



Personal Tax Planning under the new Coalition Government

BRIEFING

Our new Chancellor George Osborne described his Emergency Budget on 22 June as '*unavoidable*'. On the macro level, it will be interesting to see whether the combination of spending cuts (with more details to be announced in the Autumn) and tax increases does indeed deliver the net savings anticipated over the course of this Parliament - as indeed whether the Coalition will be strong enough to stand together.

Apart from the anticipated increase in the standard rate of VAT to 20% from 4 January 2011, the main highlight of the Budget announcements for private individuals was, again, an anticipated increase in the marginal rate of Capital Gains Tax (CGT). However, the figure of 28% was less than the 40% (or even more) that some had feared, though the effective date of midnight on Tuesday 22 June, against the warnings of a number of tax commentators, will produce problems with a split year for rate purposes. The increase of the lifetime entrepreneurs' relief to £5m was certainly a welcome surprise.

And, happily, higher rate Income Tax relief continues for both charitable donations and (subject to limitation) pension contributions, though the latter regime from 2011/12 is to suffer from further amendment.

Further, there have as yet been no restrictions on the ability to switch elections for CGT main

residence relief purposes. Full advantage should be taken of this facility.

It was good to see that deemed trading treatment for both Income Tax and Corporation Tax purposes will continue for furnished holiday lettings, subject to some tinkering with the conditions from 2011/12.

So what follows puts the latest announcements in some form of context, including a look at a couple of decided cases in the Courts this year and at current trends within HMRC.

Sadly, life is never static when it comes to tax planning: not only must action taken in the past be kept under regular review, but any present planning undertaken needs to be set against the current regime. So, against that background, that is now what we proceed to do, starting with CGT.

Capital Gains Tax

The Coalition Agreement issued on 11 May stated a commitment to '*seek detailed agreement on taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities*'.

Those whose gains attract the entrepreneurs' relief introduced in 2008, where the lifetime limit was increased from £1m to £2m for disposals from 6 April 2010, could not in their wildest dreams



have hoped for an increase to £5m for disposals from 23 June. Consider a person who made qualifying gains of £5m on 22 June: he would pay tax of 10% on £2m and of 18% on £3m, a total of £740,000. A person making a disposal a day later would pay just £500,000 in tax, saving £240,000. While there had been some discussion as to the definition of assets that attract relief, it looks as though no changes will be made here.

Rates of CGT

For those selling non-business assets, there is a significant increase (by more than half) in the maximum tax rate, albeit not as bad as some had thought, eg to 40% (or even beyond) – which would have been more than double the 18% rate. Significantly, there is no return to any kind of taper relief or indexation allowance. That is, if a higher rate taxpayer makes a chargeable gain of £100,000 on top of his annual exemption on or after 23 June, he will have to pay £10,000 more tax than if he had made the sale on 22 June or before, regardless of whether the asset has been held for one or ten years – or even longer. Presumably, apart from the Chancellor's express desire to avoid the complications inherent in some form of tapering, this could be seen as some sort of 'rough justice' for having a rate of CGT that is somewhere between the basic rate of Income Tax of 20% and the first higher rate of 40%. So the 'special pleading' put in before the Budget on behalf of, for example, older people with second homes has perhaps borne some fruit.

Certainly, the adoption of a mid-tax year rate change (for the first time) will produce certain

complications. It seems that both (a) the annual exemption and (b) losses for 2010/11 and losses brought forward can be used in a way which is most beneficial to the taxpayer, that is he can choose to set them off against post-22 June rather than pre-23 June gains. However, in principle, we are back to the system which applied between 1998 and 2008, namely that the rate of CGT depends upon one's taxable income:

- a rate of 18% will apply if the total taxable income plus chargeable gains on top of the annual exemption (which stays at £10,100) does not exceed the 40% threshold of £37,400 in 2010/11.
- However, to the extent that chargeable gains after the annual exemption added to the taxable income exceed £37,400, the gains will attract CGT at 28%.

Not surprisingly, trustees of all non-charitable settlements and personal representatives of deceased estates will pay CGT at 28%, whatever the level of gains above the annual exemption (which in the case of trustees can be anything between £5,050 and £1,010 depending on the number of settlements made by the settlor since 6 June 1978). Gains of settlor-interested trusts will be assessed on the trustees, not (as was the case before 2008/09) on the settlor.

Will more tax be raised?

Of course, as was reported in the press, a number of people were making disposals prior to Budget Day and they turn out to have been rewarded,



especially against suggestions that any increase might have been backdated to 6 April (wholly unconstitutional) or indeed 11 May (the date of the Coalition Agreement, though expressed in rather vague terms). The 'neatest' solution might have been for any increase to be introduced from 6 April 2011, so avoiding complications of an immediate rate change. Sadly, that was not to be.

This is coupled with an interesting point made in representations to the Chancellor before the Budget, namely that against the Government's expectations the total take from CGT may indeed go down under the new regime. Research published some years ago in the US and since adapted to Europe has suggested that 18.4% or thereabouts is the optimum revenue-raising rate in terms of being sufficiently low as not to dissuade people from making disposals. To some extent we have not been given an opportunity to see whether that is true, as in 2008/09 and 2009/10 markets generally have been depressed. And indeed, although the £5.27bn take from CGT in 2007/08 rose to £7.85bn in 2008/09, the current estimate for 2009/10 is just £2.46bn. Certainly, the Government is expecting to raise some £0.9bn more each year under the new regime: we shall watch with some interest the tax revenue statistics as they are produced and updated by Her Majesty's Revenue & Customs (HMRC).

Non-UK domiciliaries

There are knock-on effects both (a) for non-UK domiciled individuals who are resident in the UK who have opted to be taxed on the '*remittance basis*' (that is on their offshore income and gains

only insofar as they bring them into the UK) and indeed (b) on the gains of offshore trusts which can be attributed to '*capital payments*' received by UK beneficiaries. Many of those affected were also making disposals before 23 June and are so seen to have been better off as a result.

Deferral of gain

Finally, it is worth alluding to two deferral regimes:

- a) the roll-over relief for replacement of business assets; and
- b) the Enterprise Investment Scheme (EIS).

Happily, in general terms, the increase in the entrepreneurs' threshold should, subject to qualification, ensure that any gains on business assets which have been deferred through roll-over relief will attract CGT at just 10% on disposal. With EIS investments, the opportunity always remain to defer a gain on any asset through a subscription in qualifying EIS shares (which is effectively '*washed*' on death).

So much for CGT. Now on to the other principal tax on capital!

Inheritance Tax (IHT)

Here there are just two announcements:

- Alistair Darling's last Budget proposal on 24 March 2010 that the nil-rate band would remain at £325,000 until 2014/15 has been endorsed by George Osborne.



- Second, there are proposals to add arrangements designed to avoid IHT on trusts to the so-called 'DOTAS' (Disclosure of Tax Avoidance Schemes) system. This is the statutory requirement first introduced in 2004 to disclose to HMRC tax avoidance schemes, whether for purposes of Income Tax, Corporation Tax, CGT, VAT or Stamp Duty Land Tax (SDLT).

Planning ingenious schemes continues, to avoid the restrictive impact of the nil-rate band on sheltering non-business assets (that is, which do not attract business property relief from IHT) on putting them into trust. Witness to this were the anti-avoidance measures announced in the Pre-Budget Report on 9 December last, enacted in Finance Act 2010. So, for those who might be tempted, we have been warned.

But otherwise it remains 'business as usual' for IHT. That is, for example

- The availability of the £3,000 annual exemption, the £250 small gifts exemption, the 'normal expenditure out of income' exemption and the marriage exemption continues.
- Relief at 100% continues for qualifying business or agricultural property.
- The ability to make a '*potentially exempt transfer*' (PET) of any amount to an individual, survive for seven years and make the gift exempt (remembering that the gift is a disposal for CGT purposes and so the CGT implications must be considered).

- For those who are minded to make a gift, though not to an individual, and wish to achieve some form of protective structure for assets which do not qualify for the 100% relief given to defined business or agricultural property, the threshold of £325,000 on a seven-year basis can be a limiting factor: above it there is a 20% IHT entry charge. This figure also continues to be the relevant one for charging property within a '*relevant property*' trust on each ten-year anniversary, including a number of old '*accumulation and maintenance*' trusts which went into the less favourable '*relevant property*' regime on 6 April 2008. Certainly, regular review should be made of the IHT implications for all such trusts, with proper planning well in advance of any ten-year anniversary.

- As a possible way round this problem, some have advocated the use of family limited partnerships to achieve the PET treatment. This would avoid the trust implications for IHT, but also achieve protection of the asset against the possibility of insolvency or matrimonial reverse on the part of the younger generation. Such vehicles are far from straightforward, though can achieve benefits in appropriate cases.

Trusts and Income Tax

Non-charitable trusts of whatever description suffer the higher rate of CGT as noted above. However, there is a significant Income Tax difference between (a) trusts which give a right to income to one or more beneficiaries as that



income arises and (b) trusts where the distribution of the income is subject to the discretion of the trustees. Under (a), a so-called interest in possession structure, the Income Tax liability of the trustees is limited to the basic 20% rate (satisfied in the case of dividend income by the 10% tax credit), any higher rate liability depending upon the personal circumstances of the beneficiary. By contrast, with (b), whether a discretionary or an accumulation trust, while the first £1,000 of income suffers tax at no more than 20%, the balance (whatever the level of income of the trust) attracts 50% tax (or 42.5% on dividend income). There may be the possibility of recovery of tax paid (except in relation to the 10% dividend tax credit) by or on behalf of a beneficiary who is no more than a basic rate taxpayer, but there are compliance and cash flow issues involved here.

All in all, except in the case where trustees genuinely want the flexibility and freedom of a discretionary structure, it can make a lot of sense to create interests in possession (which need not last for all time and can be 'revocable'), with a view to increasing Income Tax efficiency.

Wills

There remains a relatively high proportion of the population who do not have a Will at all or at least have a Will which was made many years ago and which does not reflect current intentions and circumstances. It really is essential that everyone, professional advisers included, has a regularly reviewed Will which reflects current intentions.

The nil-rate band gift

A recent case called *RSPCA v Sharp* has highlighted some drafting issues. In his Will Mr Sharp left two gifts:

- the one expressed to be '*the amount at which my death equals the maximum which I can give by this my Will without Inheritance Tax becoming payable in respect of this gift ...*'; and the other
- a tax-free gift of land worth £169,000 to certain named individuals.

Residue was left to the RSPCA, attracting exemption as a charitable gift. When Mr Sharp died the nil-rate band was £300,000. The question for the High Court Judge was whether (a) the first gift should take effect as a gift of £300,000; or (b) it should be reduced by the amount of the second gift to £131,000, to ensure that no IHT was payable at all on the estate.

The Judge adopted option (a) and in so doing has been heavily criticised by many in the professions, who generally think that the first gift should be limited to £131,000. He also roundly criticised the RSPCA for bringing the case: '*it is a matter of regret that this action was ever brought*'. Apart from the adverse publicity given to the RSPCA, the charity of course got less than it otherwise might have done – and might still get, if the decision is overturned by the Court of Appeal – and in particular because the charity must bear the tax on the grossed up amount of the second gift of £169,000. The problem was that the Will simply



failed to make clear what Mr Sharp had intended, so that is really the moral of the case - know what you want to achieve in your Will and make sure that the solicitor advising you knows this and drafts your Will appropriately.

The transferable nil-rate band (TNRB)

Our second point on Wills concerns the introduction of the TNRB on 9 October 2007. That is, given the exemption from IHT for assets passing between spouses and civil partners, the percentage balance of an unused nil-rate band on the first death can be carried forward for use on the second. Generally, this is thought to be 'a good thing'. And so solicitors generally have been advising clients to take advantage of it, especially in the hope that by the time of the second death the nil-rate band might have been increased to £1m, the stated aspiration of the Conservative Party before the General Election (which, alas, must now in present circumstances of national financial stringency be seen as something of a pipe dream). The benefit of such a move would have been seen especially in the case where the first death occurred when the nil-rate band was £325,000 and the second after it had risen to £1m, a saving of £270,000 (40% of the difference between £1m and £325,000). All that must be put to one side, however - certainly for the time being.

However, one might need to rethink the wisdom of the TNRB if, on the basis of the 'accepted wisdom' before 9 October 2007, the optimum IHT-efficient structure on the first death would be to use the nil-rate band in leaving assets away from the surviving spouse, whether for example to the

named children or indeed to a discretionary trust for named beneficiaries (including the surviving spouse, so making it possible to benefit him/her from income or capital, but avoiding the trust assets forming part of the chargeable estate on the second death).

The point is this: if it is thought on a first death now that suitable assets can be identified (ideally not including a share in the family home) to go into a nil-rate band trust which are likely to grow faster than the nil-rate band itself (albeit losing the potential for doubling up, through a claim to the TNRB on the second death), then (possibly) it may be preferable to go back to the old accepted wisdom. Of course, within a trust, there is the ten-year anniversary charge to remember, but this can never be more than 6% every ten years and on a value of say £650,000, assuming a nil-rate band of £325,000, would be just 3%. This may be worth thinking about.

Pensions

We are currently in a transitional regime covering 2009/10 and 2010/11 restricting higher rate Income Tax relief for pension contributions by those earning over (broadly) £130,000. Relief is given on periodic contributions made at least quarterly for which a commitment had been made before 22 April 2009 (subject to a limit of the greater of 'relevant UK earnings' and the annual limit of £245,000 for 2009/10 and £255,000 for 2010/11). Failing that, the limit is the greater of (a) gross contributions of £20,000 per annum and (b) the mean of gross pension contributions made in



the three previous tax years, subject to an absolute limit of £30,000.

The new regime for higher rate relief which was due to have come into effect in 2011/12 is to be revised, perhaps with an annual allowance for higher rate contributions somewhere between £30,000 and £45,000. We shall be looking forward to seeing further detail of this.

Meanwhile, however, there has been a very significant case before the First-tier Tax Tribunal involving the IHT-free payment of pension death benefits before the individual starts to take them. The case is called *Fryer and Others v HMRC*, the taxpayers being the executors of Mrs Arnold. Before she reached her normal retirement date of 60, Mrs Arnold was unfortunately diagnosed with terminal cancer of which she died shortly before her 61st birthday. At that point she had a pension fund of around £147,000 which, in accordance with generally accepted practice, she had written in trust for her family, expecting that should she die before drawing her pension benefits, the payment could go to them free of IHT.

Unfortunately, a provision in the Inheritance Tax Act 1984 (section 3(3)) treats a person as making a transfer of value for IHT purposes when '*they omit to exercise a right*'. The argument of HMRC therefore was that, just before she died, Mrs Arnold could have elected to take her benefits, which she had not done, and should therefore be treated as making a chargeable transfer of the full amount. The Tribunal Judge agreed with this argument, though he reduced the measure of the chargeable transfer to around £90,000.

All this goes back to discussions between HMRC (or the Inland Revenue as it then was) and the Association of British Insurers (ABI) in the early 1990's, which culminated in a statement of HMRC's policy in March 1992 (now replaced by a provision in the legislation). There they said that, in circumstances such as Mrs Arnold's, the section 3(3) point remained good, although they would not press it where (in particular) the policyholder survived the decision not to draw pension benefits by at least two years (which she did not in this case). Subject therefore to any appeal in the case or to any statement by HMRC or indeed the ABI, the position remains uncertain, although generally speaking the decision is taken to be correct (with the odd technical query). The question therefore is - what should people do?

We do not advise on pensions as such and are recommending to all our clients that they should consult their pensions adviser, with a view perhaps to taking the following action if the pension documentation allows it. That is, one might elect to increase the specified Normal Retirement Date (NRD) to the last possible age of 75 (or such later age as may be introduced in future). This is on the assumption that the particular scheme both allows such a deferral and gives power to the trustees to adopt a request by the individual to take benefits earlier than this, eg on reaching age 60, 65 or whenever he/she wishes to do so. It is important that such a change is made before the individual reaches their NRD.



Tax Avoidance

Through the DOTAS regime mentioned above and through ‘*Spotlights*’ (of which HMRC have now issued 10 in the last year or so), HMRC continue to be alive to schemes designed to reduce the tax which taxpayers must legitimately pay. ‘*Spotlights*’ are descriptions of arrangements of which HMRC become aware as being adopted in the market place which they do not believe achieve the tax benefits promised, though as yet untested in the Courts. A couple of recent ‘*Spotlights*’ have involved some fairly blatant tax planning by charities which in our view simply do not work. However, it goes to show what people will get up

to. And so the moral is to be fairly ‘*conservative*’ in one’s tax arrangements.

Conclusion

So there it is. Personal tax planning is a subject which remains alive and well and which we all ignore at our peril!

For further information – please contact:

Hugh MacDougald

DT: 020 7593 5149

E: hmacdougald@wslaw.co.uk