the bottom line

SPECIAL EDITION

This Special edition deals with the major reforms proposed by the Chancellor's Pre Budget Statement with respect to the taxation of Non Domiciled individuals, Capital Gains Tax and new rules on Income Shifting in family businesses.

All of these changes are due to be implemented with effect from 6 April 2008 even though a substantial part of the draft legislation is still under consultation and will be part of the Budget Statement due on 12 March 2008. The final legislation will be included in the Finance Act 2008 which is expected to be passed by Parliament during July 2008. The speed of the changes, coupled with the far reaching implications have been much criticised, and has resulted in last minute relaxations and statements of clarification by the Government. It remains to be seen what else will be proposed before and during the period running up to the Budget Statement on 12 March 2008. This special edition of The Bottom Line summarises the main points as they stood at the time of writing.

PROPOSED CHANGES TO THE TAXATION OF NON-UK DOMICILIARIES

The Government has now released draft legislation which radically alters the way that UK-resident but non-domiciled individuals are to be taxed in the UK. The intention is that the draft changes will be enacted in Finance Act 2008 to apply from 6 April 2008. The proposed changes are not yet law; however, it is likely that the main proposals will become law from 6 April 2008.

Availability of the Remittance Basis

Currently, non-domiciled individuals resident in the UK are only taxable on offshore income and gains to the extent that they are brought in or "remitted" to the UK. From 5 April 2008, it is proposed that this "remittance basis" will only be available automatically to those whose offshore income and gains total less than £1,000 in any given tax year.

All other non-domiciled taxpayers will need to formally elect for the remittance basis to apply to their income and gains. Taxpayers will be able to elect in and out of the remittance basis on an annual basis. If the remittance basis is not claimed, non-domiciliaries resident in the UK will now be taxable on their worldwide income and gains.

Individuals who have been resident in the UK for 7 out of the preceding 9 years will need to pay an additional £30,000 tax charge if they wish to use the remittance basis and their offshore income and gains exceed £1,000 in the year. Assuming higher rate tax of 40% applies to their UK income, offshore income and gains will need to exceed around £75,000 to make an election worthwhile. It has been confirmed that there will be no further tax charge on

Greenback Alan LLP
CHARTERED ACCOUNTANTS
11 Raven Wharf
Lafone Street, London SE1 2LR
Tel: +44 (0)20 7403 5959
Fax: +44 (0)20 7403 3111
Email: gba@greenback-alan.co.uk
Web: www.greenback-alan.co.uk

funds remitted to meet the £30,000 charge although, as things stand, it seems that the charge will not qualify for credit as a foreign tax in some other countries: most notably the United States.

Those who have not been resident in the UK for 7 out of the preceding 9 years will not be subject to the £30,000 charge.

The UK personal income tax allowance (currently £5,225) and annual CGT exemption (currently £9,200) will no longer be available to anyone who elects for the remittance basis in the year of election.

Offshore Structures

Further measures are proposed to bring the gains of offshore companies and trusts within the charge to UK tax for non-domiciliaries, unless the remittance basis is claimed:

- The gains of offshore companies will be chargeable proportionately on UK-resident shareholders owning more than 10% of the share capital, unless the remittance basis is claimed. The remittance basis will not be available for UK-situate assets, for instance UK property.
- UK-resident settlors of offshore trusts will be chargeable on the trust gains as they arise, where they are a beneficiary of the trust. The remittance basis can be claimed (for offshore assets only) but any unremitted gains will be added to the stockpiled gains pool (see below).
- UK-resident beneficiaries of offshore trusts, regardless of their domicile, will be chargeable on capital payments made to them by the trustees which are matched with stockpiled gains, whether they are settlor or not. This includes any gains chargeable on settlor which have not been remitted to the UK. A recent statement made by the acting Chairman of HMRC has sought to soften this draconian measure by stating that it is intended only to apply to gains accrued or realised after 5 April 2008. This would mean that any gains currently within trusts would escape the charge. However, we are awaiting clarification on this point.

After 6 April 2008, the remittance basis is not available for UK beneficiaries of offshore trusts receiving capital payments, whether the payments are made on or offshore, where the payments are matched with trust gains made after 6 April 2008. It will therefore be very difficult to receive capital payments from offshore trusts in the UK without a tax charge where new gains accrue to the trust after 6 April 2008.

Residence Test

Days of arrival and departure will now be counted when assessing whether a taxpayer is resident in the UK for the purposes of both the main 183-day "presence" test and the 90 day "habitual visitors" test. People who make frequent short visits to the UK should therefore be particularly careful. It has been confirmed that time spent at a UK airport awaiting an international transfer will not be counted.

Other changes

- Certain loopholes used to convert a remittance into a non-taxable receipt in the UK will be closed. This includes the gift of income or gains to relatives or associates which will now count as a remittance if brought into the UK.
- Income or gains converted into goods or assets overseas and then brought into the UK will now become taxable when the asset is brought into the UK. There will be a concession for artworks brought into the UK for public exhibition.

Inheritance Tax (IHT)

The proposed changes do not affect the IHT position of non-UK domiciliaries. Individuals who are non-domiciled and non- "deemed" domiciled for UK IHT purposes will still benefit (for IHT purposes) from holding assets offshore, including in offshore companies and trusts.

PROPOSED CHANGES TO THE CAPITAL GAINS TAX (CGT) REGIME

The Government has also released draft legislation detailing the proposed changes to CGT which it intends to apply from 6 April 2008.

Rate

The current CGT rates are due to be replaced with a single rate of 18%. Currently, the rate of CGT depends on the nature of the gain and the marginal income tax rate of the taxpayer.

Compulsory Rebasing

When computing a chargeable gain in respect of an asset held at March 1982, a taxpayer can currently choose whether to use original cost or the value as at March 1982. Now, the latter will be compulsory. This will not affect most taxpayers as the majority of assets have risen in value between acquisition and March 1982.

Abolition of Taper Relief and Indexation Relief

Taper relief will not be available in respect of any disposal made after 6 April 2008 by individuals or trustees. Indexation will no longer be available for most gains, other than those which were deferred before 5 April 2008 (for instance through investing in an EIS/VCT scheme). Instead, the new flat rate of 18% will apply to the "simple" gain – i.e. the difference between the sale price and original purchase price.

Indexation relief has, up until now, allowed a measure of relief against inflation for assets held at any point between March 1988 and March 1998. The base cost of an asset held throughout that period is typically uplifted by approximately 100%. As indexation is based on acquisition cost, its loss is unlikely to be significant where the cost is relatively small. However, where the base cost is relatively large in comparison with the current value, consideration could be given to utilising the relief by making a sale before 5 April 2008.

In some cases, for example where an asset has been held for a significant period prior to March 1998, a married couple may be able to "bank" the indexation relief by transferring those assets to their spouse.

Taper relief currently applies to reduce the chargeable gain by reference to the period held from March 1998. Maximum relief for non-business assets is given after 10 years with gains being tapered by a maximum of 40%. Maximum relief for business assets can apply, in certain circumstances, after just two years' ownership with gains being tapered by a maximum of 75%.

Assuming a CGT rate of 40% currently applying to chargeable gains, the rates applicable to assets which qualify for full taper relief are 10% and 24% for business and non-business assets respectively. From 6 April 2008, subject to a new Entrepreneurial Relief (see below), all gains will be subject to an 18% flat rate with no indexation or taper relief available.

It can therefore be seen that holders of non-business assets (for instance residential let property) will be better off under the new regime and may wish to defer any forthcoming sales until 6 April 2008. However, owners of business assets may be worse off as a result, although the new Entrepreneurial Relief is to be introduced which may mitigate this.

Entrepreneurial Relief (ER)

Following lobbying from various groups, the Government has made some last-minute changes to the proposals by introducing a new ER for certain disposals. The new relief will provide a 10% rate of CGT but only for cumulative gains on business assets of up to £1,000,000 in any taxpayer's lifetime. Any excess gains will be subject to the 18% rate.

The rules for ER are tighter than for business asset taper relief. In order to qualify a shareholder will need to hold at least 5% of the shares in the company and be a Director or employee. The relief will also be available for the disposal of all or part of a sole trade / partnership trading business and any business assets which are owned personally but sold as part of the same deal.

Although this limited 10% rate band is welcome it should be noted that minor investors in employer and AIM companies will not longer benefit as they do under the current regime, unless they hold a 5% interest. Furthermore, the 10% rate is only applicable to lifetime gains of £1,000,000, whereas currently the rate applies to uncapped business asset gains.

INCOME SHIFTING: PROPOSED NEW LEGISLATION

Following the Government's failure in the recently publicised *Arctic* case, the Treasury has released draft legislation which it intends to use to tackle alleged "income shifting" within family businesses. The legislation would apply from 6 April 2008 if enacted.

The *Arctic* case, which we have covered in detail in previous editions, may be summarised as follows. Mr Jones had set up a company and given half the shares to his wife. Mr Jones was the main income generator, with Mrs Jones providing administrative support to the company. The profits were shared equally between them through the payments of dividends. HMRC sought to tax all the dividends on Mr Jones using the long-existing 'settlements' legislation, but were unsuccessful.

As a result of this, the Government has proposed legislation to counter similar arrangements.

The proposals

The legislation seeks to identify where "income shifting" has taken place. This is defined as where one person shifts business income to another with the result that less income tax is paid overall.

Where income shifting has taken place, the legislation requires that any tax advantage is removed by the income being taxed on the first individual. The rules do not apply where there is a legitimate commercial reason for the income split, or if HMRC accepts that tax mitigation was not one of the main purposes of the arrangement.

Two main scenarios are envisaged where income shifting may take place: (a) where excess dividends are paid from company profits to shareholders; and (b) where excess partnership profits are shifted from one partner to another.

In quantifying if income has been shifted, or the extent to which it has been shifted, the guidance recommends that consideration is given to the following:

1. Does the work done by the individual reasonably justify the level of award received, taking into account the type and amount of work undertaken? The extent of responsibility is also emphasised.

2. Has the individual invested capital in the business? An investment might warrant a certain return.

3. To what extent has the individual taken on risk in being involved in the business? This could include taking out loans secured on personal assets, or taking on a partnership with unlimited liability.

The Practicalities

HMRC expect taxpayers to come to a decision as to if and to what extent income has been shifted in any year and to report it on their self-assessment tax return. There is little practical guidance which makes "shifted income" very difficult to quantify.

Although HMRC does not require any further records to be kept as a result of the changes, it is likely that family businesses will have an onerous and uncertain burden put on them in that they will need to be able to provide evidence if asked to justify that the income split is on a commercial basis. Business records will now need to demonstrate the value of each family member, and might, for example, include time spent, duties carried out, board minutes and any research done on the market rates of pay for the duties.

Gifts

The legislation is not designed to capture investments in assets where there is no connection between the parties (e.g. quoted companies). However, it may apply to gifts where there is a subsequent shifting of income in the form of dividends or partnership profit share.

Contacts:
For further information about the issues raised in this newsletter or if you would like to find out about the range of services that we can offer, please contact Stephen Dabby, Morisha Christy, Tony Sian, Nick Nicolaou or Alex Green.

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