

AUTUMN CLIENT NEWSLETTER

CAPITAL GAINS TAX REFORMS

In October's Pre-Budget Report, the new Chancellor announced a radical reform of capital gains tax, which is due to come into effect from 6 April 2008. Mr Darling's three main proposed changes are:

(i) Taper Relief

Taper relief will be abolished. At present there are two types of taper relief:

- *Business assets taper relief* which reduces gains by 50% after a business asset has been held for one year and by 75% after two years. One simple way of looking at this is to say that business assets taper relief makes your maximum effective rate of capital gains tax just 10% after 24 months.

The definition of business assets is wider than you might expect and includes the shares of trading companies listed on AIM. Shares in your employer also qualify as business assets, even if your employer is a FTSE 100 company.

- *Non-business assets taper relief* applies to anything that is not a business asset, eg unit trusts, buy-to-let residential property and ordinary shares. This taper relief is much less generous. Broadly speaking, your gain is reduced by 5% after three years of ownership, rising by 5% a year up to a maximum of 40% after ten or more years. For good measure, you are entitled to add one year to your taper relief entitlement if you held the asset before 17 March 1998.

(ii) Indexation Relief

Indexation is to be scrapped for individuals (and trustees) from 6 April 2008.

Indexation relief was the predecessor of taper relief and was designed to remove inflationary gains from tax. It continues to apply for companies. For individuals, indexation stopped accruing from April 1998. Nevertheless, it can be quite valuable where a long term investment has grown only in line with prices – a notable example is farmland (see 'Winners and Losers' below).

(iii) Tax Rate

From April 2008, your capital gains will be taxed at a flat rate of 18%.

For individuals, capital gains are currently taxed as the top slice of income at savings rates (ie 10%, 20% or 40%). For trustees, capital gains are taxed at 40%.

The proposed reforms have met with an outcry from the business community. Its complaint has been that small business owners who sell up after 5 April 2008 face an 80% hike in their tax bill – from 10% of gains to 18%. There have already been hints that the Chancellor will temper his new rules by re-introducing a form of retirement relief in the March Budget. This would, for example, exempt the first £100,000 of gains on disposal of a business.

Much less noise heard from winners under the proposed new regime. If you are a trustee or higher rate taxpayer, 18% CGT is much less painful than 40% on short term investment gains and 24% (allowing for taper relief) on gains made over a decade or more. However, the loss of taper relief may mean that more gains fall outside the annual exemption, which the Chancellor has said will remain.

Winners and Losers

Winner

Gill is a higher rate taxpayer who invested £300,000 in a buy-to-let London flat just over three years ago. She is now planning to sell it for £390,000. She will want to wait until 6 April 2008 to exchange contracts:

	Sell Now	Sell 6 April 2008
	£	£
Gain	90,000	90,000
Taper relief @ 5%	<u>4,500</u>	-
Taxable gain	85,500	90,000
Annual exemption	<u>9,200</u>	<u>9,200</u>
Net taxable gain	<u>76,300</u>	<u>80,800</u>
Tax payable	<u>30,520</u>	<u>14,544</u>

Loser

Joe has a 500 acre farm which cost him £1,100 an acre in March 1982. He has farmed the land ever since and is now thinking of selling up. The land is now worth £2,700 an acre. Joe will very much want to sell before 6 April 2008:

	Sell Now	Sell 6 April 2008
	£	£
Gain	800,000	800,000
Indexation relief	<u>575,850</u>	-
Post-indexation gain	224,150	-
Taper relief @ 75%	<u>168,113</u>	-
Taxable gain	56,037	800,000
Annual exemption	<u>9,200</u>	<u>9,200</u>
Net taxable gain	<u>46,837</u>	<u>790,800</u>
Tax payable	<u>18,735</u>	<u>142,344</u>

ACTION

As part of your year end tax planning, you should review your investments and consider whether it makes sense to realise gains now under the current regime. There is no easy rule of thumb – as the examples show, it is a question of crunching the numbers. Longer term, the way in which you hold investments should be reviewed.

Call us today to fix a date for your year end tax review.

WHEN TWO IS BETTER THAN ONE PLUS ONE

The Chancellor's Pre-Budget Report announcement of a major reform to inheritance tax (IHT) was not a complete surprise. Up until a few days before, the Report had been seen more as Pre-Election than Pre-Budget and there was a certain inevitability that something would be done to spike the Conservatives' proposal of a £1m IHT nil rate band. Press reports had suggested that this had gone down very well in the more prosperous marginal constituencies.

In the event Mr Darling announced a doubling of the nil rate band for married couples and civil partners, although this was *not* quite what he did. The new IHT rule, effective from 9 October 2007, is that on second death, the estate of the survivor can benefit from any unused nil rate band of the first spouse/partner to die, regardless of when that happened. The example below shows how this operates in practice.

Inheriting the Nil Rate Band

Harry died in January 2003. At the time the nil rate band was £250,000 and he left £50,000 in trust to his grandson, ie 20% of the then nil rate band. The rest of Harry's estate passed to his wife, Mary. Mary died in November 2007, leaving an estate of £750,000. Her taxable estate is calculated as:

	£
Gross Estate	750,000
Mary's nil rate band	(300,000)
Harry's unused nil rate band: £300,000* @ 80%	(240,000)
Taxable estate	<u>210,000</u>

*The proportion of the nil rate band unused on first death is applied to the IHT nil rate band in force at the date of the *second* death.

If your estate planning was already designed to use the nil rate band on first death, for example by creating a nil rate band discretionary will trust, then Mr Darling's reform will not save you any IHT. On the other hand, if your wills leave everything to the survivor, Mr Darling has cut your final IHT bill by up to £120,000, based on the current nil rate band.

As the change applies to second deaths after 8 October 2007, many widows and widowers have suddenly seen the potential IHT bill on their estate reduce or even disappear completely.

The administration of the new rules is quite complex. For example, you cannot inherit more than 100% of the nil rate band, eg from a spouse who has been previously widowed. The executor's claim for the inherited nil rate band on second must be supported by documentation which may now be difficult to track down, eg a copy of the grant of probate and will of the first person to die.

ACTION

This IHT change means that if you are married or in a civil partnership, your estate planning needs to be reviewed. In some instances, it may be possible to simplify arrangements and avoid the use of will trusts on first death. However, there will be other circumstances where it is not necessary to alter your existing strategy.

Call us today for an appraisal of your current estate planning.

LASTING POWERS OF ATTORNEY

A will is a vital component of your financial planning, which deal with matters after your death. But what would happen to your finances if you became unable to handle them because of mental or physical incapacity?

In England and Wales (similar provisions apply elsewhere in the UK), the Court of Protection would step in unless you have given someone the power to act as your attorney. The rules for appointing an attorney to cover such a situation changed at the start of October. The Mental Capacity Act 2005 has replaced the Enduring Power of Attorney (EPA) framework with a new Lasting Power of Attorney (EPA) structure. If you signed an EPA before 1 October, it remains valid, even if it has not been registered. However, you may wish to review it now LPAs have arrived.

There are two types of LPA, although they can be combined into one document:

- *The Property and Affairs LPA* allows the person(s) you appoint as attorney to make decisions on your behalf about financial and property related matters. It is very similar to the old EPA.
- *The Personal Welfare LPA* gives your attorney the power to make decisions on your personal welfare, eg whether to give consent for medical treatment. This is as near as the legislation comes to the creation of a 'living will'.

The legislation supporting LPAs has drawn upon the experience of EPAs and in particular the various conflicts of interest that can arise. For example, every LPA must include a certificate confirming that the person granting the power understood its implications and was not placed under any pressure to complete the LPA. That certificate must be signed by either an appropriate professional or someone who has

know the person for at least two years and is not related to them or the attorney and has no business links with either party.

ACTION

There is a strong argument for saying that you should create an LPA and will together and review both regularly. As your will may need revision following the Pre-Budget Report changes, now is an excellent time to consider putting an LPA in place.

Call us for a review of your will and more details on LPAs.

MORE STATE PENSION CHANGES....AND NATIONAL INSURANCE CHANGES, TOO

When Gordon Brown announced a restructuring of tax and national insurance contributions (NICs) in the March Budget, he threw a large spanner in the DWP's plans for reforming the State Second Pension (S2P). The DWP had been working on the assumption that the ceiling for employees' full rate national insurance contributions, the upper earning limit (UEL), would rise in line with inflation, but Mr Brown decided to give it a much greater increase in the next two tax years.

A National Insurance Contributions Bill just introduced to Parliament has now cut this Gordian (sic) knot. Assuming the Bill becomes law:

- In 2009/10, S2P will only accrue on earnings up to £40,040 a year, the new 'upper accrual point' (UAP). The UEL will be higher.
- At the same time, the first tier of S2P accrual (between £4,524 and £13,000 a year in 2007/08 terms) will move to a flat rate basis. This will be £72.80 a year pension (revalued in line with earnings from 2005/06) for each year of S2P membership.
- From 2010/11 onwards, the UAP will be frozen at £40,040. According to the Treasury, the result will be that by around 2031/32, S2P will become a completely flat rate pension scheme, rather like another layer of basic state pension (but only for employees, not the self employed).

In the long run the National Insurance Contributions Bill brings us back to what the 2006 Pensions White Paper proposed – a flat rate second tier state pension that favours the lower paid.

The reform to NICs which has prompted these changes will start to be felt from April 2008. The UEL will increase by £5,200 to £40,040 a year. If you are currently earning at or above the £40,000 level, you will see a substantial jump in your NICs. However, the fall in the basic rate of tax to 20% and upratings of allowances and tax bands will often – but not always – counterbalance this.

One strange side effect of the NICs reforms is that if you have any taxable fringe benefits, such as a company car, you may find there is a slice of your earnings on which you pay 40% tax *and* 11% NICs, ie the government takes more than half your pay. This could open up an interesting opportunity for pension planning.

ACTION

The changes introduced by the Bill should ultimately mean either a lower S2P pension or smaller rebates if you are contracted out of S2P (eg via your employer's final salary scheme), unless you currently earn under £13,000 a year. They make private retirement planning all the more important.

Talk to us about the scope for turning the increase in NICs to your advantage by the use of salary sacrifice to fund pension contributions.

WHEN 'FREE' IS NOT WORTH HAVING

Does your employer provide you with 'free' fuel for your company car?

If they do, be prepared for a large jump in your tax bill from April. At present the taxable value of free fuel is calculated as £14,400 multiplied by your CO₂-based car benefit percentage. For example, if you have a petrol car with 170g/km emissions, the benefit percentage is 21% and the taxable value of your 'free' fuel is £3,024 (£14,400 x 21%). In 2008/09 the base amount will rise by £2,500 to £16,900, so the taxable amount will rise correspondingly (to £3,549 in this example).

ACTION

It is worth checking whether 'free' fuel is worth having. You may be better off if you claim for business mileage and pay for your own private mileage. And that is before you ask for a compensatory pay increase...

AFTER THE WRECK OF THE ROCK

The problems at Northern Rock highlighted the weaknesses in the UK's deposit protection system. So far they have prompted one change: from 1 October deposit protection has been extended to 100% of the first £35,000 of deposits, whereas before only the first £2,000 was 100% covered, with 90% protection applying to the next £33,000. The cover is given on an individual basis, so for a joint account protection is doubled.

One important point to note is that protection is not *per account* but *per FSA registered institution*. This can mean that accounts with different deposit takers are lumped together for deposit protection purposes if they share a common parent, eg Bank of Scotland, Halifax and Birmingham Midshires all operate under one FSAS registration.

ACTION

If you are worried about the Northern Rock problem being repeated, keep to the £35,000 per person per institution limit.

For more information on interest rates and alternative homes for your cash, such as money market funds, please contact us.

Past performance is not a reliable guide to the future. The value of investments can go down as well as up. The value of tax reliefs depend upon individual circumstances and tax rules may change. The FSA does not regulate tax advice. This newsletter is provided strictly for general consideration only and is based on our understanding of law and HM Revenue & Customs practice as at November 2007. No action must be taken or refrained from based on its contents alone. Accordingly no responsibility can be assumed for any loss occasioned in connection with the content hereof and any such action or inaction. Professional advice is necessary for every case.