

Making sense of the Budget*

The Chancellor's Budget 2007



Private client summary

From a personal tax perspective, the Chancellor's speech saved the best to last, with his closing remarks being an announcement that the basic rate of income tax was to be cut with effect from April 2008 from 22% to 20%.

As in previous years, the bulk of the provisions impacting individual taxpayers were contained in the Budget Notes released after the Chancellor's speech. The Budget contained few significant changes from a personal tax perspective, although there were some welcome announcements including those relating to individuals holding overseas properties via a company and changes to the tax treatment of non-cash benefits provided to pensioners.

*connectedthinking

Making sense of the Budget

The Chancellor's Budget 2007

Budget 2007 continued to build on the anti-avoidance theme contained in previous Budgets with a series of measures aimed at countering avoidance, albeit the number of measures introduced were more modest than in previous years. Finance Bill 2007 also heralds the arrival of the targeted anti-avoidance rule (TAAR) as announced in the Pre-Budget Report 2006.

Further details of the changes introduced are set out below.

Rates and allowances

Income tax rates and allowances

As indicated above, the Chancellor announced today that the basic rate of income tax would be cut from 22% to 20% with effect from 6 April 2008.

The starting rate (currently 10%) will be removed by Finance Bill 2008 for earned income and pensions, but will continue to be available for savings income and capital gains. There are no planned changes to the rates applicable to dividends.

For 2007/08 the income tax starting rate and basic rate limits are to increase in line with inflation to £2,230 (from £2,150 in 2006/07) and £34,600 (from £33,300 in 2006/07) respectively.

Personal allowances

As previously announced the personal allowance for those aged under 65 will increase from £5,035 to £5,225

for the 2007/08 tax year. For those aged between 65 and 74, the allowance is increased to £7,550 (2006/07: £7,280) and for those aged 75 and over the allowance rises to £7,690 (2006/07: £7,420).

National insurance contributions (NICs)

NIC rates and thresholds for 2007/08 were previously announced in the 2006 Pre-Budget Report. The starting point for employers', employees' and self-employed NICs in 2007/08 will increase in line with inflation to £100 per week.

For the self-employed, Class 2 NIC will increase from £2.10 to £2.20 per week.

Of more interest were the Government's plans to align the thresholds for income tax and national insurance contributions so that with effect from 2009/10 there will be two rates and two thresholds. This will see the upper earnings limit (UEL) for employees' Class 1 NICs for 2008/09 increase by £75 per week (£3,900 for the year) above indexation. The Class 4 NIC upper profit limit (UPL) will also be increased by the same amount.

From 6 April 2009 the UEL/UPL will be fully aligned with the income tax higher rate threshold.

Capital gains tax annual exemption

The Chancellor today announced an increase in the CGT annual exempt amount of £400; bringing the exemption to £9,200 in 2007/08.

Inheritance tax – nil rate band

The Chancellor today announced plans to raise the nil rate band for inheritance tax (IHT) to £350,000 in 2010/11.

As previously indicated, the IHT nil rate band will rise to £300,000 in 2007/08, £312,000 in 2008/09 and £325,000 in 2009/10.

Working tax credit (WTC)/child tax credit (CTC)

The basic element of WTC will increase by £65 in 2007/08 to £1,730. The childcare element of the WTC will remain at £175 per week for one child and £300 per week for two or more children.

The family element of child tax credit will remain at £545 for 2007/08 although the child element will increase by £80 to £1,845. The child element of the CTC will rise to £2,080 from 6 April 2008.

Anti-avoidance

Disclosure regime

The tax avoidance disclosure regime, introduced in Budget 2004, has been modified by introducing new powers for HM Revenue & Customs (HMRC) to investigate a scheme where there are reasonable grounds to believe that a promoter has failed to comply with its statutory disclosure requirements.

The final legislation will be published in the Finance Bill later this year.

Life insurance policies and commission arrangements – closure of avoidance schemes

A measure, effective from today, is introduced to tackle schemes that use individual policies and commission arrangements to avoid tax on investment income. The schemes are typically marketed by advisers to individuals with significant sums to invest.

Making sense of the Budget

The Chancellor's Budget 2007

The measure is designed to target the larger premium, relatively short term policies used in such schemes.

Partnerships and sideways loss relief

A measure to counter the avoidance of tax through the sideways loss relief was announced on 2 March 2007. The measure took effect from 2 March 2007.

Targeted anti-avoidance rule (TAAR)

The TAAR introduced in the Pre-Budget Report 2006 will be contained in Finance Bill 2007. As previously advised, the measure is designed to counter schemes to create and use artificial capital losses to avoid tax. The measure will ensure that allowable capital losses are restricted to those arising from genuine commercial transactions.

Tackling managed service companies

As expected, legislation will be introduced in Finance Bill 2007 to control managed service companies (MSC). The definition of an MSC is being re-focused from the draft issued with the Pre-Budget Report, so the target is the MSC provider.

Income received by individuals providing their services through MSCs will be treated as employment income, if it is not done so already. As a consequence, MSCs will have to operate PAYE and Class 1 NIC on all payments received by individuals in respect of services provided by such companies from 6 April 2007. Where an MSC has incurred a PAYE/NIC debt and it cannot be recovered from the company, legislation has been introduced to enable HMRC to pursue the directors of the MSC from August 2007 and certain third parties from January 2008.

Pensions

Pension tax

Budget 2007 announced the introduction of legislation in Finance Bill 2007 which modifies the pension tax rules. The measures are designed to exclude from tax minor benefits provided by former employers for retired former employees.

At the same time the IHT pension rules in respect of the payment of lump sum benefits following the death of a scheme member will be amended to allow the exemption from IHT charges to operate within the same timeframe as permitted by the rules of a registered pension scheme.

Two anti-avoidance rules will also be introduced. The first will ensure that the payment of unauthorised member and employer payments cannot be structured to reduce the overall tax charge on the scheme and member or employee. The second aims at ensuring that the flexibility introduced in Finance Bill 2007 on scheme pensions paid early on ill-health grounds do not prevent the existing anti-avoidance arrangements from applying.

The changes will have effect from 6 April 2006.

Tax relief on personal term assurance

A measure was introduced to remove an individual's entitlement to tax relief on pension contributions they pay that are used to fund personal term assurance policies. It does not impact upon the relief available for contributions paid by employers.

The operative date will vary depending upon the type of pension scheme. For occupational registered pension schemes the changes will have effect for all

contributions made on or after 1 August 2007, unless the insurer received the application for the policy before 29 March 2007 and the policy was taken out as part of the pension scheme before 1 August 2007.

For contributions under other registered pension schemes it will take effect from 6 April 2007 for all contributions in respect of personal term assurance policies, unless the insurer received the application for the policy before 14 December 2006 and the policy was taken out as part of the pension scheme before 6 April 2007.

Alternatively secured pension (ASP) rules

Legislation is to be introduced in Finance Bill 2007 which will include the introduction of a requirement to draw a minimum income from an ASP fund and a tax charge where ASP funds remaining on the death of a member are transferred to the pension funds of other members in the scheme. The measures take effect from 6 April 2007.

The unauthorised payments charges to be introduced on the transfer of funds to other members of the scheme on the death of the ASP member will not have effect where the member or dependent died on or before 5 April 2007. This represents a change from the draft legislation published in the Pre-Budget Report 2006 which disappplied the changes where the member died on or before 6 December 2006.

Tax relief for pensions – rules to prevent inheriting tax-privileged pension savings

The Government also announced today that there will be a consultation on measures that will be introduced to prevent ways of inheriting tax privileged pension savings.

Making sense of the Budget

The Chancellor's Budget 2007

Investments

Alternative finance arrangements

Legislation will be introduced in Finance Bill 2007 to provide new rules on the taxation of certain investment bonds, known as sukuk, which satisfy the Shari'a law prohibition on paying or receiving interest. These products replicate the economic effect of debt securities on which interest is payable and the measure will ensure they are taxed on a par with equivalent conventional securities.

For income tax purposes, the changes will apply to all arrangements entered into on or after 6 April 2007. For income tax payers, they also apply to amounts received or paid on or after 6 April 2007 in relation to arrangements entered into before that date.

Taxation of dividends – non UK resident companies

Individuals in receipt of dividends from non UK resident companies will, from 6 April 2008, be entitled to a non-repayable dividend tax credit subject to certain conditions.

The proposed changes will extend the one ninth tax credit to dividends from non UK resident companies. In order to qualify for this credit the individual must own less than 10% shareholding in the distributing non UK resident company and in total they must receive less than £5,000 of dividends a year from non UK resident companies.

The Government is also considering whether it is possible to deliver a more general extension of the non-payable tax credit for the small minority of individuals in

receipt of dividends from non UK resident companies who do not meet the conditions outlined above, and if so how this might be effected.

Individual savings accounts (ISAs)

The annual ISA investment limit will be raised with effect from 6 April 2008. An individual will be able to subscribe up to £7,200 in a stocks and shares ISA and up to £3,600 in a cash ISA. Subject to an overall limit of £7,200 subscribed to both ISAs in a tax year.

Venture capital schemes and enterprise management incentives

Investors should be aware that changes have been introduced today to the enterprise investment scheme (EIS), the corporate venturing scheme (CVS) and the venture capital trust (VCT) scheme. In addition, measures were introduced which will impact on companies using enterprise management incentives (EMI).

Broadly, the changes introduce new qualifying company rules for EIS, VCT and CVS to set limits on the number of employees allowed and the capital that can be raised in any 12 month period.

For VCTs a change will be made to the 70% qualifying holdings condition to deal with cash realisations, provision will also be made for regulations on inadvertent breaches of the VCT approval conditions.

For EIS the investment period in which a manager has to invest 90% of the funds raised by an approved EIS fund is extended from six months to 12 months.

For EIS, VCT and CVC and EMI, a change will be made to allow the transfer of the qualifying trade of exploiting

relevant intangible assets (RIAs) around a group of companies.

The changes will have effect from 6 April 2007 except that the changes to the investment period for EIS approved funds will apply for funds that closed after 6 October 2006. The employee test and investment limits will not apply in relation to investments made out of funds raised by VCTs before 6 April 2007, nor to EIS or CVS shares issued before the date on which the Finance Bill receives Royal Assent.

Other measures

Recognition of stock exchanges and definition of 'listed' for tax purposes

New legislation to be included in Finance Bill 2007 will allow HMRC to designate as a recognised stock exchange for tax purpose, any investment exchange designated as a recognised investment exchange (RIE) by the Financial Services Authority (FSA).

At the same time, the measure will put in place a definition of the term 'listed' and update references used in conjunction with 'listed' and 'stock exchange' to reflect regulatory and market changes.

For individuals who are shareholders this may impact upon the availability of tax relief. For example, the listing of shares on a recognised stock exchange is a requirement for receipt of certain tax reliefs, for example, shares held in an ISA. Equally, a number of tax reliefs are available only where the shares are not listed on a recognised stock exchange, such as capital gains tax business asset taper relief.

Making sense of the Budget

The Chancellor's Budget 2007

At present, the Government has indicated this measure isn't aimed at securities listed on AIM.

Landlords – service charges and sinking funds

All landlords will, from 6 April 2007, be eligible for relief from the special trust rate of tax for service charges and sinking funds held on trust by registered social landlords and other social landlords.

The extension of the relief will apply to income arising on service charges and sinking funds held on trust by private sector landlords in respect of properties situated in the UK.

Currently, most landlords are required to hold service charges and sinking fund payments on trust, these monies are held typically in an interest bearing account. Income arising is chargeable to tax at 40%. However, under the relief income arising will only be taxable at 20%.

Overseas properties held via a company

Retrospective legislation has been announced today which will ensure that individuals who have bought or will buy a home abroad, will not face a benefit in kind tax charge for any private use of the property if purchased through a company.

Currently some UK resident individuals have set up or acquired companies to own a property abroad, generally for holiday use. Where they direct the company's affairs, they can be within the scope of the living accommodation charge, although they may not have been aware of this or may have considered that no tax or NICs arose in these circumstances.

The measure to be introduced will remove that tax charge, provided that certain conditions are met, and will ensure that all those who fall within the scope of the legislation will not be subject to the benefit in kind tax charge, however long they have owned the property through a company. Draft legislation will be published for consultation later this year.

HMRC has indicated that they will not seek to tax anyone in the intervening period where the following conditions are met:

- The property is owned by a company owned by individuals;
- The company's only activities are ones that are incidental to its ownership of the property;
- The property is the company's only or main asset; and
- The property is not funded directly or indirectly by a connected company.

Pre-owned assets: late elections

Following widespread representations from across the profession, provisions are to be introduced to allow HMRC to accept late elections for IHT treatment that would otherwise be too late under the existing legislation.

Finance Act 2004 introduced an income tax charge from 6 April 2005 on the benefit people derive from having free or low cost enjoyment of assets they formerly owned or they provided the funds to purchase. As an alternative to the charge, taxpayers can elect for IHT treatment on the relevant property. The time limit for election is the same as the self assessment deadline

for making a tax return for the tax year in which an individual is first liable for the pre-owned asset charge. For individuals who were liable in 2005/06 the deadline was 31 January 2007.

Trust modernisation

The legislation forming part of the trust modernisation programme was introduced in Finance Act 2006. Two minor changes have been announced to the legislation.

The first change relates to payments received by trustees following the purchase by a company of its own shares. This is treated as income in the hands of the trustees. Under the existing legislation, trustees could be liable to tax on the entire payment received rather than on the amount in excess of the original subscription value. This legislation will be amended to rectify this.

The second omission concerns the interaction of trustees' tax pools with payments received by trustees which are chargeable event gains on certain life assurance policies. Again, these payments are treated as income in the hands of the trustees. Under the existing rules, it is possible that the notional tax credit of 20% attached to the chargeable event gains could be added to the tax pool, the legislation is to be amended to ensure that the notional tax credit does not do so.

Gift aid

For donations to individuals to qualify for gift aid tax relief the value of any benefit received by the donor as a consequence of making the donation should not exceed certain proportional limits, subject to an overriding limit of £250.

Making sense of the Budget

The Chancellor's Budget 2007

The current limits on the value of benefits received relative to the donation are:

- 25% of the value of the donation where the donation is less than £100;
- £25 where the value of the donation is between £100 and £1,000; and
- 2.5% of the value of the donation, where the donation exceeds £1,000.

Under the new legislation, which will have effect from 6 April 2007 for donations of more than £1,000 the limit on the value of the benefits received will be increased from 2.5% to 5% of the donation, subject to the overriding limit which will increase to £500.

Residence and domicile

There were no announcements on residence or domicile.

Excise duty – alcohol and cigarettes sent from abroad

Finance Bill 2007 will introduce legislation so that from the date Royal Assent is received, all alcohol and cigarettes sent via the postal system from abroad will be liable to UK excise duty.

Car vehicle excise duty rates

Car vehicle excise duty rates for the next three years have been announced. Rates for the most polluting cars will rise to £400.

Stamp duty land tax (SDLT)

Exchanges of property between connected persons

Finance Bill 2007 will implement legislation to amend the SDLT treatment of exchanges of property by providing that where an exchange takes place between connected persons the two legs are not linked with each other for determining the rate of SDLT.

The normal rule is that an individual who acquires property in the UK is charged SDLT by reference to what they pay for the property, regardless of any connection between them or the market value. However, if there is an exchange of property the rule is different and SDLT is charged by reference to the market value of the property acquired.

For connected persons (for example, husband and wife) under the current rules the two legs of the exchange are linked, for example, if property of £300,000 is exchanged for £220,000 the rate of SDLT is 4% (as the aggregate value is £520,000).

The new measures will provide that the two legs of the exchange are not linked, so that in the above example the property worth £220,000 is taxed at 1% and the property worth £300,000 is taxed at 3%.

Anti-avoidance measures

The regulations currently in place to counter SDLT avoidance schemes, and which have effect only for 18 months from the date they were made, will be replaced by permanent provision in Finance Bill 2007. The Finance Bill will incorporate a number of changes, taking account of representations made on the regulations.

Relief for shared ownership trusts

Legislation will be introduced in the Finance Bill 2007 to extend the same tax benefits for SDLT that are currently available for shared ownership leases to shared ownership trusts.

The relief will apply to all transactions on or after the effective date, which will be the date that Royal Assent is given to the Finance Bill.

Payment of tax and self certification

Payment of the amount of SDLT self-assessed in a land transaction return will no longer need to accompany the return as a result of new legislation to be introduced. The tax will still need to have been paid by the filing date for the return.

The measure will be operative from the date the Finance Bill receives Royal Assent and will impact purchasers of freehold or leasehold property.

Relief for zero-carbon homes

A new time limited relief from SDLT for zero-carbon homes will be introduced in Finance Bill 2007. Details of the criteria to be met in order to qualify for the relief will be laid before Parliament in due course.

The measures will take effect on or after 1 October 2007. The relief will be time limited for five years.

Making sense of the Budget

The Chancellor's Budget 2007

Company cars

Car/car fuel benefits — employees earning less than £8,500 per year

New legislation is to be introduced from 6 April 2007 to give legislative effect to an extra statutory concession under which HMRC do not double tax employees earning less than £8,500 per year who are provided with car and fuel benefits financed via an employer's credit card or voucher.

Company car and fuel benefit tax

Under current laws, where a car is made available for an employee's private use a taxable benefit arises. Company car tax is now calculated by applying the appropriate percentage to the list price of the car. From 6 April 2008 there will be a 2% discount from the appropriate percentage rate for company car drivers who drive a car capable of being run on E85 fuel (an alcohol fuel mixture).

The fuel benefit charge has been calculated by applying the company car-tax percentage to a set figure (the multiplier). The company car fuel benefit multiplier for 2007/08 will remain unchanged at £14,400 (2006/07 - £14,400).

Energy

Landlord's energy saving allowance (LESA)

Following the announcement made in the Pre-Budget Report 2006, legislation will be introduced to extend the LESA until 2015.

The LESA is a deduction which applies to individual landlords who let residential properties and pay income tax (and equally to corporate landlords who let residential property and pay corporation tax — subject to state aid approval from the European Commission).

The LESA is currently capped at £1,500 per building, however, with effect from 6 April 2007 the cap will be applied to each property rather than each building. In addition, the new legislation will add floor insulation to the energy saving items which qualify for the LESA.

Microgeneration: tax treatment of renewables obligation certificates (ROC)

As announced in the Pre-Budget Report 2006, householders who have installed microgeneration technology for the purpose of generating electricity for their own personal use, the receipt of a ROC will not be subject to income tax and gains on disposal of a ROC will not be liable to capital gains tax.

ROCs are issued by Ofgem to accredited generating stations to certify the quantity of electricity produced from qualifying renewable sources. A householder can sell the ROCs they receive. The exclusions from income tax and capital gain tax outlined will not apply where the householder is trading.

Tax administration

New criminal investigation powers and safeguards

Legislation is to come into force before the end of 2007 which will ensure that existing powers for England, Wales and Northern Ireland are applied consistently

to HMRC's criminal investigations. For Scotland, new powers and safeguards are to be introduced and existing ones will be applied consistently.

Penalties for incorrect returns

Individuals (and businesses) who understate their tax liability because of failing to take reasonable care in completing returns for income tax, corporation tax, pay as you earn (PAYE), national insurance contributions (NIC) and value added tax (VAT) and those who deliberately understate their liability to any of these taxes, will be subject under new legislation to a single new penalty regime.

The date the legislation will take effect is not yet known but it is expected that it will apply for return periods commencing after 31 March 2008 where the return is filed after 31 March 2009.

Under the new regime, the penalty will be determined according to the amount of tax understated, the nature of the behaviour giving rise to the understatement and the extent of disclosure by the taxpayer. In addition, there will be a new concept of suspended penalties.

Enquiry windows, existing powers to require online filing and effective date of payment by cheque

Under new rules which will apply to income tax self assessment tax returns for 2007/08 and all subsequent tax years, the enquiry window will close one year after delivery of the return. Consequently, where a return is delivered before the filing deadline under the new rules the enquiry window will close earlier than under current legislation.

Making sense of the Budget

The Chancellor's Budget 2007

Once the Finance Bill 2007 receives Royal Assent, HMRC will have the power to make regulations concerning online filing and electronic payment, including the regulation making powers for changes to the effective date of payment of cheques.

The requirement to file PAYE in-year forms online will be introduced in phases from 2009; the requirements to file online and pay electronically for VAT are expected to be phased in from 2010 and for corporation tax from 2011.

HMRC currently deem payment to have been made as soon as HMRC receive the cheque. It is expected that the legislation being introduced will allow for changes to be made to the current position, so that where a business pays corporation tax or VAT by cheque, HMRC will deem payment to have been made only once the funds have been cleared into HMRC's account.

Self assessment: changes to tax return filing dates

Under new legislation to be introduced in this year's Finance Bill, there will be two separate filing dates for 2007/08 and subsequent years. For paper returns there will be a new date of 31 October. For returns filed online the filing date will remain at 31 January.

For a small minority of taxpayers for whom facilities are not available to file online, HMRC will allow extra time (until 31 January) for those taxpayers to file their returns

For taxpayers filing paper returns who want HMRC to calculate their tax liability for them, the cut off date will move from 30 September to 31 October to align with the new paper return filing date. A calculation of tax liability is automatically provided when a return is filed online.

The period during which a return can be amended will be linked to the 31 January anniversary date for all paper and online returns, notwithstanding the introduction of the two separate filing dates.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2007 PricewaterhouseCoopers LLP. All rights reserved. 'PricewaterhouseCoopers' refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.