

PRE BUDGET REPORT

The new Chancellor of the Exchequer, Alistair Darling, delivered his first pre Budget report in a climate of economic uncertainty.

The decision not to call a General Election, the postal strike, the Northern Rock crisis, and the "credit crunch" created a difficult background for the new Chancellor. Although next year's economic growth targets have been reduced, the forecast is for the economy to bounce back strongly from 2009.

The Chancellor announced a number of consultations and proposed "simplifications" to the tax system: these normally result in hundreds of more pages of legislation! Despite the uncertainties in the economy, the proposals announced in the pre Budget report will definitely have the effect of increasing taxes.

In this article we examine four of the major changes announced which will affect our clients:

Capital Gains Tax

Nine years ago, Gordon Brown announced major changes to Capital Gains Tax, bringing in "taper relief" in order to reduce the effective rate of tax where assets have been held for some years. Before this there was an inflation allowance, and 25 years ago the then Chancellor Geoffrey Howe recognised the effects of inflation by setting a new base year for Capital Gains Tax to 1982.

At a stroke, Alistair Darling is proposing to sweep away all of these tax rules and replace them with a flat rate of 18% tax. Although the move was perhaps forced on the Government in response to the publicity given to the 10% rate of tax paid by directors of private equity funds ("the boss pays a lower rate of tax than the cleaner"), the new rules have a much wider application. People selling businesses or family companies will lose out: previously the tax rate where they had been held for a minimum of two years was no more than 10%, with other reliefs often much lower - especially if the business had been owned for some time. Long term property investors, particularly those with commercial properties let to smaller company tenants, will also find themselves paying more tax when they sell.

Conversely, it is those who are making profits on property held for short periods, such as those who have enjoyed the increases in the residential property market over the last few years, who will benefit the most. These investors would otherwise have been paying

somewhere in the region of 30-40% tax (so long as they pay tax at the higher rate) and are now benefiting from the flat rate of 18%.

To illustrate the changes, let us take two potential clients, Mr X and Mrs Y.

Mr X started a business with £50,000 in 1982, and will sell it in 2008 for £250,000 when he retires. He will therefore make a profit of £200,000.

Under the old tax rules, taking into account inflation allowances, taper relief and the annual exemption, he would pay tax of approximately £11,000 or an effective rate of 5.5% on his gain. This assumes that Mr X is a higher rate tax payer, if he pays tax at the basic rate then he would pay approximately £6,000 tax or 3%.

Under the new rules Mr X would pay approximately £34,000, an effective tax rate of 17%, assuming also that he can use his annual exemption. The tax is the same whether he is a basic rate or higher rate taxpayer. In this case, Mr X would certainly be advised to sell the business before 5 April 2008.

Mrs Y, who is a higher rate tax payer, purchased a property in an up and coming area in 2005 for £350,000. She proposes to sell it in 2008 for £500,000. Both figures are net of purchase and sale costs and stamp duty, and therefore show a gain of £150,000.

Under both old and new rules, Mrs Y would be allowed her annual exemption, but the difference is that under the old rules she would pay tax at 40% and under the new rules at only 18%. Her tax liability under the old rules would be approximately £56,000, an effective rate of 37% on the gain before annual exemption. Under the new rules, she would pay only approximately £25,000 or 17% of the gain. This illustration shows clearly how Mrs Y benefits under the new rules.

There has been much commentary in the press about these proposed changes, especially surrounding employee share schemes, and there may well be second thoughts from the Chancellor before the new rules are due to come in from April 6, 2008. If you are thinking

of making any sales of assets, particularly if you are considering disposing of private company shares or shares in a business, do talk to us as soon as possible to see whether it would be worth bringing forward the sale to before April 5, or even to delay it until after that date.

Family Company Dividends

Buried away in the small print which followed the Chancellor's speech was the intention to stop what the Revenue term "income shifting" to other family members who pay tax at a lower rate. This follows the case known "Artic Systems" which HM Revenue & Customs lost in the House of Lords this year - a family business where the wife had received what the Tax Inspector felt to be a rather large dividend in relation to her contribution to the business. HMRC's position rather goes against modern principles of equality, and the House of Lords decision was not surprising, but, with tax at stake, the Government has decided to change the rules for the future!

There will be a period of consultation, but the new tax rules will be brought in from April 5 next year to tax dividends or partnership profits paid to those the Tax Inspector can show have received more than a "fair" (whatever that may mean) share.

Until the new rules are published we will not know how the trial of the new legislation will go. However, we can expect family company dividends to be looked at in more detail from April 5, 2008 onwards, so if you are thinking of paying dividends to family members, it may well make sense to pay them before that date. Again, please discuss this with us before you take any action.

Non Resident/Domiciled Individuals

There has been a lot of publicity over the last few weeks about overseas multi millionaires operating in the UK but paying no tax. The Conservative Party suggested a charge of £25,000 on people domiciled overseas (ie originally not of UK origin) who are living in the UK. Despite initially rejecting this, Mr Darling has adopted it in his pre Budget report but set the level at £30,000, only applicable to those who have been in the UK for seven years.

Non-domiciled individuals will therefore continue to pay tax on their UK income and gains, but have a choice as to the tax they pay on their overseas money. They can either pay tax on all the income or gains as the money is earned or pay £30,000 a year and then only pay tax on any overseas income or gains which they bring into the UK. These changes will not only affect the very wealthy, but could be quite relevant for non-domiciled individuals who are in the process

of selling overseas assets - especially coupled with the new flat rate of 18% UK Capital Gains Tax. Detailed rules are to be published by Christmas and will include the method of dealing with accumulated income and gains.

A further change affects the tax exemptions given to individuals who claim to be non resident because they spend less than 90 days on average in the UK per year. The average has previously been calculated by ignoring days of arrival and departure, and this has enabled some wealthy businessmen to run UK businesses by flying in and out of the UK during the week while living abroad. From April 6 next year, days of arrival and departure are to be included in the 90-day average calculation.

Inheritance Tax

At last, some good news - but not much! The Chancellor made great play of his announcement that married couples and civil partnerships will be able to gain the benefit of each other's tax exempt bands of £300,000 on death, giving a total of £600,000 per couple, which will rise to £700,000 by 2010.

This is a definite benefit in those cases where there is a surviving spouse or partner and tax planning has not been previously carried out, perhaps because the assets are worth substantially more than originally expected because property prices have risen.

In many cases, a similar situation had already been achieved by the use of "nil rate discretionary trusts" written into Wills or by changing the Will by a Deed of Variation after the person's death.

Indeed, the changes to the rules will mean that many Wills will need to be redrafted since the "nil rate Discretionary Trust" provisions are no longer tax efficient in all cases. These new rules have already come into force on October 9, and we therefore recommend that all clients review their Wills as soon as possible.

Despite the good news for married couples and civil partnerships, it is unfortunate, that the Chancellor did not address a number of other Inheritance Tax problems, such as those facing couples who have either not married or formed a civil partnership, or other situations such as two sisters living together or children who live with elderly parents. In such cases, early Inheritance Tax planning may be possible, although without any defined exemptions the situation is more complex.

As always, we are very pleased to advise our clients on these matters.

Prestigious award

Burgess Hodgson is celebrating after being shortlisted for a prestigious national award for excellence. The firm beat off competition from all over the UK to join just five others on the shortlist for the Accountancy Age Awards' Medium Firm of the Year.

Burgess Hodgson had to demonstrate how it has developed and how this growth has improved client focus, effectiveness and innovation. The 13th Annual Awards for Excellence celebrate success and achievement across the entire industry, from accountants in business, to practice and public sector.

Not only that, but the awards are judged not only by a number of highly respected financial and business leaders, but by people within the industry.

Steve Sutton, senior partner at Burgess Hodgson, said the award recognised the hard work of the partners and employees of the firm. "We are delighted to be shortlisted for the National Award for Excellence," he said. "It's recognition of the quality of our people and the service they provide to our growing client base."



We are a leading firm of chartered accountants and business advisers, specialising in personal and corporate tax planning. Our experienced professionals have a strong reputation for providing quality technical advice and the ability to implement practical financial solutions as flexibly as our clients demand.

Building relationships has always been at the heart of our business. We understand that business success is measured by the strength of our relationships with clients. Our partners' technical skills, professionalism and business acumen is complemented by the commitment of our staff to provide our clients with the best service possible.

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