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SHARON MCKIE

The Pre-Budget Report: All Change

LT Capital gains tax; Foreign income; Non-residents; Pre-Budget report; Taper relief; Tax planning; Tax rates

The Pre-Budget Report showed our new Chancellor resolutely dismantling the structure of capital taxes which had been erected by his predecessor and new boss, Gordon Brown. At least that's one way to look at it. One has to take a positive slant when faced, once again, with major changes to capital taxation designed to placate the newspapers. Whatever the political motivations for the changes, they have very significant implications for private client tax planning in both the short and the long term.

This article was written shortly after the publication of the Pre-Budget Report on October 9, 2007, and before the draft legislation has been published.

The root and branch reform of capital gains tax in 2008/09 was perhaps the most startling of the Pre-Budget Report measures, announced without prior consultation and arousing, perhaps predictably, a riot of angry response. For non-UK domiciled UK residents the privilege of the remittance basis is to be enjoyed from 2008/09 only at an annual cost.

Capital gains tax reform

A flat rate of capital gains tax of 18 per cent is to be introduced from 2008/2009 onwards and at the same time various reliefs including taper relief and the indexation allowance have been withdrawn. One of the earliest of Gordon Brown's acts as Chancellor was to launch a consultation on the reform of capital gains tax. Most respondents plumped for a system with a low tax rate coupled with a simplification of the tax and a withdrawal of reliefs so as to create a broader tax base. Mr Brown chose to ignore his own consultation and introduced taper relief.

Now his successor has abolished taper relief, created a relatively low flat rate and broadened the tax base by eliminating reliefs. Inevitably, the winners are not particularly grateful and the losers are howling with rage. For tax planners,

however, there is much work to be done in reviewing clients' assets and their future intentions for those assets to determine whether or not they will be better or worse off under the new system. Those who will be worse off may be able to forestall the change by creating disposals before April 6, 2008. Indeed commentators in the newspapers are already suggesting that this should be done.

The most obvious ''winners'' will be those holding non-business assets, for whom the rate of tax will fall from a minimum 24 per cent (assuming a maximum 10 years' worth of taper) to the flat rate of 18 per cent. Against this must be factored in the downside of the loss of indexation allowance which for assets with a relatively high base cost at March 31, 1982 (effectively doubling the base cost) could be quite significant. Another, less noticed, class of winners will be UK domiciled beneficiaries of capital payments from non-UK resident trusts, where the maximum 64 per cent rate (assuming six years' worth of supplementary charge) will fall dramatically to just 28.8 per cent.

The trouble is that having created an incentive for people to make disposals, HMRC may well see doing so as an abuse. So far the only details of the ''reform'' are contained in the four-page press release. Further details and draft legislation are being published in December 2007. Advisers would be wise to refrain from action until that draft legislation is published but they cannot delay until then to consider the matter. The abolition of the ''kink'' test and of ''halving'' relief and the ''simplification'' of the share identification rules ensure that the comparison between the old and the new rules will be a complex one. On publication of this article there will be less than three months before the end of the tax year, so advisers would be prudent to inform their clients immediately of the necessity for there to be a review of their assets and to gather the information necessary to make that review.

One way of banking indexation might be to make a transfer to a spouse. Taxation of Chargeable Gains Act 1992 s.58 provides that an inter-spouse transfer is treated as having been made for such a consideration as secures that on the disposal neither a gain nor a loss accrues. So the base cost of the asset in the transferee's hands will be equal to the base cost *and* indexation relief given on the transfer. There is, based on current legislation, a trap, however, for assets owned by a transferor spouse on March 31, 1982. Under Taxation of Chargeable Gains Act 1992 s.55(6) and Sch.3 para.1, where a person acquires an asset by means of a no gain no loss disposal after March 31, 1982 and all prior disposals of the asset after March 31, 1982 have also been no gain no loss disposals, that person is treated as having owned the asset at March 31, 1982. A ''no gain no loss disposal'' includes a disposal under s.58, so the effect of these provisions is that the transferee's spouse's base cost will not be increased by indexation accrued up to the time of the inter-spouse acquisition.

HMRC have confirmed that this technical difficulty will be corrected in favour of the taxpayer.

Non-UK domiciliaries and the remittance basis

In 2008/2009 onwards, those who take advantage of the remittance basis will be charged an additional £30,000 of tax per year. It is understood that the new change will not be a tax capable of relief under an applicable double taxation convention. Taxpayers will therefore have a choice between being taxed on their worldwide income and gains or paying £30,000 in addition to any tax chargeable on their UK source income and gains and on their remittances of foreign income and gains. It would, of course, be quite untrue to say that the change is a blatant copy of the Conservatives' proposals. The Conservatives, after all, had proposed a charge of £25,000.

Once again the details of the rules have not yet been published but there is to be a ''consultation'' on draft legislation ''towards the end of [2007]''.

The new charge will only ''apply after a non-domiciled individual has been resident in the UK for seven years'', which is to mean in at least seven out of the last ten tax years. It appears, therefore, that the new rule will apply in the eighth year of residence and not in the seventh. Although the new charge will apply for the first time in 2008/2009, the seven-year period will include periods of residence before that year and so many non-domiciliaries will fall within the new charge in 2008/2009.

At the same time:

> ''. . . a number of changes are being made to ensure that where foreign income and gains are remitted to the UK then tax is charged on those remittances. The changes include:
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> - correcting a flaw in the current claims mechanism which allows income arising in one year to be remitted tax free the following year by claiming the remittance basis in the first year but not in the second;
> - reducing the scope for the alienation of income and gains through the use of offshore structures, such as companies and trusts, which convert taxable income and gains into non-taxable payments;
> - extending those existing anti-avoidance measures which currently do not apply to remittance basis users so in the future they do;
> - removing the ''ceased source'' rule; and
> - extending the definition of remittance in relevant foreign income.''

Plainly these provisions are going to be complex and it is not yet clear whether the legislation will include forestalling provisions. What is meant by the third category? It may indicate that the offshore settlor charge (under Taxation of

Chargeable Gains Act 1992 s.86) is to be extended to settlements with a non-domiciled settlor, that capital payments made to non-domiciliaries will result in chargeable gains arising to non-domiciled beneficiaries (under Taxation of Chargeable Gains Act 1992 s.87) and that the transfer of assets abroad legislation will be modified to remove or restrict the relief for income which would be taxed on a remittance basis if it had arisen directly to a transferor. Perhaps, also, the relief from assessment under Income Tax Act 2007 s.732 (non-transferors receiving a benefit as a result of a relevant transaction) for benefits received by non-domiciliaries outside the United Kingdom will be withdrawn.

Intriguingly, the press release states:

> ''When deciding if an individual is resident in the UK for tax purposes HMRC does not currently count the days they arrive in or depart from the UK. On and after 6 April 2008, days of arrival and departure will be counted as days of presence in the UK for residence test purposes.''

This presumably simply means that HMRC are going to change their practice published in IR20 but as they declined to follow this practice in *Gaines-Cooper v Revenue and Customs Commissioners*[1] it may require them to express with more precision the circumstances in which the rules set out in IR20 will be applied and when they will not.

Once again, advisers would be wise to await the draft legislation before any action is taken, but they need to begin work now to identify income which could be taken before the introduction of the new rules and to alert their clients to the need for a detailed review of their affairs.

Interestingly, there does not seem to be any intention to change the application of inheritance tax to non-domiciliaries and in particular, to change the rules relating to excluded property.

So after the upheavals to inheritance tax made by the Finance Act 2006 advisers are faced with adjusting to radical changes to income tax and capital gains tax and a modest relaxation of inheritance tax.

Editorial Note: As this Issue was going to press, the Chancellor made the following announcement in Parliament on December 13, 2007:

> *''The Government's position on the reform of capital gains tax was set out in the pre-Budget report on 9 October. However, I have subsequently received representations from a number of organisations and individuals with whom I have been consulting, and as a result of which a wide range of proposals have been made to me. Because those proposals cover a wide range of approaches, and in some cases are quite complex, I think it desirable to have further discussions with those groups before I finalise my proposals. It is not now going to be possible to conclude that process until the new year. I can tell the House that when I am ready to make proposals, I will come to the House and make a statement in the usual way.''*

This article should be read in the light of the further announcement to be made 'in the new year'.

[1] SSCD [2007] Sp.C. 568, upheld in the High Court, as to the domicile issue, [2007] E.W.H.C. 2617 (Ch).