having received the advance he might simply decide to accept assets for his own use.

For the Future

Should the trustees of a non-settlor interested trust invest for income or for capital growth? Up to 2007/2008 income was preferable, given the marginal CGT rate of 64% for UK resident (and currently domiciled) beneficiaries receiving capital payments. However, from 2008/2009, assuming that the CGT reforms go through, the comparison will be a 40% Income Tax rate vs. 28.8% maximum CGT rate. It should be remembered that the CGT charge will not get the benefit of any remittance basis, whereas income will.

Offshore companies could prove more popular than offshore trusts, as the s.13 imputation provisions even in their revised form are less stringent:-

(a) the remittance basis will more clearly apply to companies;

(b) participators with an interest of no more than 10% will not be charged at all. However, note the need to include the interests of any associates in computing the interest of any participator;

(c) the gains may benefit from indexation allowance; and

(d) the company can pay the tax charge and perhaps even the £30,000 without this being treated as a remittance (s.13(11)).

It is likely that protected cell companies designed to get round the s.13 regime will become even more popular.

The European Angle

There are 2 respects at least in which there might appear to be discrimination capable of challenge under European law:-

(a) The fact that losses made by UK domiciliaries on non-UK assets will still be unallowable even if the taxpayer is taxed on an arising basis;

(b) The fact that under s.13, whether or not the non-UK domiciliary is taxed on an arising basis, tax paid by them when capital gains are imputed from gains made by offshore closed companies cannot be offset against subsequent gains made on the sale of the shares in that company - subject to the more limited s.13(5A) relief.

Stay or Go?

How should one decide whether or not to make the remittance basis election? From a financial perspective the question is as simple as what the level of offshore income or gains equates to a tax charge of £30,000. If a person chooses to be taxed on the arising basis, he has the benefit of the personal allowance. Next year's reliefs and tax rates are as yet unknown, but if we assume a personal allowance of £5,500, a 10% band for investment income of £2,500, a 20% band of £34,000 with 40% payable above that. The election will be favourable where unremitted foreign income is approximately £100,000 or more (ignoring capital gains for the moment). At, say, a 2% yield (which of course would be variable), that presupposes a portfolio of £5 million. Of course gains must be taken into account as well, taxed at 18% above the annual exempt amount of say £9,500 for 2008/09. If we assume that the portfolio also generates capital gains of 5.0%pa, the election would be favour if the foreign portfolio was about £3,000,000.

So for many non-UK domiciliaries it might well make financial sense to pay the £30,000 charge. We are hearing on a daily basis of extremely wealthy non-domicillaries announcing their intentions to leave the UK and liquidating their assets. There have been representations from professional and trade bodies calling for a rethink of this proposed legislation, the strength of which has caught the Government unaware. The difficulty of course is the element of disclosure/secrecy and many such individuals will feel better if they have to disclose as little as possible to HMRC.

In his letter Mr Hartnett stated that the Government's intention has always been to ensure that "Those using the remittance basis will not be required to make any additional disclosures about their income and gains arising abroad. So long as they declare their remittances to the UK and pay UK tax on them, they will not be required to disclose information on the source of the remittances." This statement does not provide any comfort because in order for HMRC to know that a taxpayer has disclosed his remittances to the UK they would need to know the taxpayer's worldwide income and gains and the nature of the assets from which they were generated.

SECTION II

CAPITAL GAINS TAX

DRAFT LEGISLATION PUBLISHED

Following the Chancellor's Pre-Budget Report ("PBR") announcement of changes to Capital Gains Tax ("CGT"), draft legislation was published on 24th January 2008.

18% Rate from 2008/2009

The draft legislation introduces a single CGT rate of 18% which will apply to all individuals, trustees and personal representatives, though not of course to companies which pay Corporation Tax on chargeable gains. Interestingly, we recall some 10 to 15 years ago there was US research which suggested that the optimum rate of CGT, i.e. to maximise the take for the state while not discouraging disposals within the market place, was some 17% or 18%. The only exception to the 18% CGT rate will be for those taxpayers who can benefit from the new entrepreneurs' relief (see below) who will pay 10% on the first £1 million of qualifying gains.

One consequence of the single rate is that the onshore settlor charge is no longer required and so TCGA 1992 ss.77 to 79 are to be repealed. Such gains will in future be taxed on the trustees and not on the settlor: which will of course have compliance implications for 2008/2009 onwards.

There is at least a 'period of grace' before 6th April 2008 for those who want (and are in a position) to take advantage of the 10% rate of business assets taper relief ("BATR") to do so, to the extent that now they will not be able to qualify for the entrepreneurs' relief.

It should be remembered that other CGT reliefs will continue to be available such as principal private residence relief, rollover relief and hold-over relief under s.165 and s.260.

As part of the simplification of CGT, the Chancellor announced a number of other measures including that of indexation allowance and taper relief being withdrawn.

Among the losers from this change are:-

- to the extent that now they will not be able to qualify for entrepreneurs' relief, those currently – and indeed prospectively - able to take advantage of the 10% BATR (including the holders of most AIM shares and those who have acquired shares under Enterprise Management Incentive Schemes);

- those for whom indexation allowance is significant, for example farmers and landowners who owned land at 31st March 1982 on which indexation allowance to 5th April 1998 effectively doubles up the base cost. The same might apply with certain chattels with high March 1982 values;

- those who have previously rolled over or held over a gain such that the chargeable gain on the asset currently held will be taxable at 18% on a disposal after 5th April 2008;

- those who let property and other assets to traders;

- those who have deferred a gain into a qualifying corporate bond ("QCB") under which the gain is deferred until the disposal of the QCB when the original taper relief is applied. It seems that on the disposal of a QCB after 5th April 2008 the original gain will be taxed without the benefit of taper relief (see below); and

- children and others who are able to take advantage of the starting rate of 10%.

The winners include:-

- those with non-business assets, including second homes not attracting main residence relief. Assets held at Budget Day 1998 which attract a minimum CGT rate of 24% will benefit from a 25% reduction in the tax if disposed of after 5th April 2008. However, one should be aware of the impact of the repeal of indexation allowance as a 24% rate with indexation could produce a lower tax bill than 18% without;

- short term holders of non-business assets, who could see a reduction in the tax rate from 40% to 18%; and

- the recipients of capital payments from offshore trusts taxed under TCGA 1992 s.87 with a CGT rate of 18% plus maximum supplementary charge, the overall rate will be a 28.8% maximum rather than the current 64%. This goes some way towards alleviating the dramatic extension of s.87 to UK resident non-UK domiciled recipients of capital payments without the benefit of the remittance basis.

Triggering a disposal before 6th April 2008

Where an individual has agreed in principle to the sale of an asset and one of the parties is not in a position to complete the contract before 6th April 2008 the exchange of unconditional contracts with deferred completion may be the answer. Where the asset is land it should be remembered that SDLT will be paid on substantial performance of the contract, whether by the purchaser taking occupation or by him paying more than 90% of the purchase price.

Those individuals who were considering a disposal to a third party in the near future which would benefit from BATR at 10% might consider triggering a disposal before 6th April 2008 to take advantage of the rate. This disposal might be to a family trust (which could be settlor-interested) leaving the consideration outstanding on loan account and no hold-over relief being claimed. This will, of course, mean that CGT will be payable on 31st January 2009.

Those individuals not thinking of an immediate disposal for value could equally trigger a disposal now by way of gift. Under TCGA 1992 s.281 the 10 year instalment facility is available, albeit carrying interest currently at 7.5% on unpaid instalments. Of course, a gift in excess of the IHT nil rate band (currently £300,000) to trustees will trigger an immediate 20% IHT charge except to the extent that APR/BPR is available. Farmers and landowners not minded to make a disposal in the foreseeable future should probably sit tight, unless there is some way of triggering an inter-family disposal, where the current market value is around the indexed 1982 value, simply to enhance the base cost going forward. That said, recent increases in agricultural land values may produce something around nearer £5,000 per acre as against an indexed base cost of just say £4,000: so one needs to do the sums first!

Because of the withdrawal of indexation relief, husbands and wives may consider inter-spouse transfers before 6th April 2008 to 'bank' the indexation allowance. For example, Mrs Baggins holds shares currently worth £400,000 which she acquired in September 1982 for £100,000. The indexation allowance is £100,800. If Mrs Baggins transferred her shares to her husband now, she would be treated as having made a no-gain no-loss transfer under TCGA 1992 s.58. Mr Baggins will be treated as having a base cost of £200,800, If Mrs Baggins held onto the shares and made a disposal after 5th April 2008 her base cost would be £100,000.

There is a general consensus of opinion that on current legislation this strategy is not effective for situations where an asset was held at 31st March 1982 by the transferor spouse. HMRC have indicated in their FAQs that it is their intention that the legislation should work equally for situations where an asset was held at 31st March 1982. To date, no amending legislation has been forthcoming.

Deferring a disposal of non-business assets until 6th April 2008

Individuals who are about to trigger a disposal of non-business assets may consider deferring a disposal until after 5th April 2008 so as to take advantage of the 18% rate. This could be achieved through the use of options (which have the added advantage of postponing the date of payment of tax for a year).

Chattels

Owners of chattels and other pride of possession assets should also review their position in terms of market value as against base cost – unless they are simply going to retain the chattel until death. The rules may work capriciously, in that some chattels may have a relatively high value at March 1982, whereas others may have had a low value. Chattels which are subject to conditional exemption, especially those which would fail the FA 1998 test, should be retained until death.

Anti-avoidance rules catching conversion of income into capital

The other interesting point is that a raft of legislation, e.g. transactions on securities in ITA 2007 part 13 chapter 1, now becomes very relevant again in the way which it was before 1988, when the rates of CGT were aligned with Income Tax rates.

Loan Notes

Those vendors in the fortunate position of not having exchanged contracts before 9th October 2007 and with the luxury of taking advantage of the 10% BATR rate are in an enviable position. In any sale agreement a proportion of the purchase price will no doubt be taken as initial cash consideration which will be liable to CGT in that period. With regard to deferred consideration previous tax planning advice was to take the deferred consideration in the form of loan notes to postpone the payment of tax until the deferred consideration was actually received. Now of course, the most sensible course of action is to crystallise the taper relief and indexation allowance by taking cash, albeit that the CGT becomes payable on 31st January 2009 which could cause possible cash flow difficulties.

However, for those people who have already sold their companies in exchange in whole or in part for loan notes which cannot be redeemed before 6th April 2008, the position is somewhat different. What might they do?

It may be possible to negotiate a pre-6th April 2008 redemption of loan notes with the acquiring company. However, this may not be straightforward where:-

- the loan notes represent a retention against further claims, in which case the purchasing company will be unlikely to agree;
- the purchasing company does not have the cashflow to enable an early redemption; or
- where redemption of the loan note is contingent on continued employment.

Alternatively, it may be possible for the loan notes to be transferred to a third party, for example a family trust. This will obviously depend on a number of factors including whether the loan notes are transferable and the cashflow impact of paying the CGT (albeit at an effective rate of 10%) before the loan notes can be redeemed and the effect on other taxes of this course of action.

ENTREPRENEUR'S RELIEF

On the same day as the publication of the draft CGT legislation the Chancellor announced the introduction of an 'Entrepreneurs' Relief'. This new relief was in response to the weight of representations on the unfair impact of the new proposed CGT regime on many business asset owners.

In A Nutshell

Essentially, the relief will be available on:-

- gains made by certain individuals who were involved in running the business;
- the disposal of all or part of a business; or
- disposals of assets following the cessation of a business.

The first £1 million of gains that qualify for relief will be charged to CGT at an effective rate of 10%. Gains in excess of that amount will be charged at the 18% rate. The £1 million is a lifetime allowance so an individual can make more than one claim.

The conditions for the new relief will be based broadly on the CGT 'retirement relief' which was phased out between 1998 and 2003. There will be no minimum age limit for relief and in general relief will be available where the relevant conditions are met for a period of one year, instead of the retirement relief qualifying period of up to 10 years.

In More Detail

Relief will apply to gains arising on disposals of the whole or part of a trading business (including professions and vocations, but not including a property letting business other than furnished holiday lettings) that is carried on by an individual, either alone or in partnership.

Where a business is not disposed of as a going concern, but simply ceases, relief will be available on gains on assets formerly used in the business and disposed of within 3 years of the cessation of the business.

The relief will also apply to gains arising on disposals of shares (and securities) in a trading company (or the holding company of a trading group) provided that the individual making the disposal:-

- has been an officer or employee of the company, or of a company in the same group of companies, and
- owns at least 5% of the ordinary share capital of the company and that holding enables the individual to exercise at least 5% of the voting rights in that company.

The terms ‘trading company’, ‘holding company’ and ‘trading group’ will have the same meaning as they currently do for the purposes of BATR.

Where an individual qualifies for entrepreneurs’ relief on a disposal of shares or securities relief will also be available in respect of any 'associated disposal' of an asset which was used in the company’s (or group’s) business. For example, if a company director who owns the premises from which the company carries on its business sells the premises at the same time as he sells his shares in the company, the sale of the premises may count as an ‘associated disposal’ and any gain may attract entrepreneurs’ relief. It should be noted, however, that the relief due on an associated disposal will be restricted where the asset in question was not wholly in business use throughout the period it was owned.

A similar rule will allow relief on an 'associated disposal' by a member of a partnership who is entitled to relief on disposal of his interest in the assets of the partnership. (Again, relief will be restricted where the asset in question was not wholly in business use throughout the period of ownership.)

The relief will also be available to trustees on gains on assets used in a business. For trustees to benefit, a beneficiary of the trust with an interest in possession relating to those assets must be involved in carrying on the business in question, personally or as a partner. In the case of shares such a beneficiary must qualify as an officer or employee of the company in question. The conditions under which trustees qualify for relief will be generally similar to those for retirement relief. In particular, the £1 million maximum limit on gains eligible for relief will apply to the trustees and the qualifying beneficiary jointly.

We have been informed that draft legislation will be published shortly but to date nothing has appeared.

Preliminary Observations

As mentioned above, there has been a considerable amount of pressure for change and the resulting relief has been closely targeted to meet the criticisms being made within the business community. Whether it will meet those criticisms completely is of course another matter. For example, the relief is unlikely to benefit the majority of holders of approved employee share options unless they own more than 5% of the shares in the company.

For a significant number of entrepreneurs the proposed changes will result in their CGT liabilities being reduced by £80,000 which is welcome. However, despite such changes, many successful entrepreneurs will face a considerable higher CGT liability from April 2008. With the loss of accrued taper relief such clients may well need to consider action before the 6th April 2008 to take advantage of their taper relief and to minimise their overall CGT liabilities (see above).

There are other particular issues for affected taxpayers and their advisers to consider such as:-

(a) whether the asset(s) concerned fall(s) within the scope of the new relief, i.e. being all or part of a business; or assets owned following the cessation of a business; or assets attracting relief as an 'associated disposal' used in a partnership business; or qualifying trust assets;

(b) as to unincorporated assets many of the issues familiar from the old retirement relief come back into play; and

(c) what needs to be done to ensure that shares will qualify. The shares must be in any trading company, whether private or listed. The individual must be an officer or employee (presumably part-time or full-time, although this has not yet been clarified) and must own at least 5% of the ordinary share capital which give voting rights. Fortunately, there is no restriction as was the case for retirement relief to any non-trading assets held within the company.

QUALIFYING CORPORATE BONDS ("QCBS")

The announced CGT changes have resulted in queries as to how these changes will apply to QCBs.

HMRC's Analysis

A Policy Adviser at Capital Gains HMRC, has responded to a number of specific queries about the effect of the revisions on QCBs as follows:-

"You are asking about the way held over gains coming into charge on the disposal of QCBs will be treated if the QCBs are disposed of on or after 6 April 2008 if the proposals announced at PBR are accepted by Parliament and form part of the Finance Act 2008.

Where shares (etc) are exchanged for QCBs and TCGA 1992 s.116(10) applies, the gain (or loss) calculated under paragraph (a) of s.116(10) is the chargeable gain (or allowable loss) that would have arisen if the shares in question had been disposed of at the time of the exchange. A chargeable gain is the gain after other reliefs and deductions etc, but is not the taxable amount after taper relief has been applied. Taper relief under s.2A is applicable where a person has net chargeable gains after deduction of allowable losses in a year of assessment. But the proposal is that taper relief will not be available for the tax year 2008/09.

The position can therefore be illustrated as follows.

Example

- *Shares which cost £100,000 in 1999 are exchanged for a QCB in January 2005, at which time the market value of the shares is £160,000.*
- *Section 116(10) applies to the exchange.*

- *Maximum business asset taper relief is available in respect of the shares.*

The chargeable gain held over under s.116(10)(a) is £60,000.

If the QCB is disposed of in January 2008 the chargeable gain will be liable to CGT in 2007/08. If there are no allowable losses to set off against the chargeable gain in the year, it will benefit from 75% taper relief and £15,000 will be taxable at the individual's marginal Income Tax rate (subject to the annual exemption).

If the QCB is disposed of in January 2009 the chargeable gain will be liable to CGT in 2008/09. Taper relief will not be available for that year. So, if there are no allowable losses to set off against the chargeable gain, £60,000 will be taxable at 18% (subject to the AEA)."

McKie&Co

SECTION III

INHERITANCE TAX

The Transferable Nil-Rate Band ("NRB")

The essence of the proposal is that a claim can be made to transfer any unused NRB on an individual's death to the estate of their surviving spouse or civil partner who died after 8th October 2007. This will apply where the NRB of the first to die was not fully used in calculating the IHT liability on their estate. This would include the case, for example, where the first estate was left to charity rather than the survivor, either with no chargeable transfers or at least any such transfers are less than the then NRB. On the second death the unused amount (expressed as a proportion of the then NRB) is added to their own NRB.

HMRC have confirmed that in applying the s.8A rule, it matters not that the estate of the first to die was below the NRB threshold although there is some doubt as to whether the draft legislation actually achieves this. It should be noted that whilst newspaper articles refer to a NRB for a married couple at £600,000 (in 2007/08) rising to £700,000 in 2010 it is not strictly true as advantage can be taken of the proposal in computing IHT on death: chargeable lifetime transfers will be taxed in the ordinary way.

Multiple spouses: limitation to double the NRB on the second death

In a situation where a person dies having survived more than one spouse or civil partner (or dies having been married to, or the registered civil partner of, someone who had themselves survived one or more spouses or civil partners), the amount of additional NRB which can be accumulated by any one survivor will be limited to the NRB in force at the second death.

Relief given through a claim on the second death

As the claim mechanism operates at the second death only, evidence will be required of the unused NRB on the first death, which could have been very many years before – and may present difficulties in locating the paperwork. [Obviously, a life interest protected from IHT by the Estate Duty surviving spouse exemption should be left undisturbed.]

Good news, in principle?

While a variety of possible permutations present themselves, in general terms this seems to be good news (see (e) and (f) below, in particular). Gifts to surviving spouses should generally not be subject to survivorship clauses. However, there may well be circumstances where the traditional use of the nil-rate band on the first death will be advisable: see (l) below.

Maximise spouse exemption on the first death, with PETS or, within the survivor's NRB, chargeable transfers shortly thereafter

Assuming that the NRB will generally increase over time it is sensible to try to minimise chargeable transfers arising on the first death, so to maximise the NRB on the second. Chargeable gifts made in the seven years before death or caught by the gift with reservation of benefit regime will in effect eat into the NRB on the first death. The spouse/civil partner exemption under IHTA 1984 s.18 applies equally to an immediate post death interest ("IPDI") as much as to an outright gift. As soon as possible after the first death, the survivor should make such gifts as he or she can reasonably afford to do without, keeping outside the gifts with reservation of benefit regime. To avoid an immediate 20% IHT charge such gifts, however, which exceed the survivor's NRB will need to be absolute rather than in trust. One should be aware of the scope of IHTA 1984 s.143 (compliance with the testator's request). Where there is an IPDI the trustees should terminate the life interest to that extent (and, being an IPDI, there would be no reading back into the Will under s.144). Providing there has been no increase in value since death, no chargeable gains will arise.

The family home, in particular

The new proposal will simplify matters relating to the family home. It provides an alternative to using NRB discretionary trusts in situations where a straightforward discretionary trust over the family home coupled with an exercise of the power to allow a surviving spouse to live in it may create an interest in possession.

Agricultural/business property

Advantage should be taken on the first death of APR or BPR at 100% on any assets. This advantage could be achieved by way of a gift into a discretionary trust.

Chattels – and precatory trusts

A gift by the surviving spouse of a painting to a child within two years after the death in accordance with an expressed wish of the deceased (even if the wish was expressed informally) will take effect as a chargeable transfer by the deceased under IHTA 1984 s.143.

Section 143 can apply to any property, not just to chattels. One would need to ensure that such gifts were not of assets inherited from the first to die over which he had expressed the wish that such gifts were made. The problem, however, could be solved by an IPDI such that the trustees cause the survivor to make a PET and s.143 could not apply.

Deaths within the last two years

For estates of those who have died within the last two years, one should consider whether a deed of variation is appropriate. In relation to relevant property trusts arising under a Will one should consider an appointment within two years of the death. One would need to bear in mind that under a deed of variation one cannot have more than one bite at the same cherry (*Russell & Russell v CIR* [1988] STC 195).

Deaths more than two years ago

Where the first death occurred more than two years ago and the NRB was fully used, nothing can be done to take advantage of the new regime [except by remarrying!]. Where a debt or charge scheme was effected on the first death, this should be kept under review to ensure that the planning will be effective on the second death – though of course this should have been done in any event.

Discretionary Will trusts and HMRC's puzzling comment

Para 15 of HMRC's states:-

> *"Where someone dies after 9th October 2007 with a nil-rate band discretionary trust in their Will, an appointment of the trust assets in favour of the surviving spouse or civil*

partner (before the second anniversary of the death, but not within the three months immediately following the death) would normally be treated for IHT purposes as if the assets had simply been left to the surviving spouse or civil partner outright. Ending the trust in this way would mean that the nil-rate band was not used on the first death, and so the amount available for eventual transfer to the surviving spouse or civil partner would be increased accordingly."

It is hard to see why this principle should not also apply where the first death occurs before 9th October 2007, provided the appointment is made within two years after death. Incidentally, the well-known *Frankland* trap no longer applies (following FA 2006) where an appointment is made within three months after death on an IPDI. Although of course, the trap continues to apply if the appointment is to a survivor absolutely within three months.

Indeed, HMRC have confirmed in their amended Questions and Answers that, to take advantage of s.144, it does not matter when the death occurred (if before or after 9th October 2007), provided that the appointment is made within 2 years thereafter.

When might it be sensible to use the nil-rate band on the first death?

The new provisions, whilst welcome should not be regarded as providing the best structure in all circumstances. Consider for example:

(i) protection of the home from liability for care fees;

(ii) cases where the capital appreciation in the NRB will trust is anticipated to outstrip future increases in the NRB;

(iii) cases where it is desired, perhaps for non-tax reasons, to have two relevant property NRB trusts for children/grandchildren going forward, the one established under the Will of the first to die and the other set up *inter vivos* by the survivor; and

(iv) the situation where a relevant property trust of £600,000 (or whatever twice the NRB then is) arises on the second death. Subject to any future increases in the NRB this would mean IHT to pay on future 10 year anniversaries, which might not have been the case with two £300,000 stand alone trusts created separately on each death – or on the first death by the deceased and shortly thereafter by the survivor.

Keeping Wills under review

So should all Wills where the couple are both alive now be reviewed? The answer is probably yes. There has been some discussion as to whether a survivorship clause should be included. Where the surviving spouse does not have sufficient assets to utilise the NRB in the normal way it is sensible to disapply the clause. Where each spouse does have sufficient assets there may be administrative reasons for retaining one.

At least with tax-efficient Wills on the first death nothing is now lost, since an appointment can be made out of a NRB trust in favour of the survivor absolutely or to create an IPDI. However, a legacy/bequest of the NRB to the children or to trustees for them should probably be replaced (other things being equal) with a gift to the surviving spouse/civil partner, who would then shortly after the death make his/her own lifetime gift in the hope of surviving seven years (but watching the anti-avoidance settlement rules for Income Tax and CGT for gifts to minor children). The amusing thing is of course that those couples who do have simple non-tax efficient Wills of 'everything to the survivor' may now be best off.

Will trusts for non-spouses/civil partners

For those couples who are not married or in a civil partnership, a NRB discretionary trust may still be appropriate, provided that where there are two or more trusts under the Will action is taken (for example, by adding property to a pre-death pilot settlement) to avoid the IHTA 1984 s.62 related settlements provisions. The potential benefit of having more than one non-related relevant trust going forward, (for example, one for the surviving partner and the other for the children is that the initial value of one will not affect the future IHT charges on the others).

'Ascertaining' the value for IHT (and so future CGT) purposes

Looking forward, one practical issue which has always applied in the case of spouse exempt gifts, is that no value will be 'ascertained' for IHT purposes (see TCGA 1992 s.274), so leading to difficulty in establishing relevant base costs on a future disposal by a beneficiary.

Caveats?

All this assumes that by the time of the second death the rule has not been repealed so resulting in the lost benefit of the NRB on the first death (assuming that it is then too late to effect a variation under IHTA 1984 s.142) and that the survivor will indeed 'play ball' in, for example, making gifts to the children (although an IPDI structure should deal with the latter problem). In fact, normally an IPDI should be the favoured option with second marriages/civil partnerships where there are children from the first marriage.

A first death under Estate Duty

The new provisions will apply to deaths occurring before 18th March 1986 and so HMRC have produced a Q&A which is set out below:-

> ***"How does this work if the first death occurred during Capital Transfer Tax or Estate Duty?***
>
> *The same basic principles apply: however, there will need to be some modifications to reflect the differences between IHT and Capital Transfer Tax (CTT)/Estate Duty. IHT was introduced on 18 March 1986, so points to bear in mind for deaths before that date are:-*
>
> - *Where the first spouse died between 13 March 1975 and 18 March 1986 then the estate would have been subject to CTT. Any transfers to the spouse would have been exempt from tax in the same way as for IHT and the transfer of nil-rate band provisions will operate in exactly the same way as it works for IHT.*
>
> - *Before 13 March 1975 Estate Duty applied. Under Estate Duty there was no tax-free transfer permitted between spouses until 21 March 1972 when a tax-free transfer between spouses of up to £15,000 was introduced. This limit was removed for deaths after 12th November 1974.*
>
> - *Where the first spouse died between 21 March 1972 and 13 March 1975 a claim to transfer the nil-rate band to the surviving spouse will be based on the*

amount of the tax free band that was unused on the death of the first spouse. For example, if a husband died in 1973 and left an estate valued at £10,000 that was all transferred to his wife, then as this is all within the spouse's exemption the husband's tax free band is unused. So if his widow dies in December 2007, her nil rate band can be increased by 100% to £600,000. Where any part of the first spouse's individual tax free band was used then there will be a proportionate reduction in the amount by which the surviving spouse's IHT nil-rate band may be increased.

- *Before 21 March 1972, there was no relief from Estate Duty for transfers between spouses so the amount by which the surviving spouse's IHT nil-rate band may be increased will be based on the proportion of the individual tax-free band that was unused on the death of the first spouse."*

Comment

Clearly where the first death has occurred under Estate Duty, HMRC consider s.8A claims possible but there is something puzzling about this. Only for a short period of 4 months before the replacement of Estate Duty by CTT in March 1975 was there an unlimited spouse exemption; between 1972 and 1974 it was limited to £15,000 and did not exist at all before 21st March 1972. Surely, therefore, it would only be in the case where the chargeable estate on the first death was less than the NRB that there could be any unused balance remaining (in the absence of course of some exemption such as what is now s154 'killed in war'). This analysis is confirmed by para 23 of HMRC's guidance, though it does not as yet seem to be reflected in the claim form IHT 216. Of course, in a case where the estate duty surviving spouse exemption is in point, nothing needs to be done, as one already has a fund which is free of both CGT and IHT on the second death.

Historic NRBs published

To assist in determining the proportion of the NRB available on the first death, HMRC Inheritance Tax have published details of NRBs going back as far as 16th August 1914, which will be of use. Of course, there will not be many First World War widows still alive! For those who didn't know, the NRB from 16th August 1914 to 9th April 1946 (in England, Wales and Scotland) and to 28th August 1946 (in Northern Ireland) it was £100.

NOTE: You should not act (or omit to act) on the basis of this Bulletin without specific prior advice.

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