CLIENT BULLETIN

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A BUDGET FULL OF SURPRISES

Last month's Budget package included more surprises than usual – and, frankly, it was mainly bad news. From 2008, the filing deadline for personal, partnership and trust Tax Returns will be brought forward, from 31 January to the previous 30 November, if the taxpayer or his accountant files on-line, and to 30 September for those who prefer to submit a traditional, paper Return. This reduction of at least two months in the time available for preparing Tax Returns will obviously cause a bunching of work in accountants' offices, which will be exacerbated by another Government proposal, to reduce the time limit for filing company accounts, from ten months to seven, and company Tax Returns, from one year to seven months, also in 2008.

Clients, also, will inevitably be affected, for some at least will have to send in the papers for their annual Tax Return much earlier than at present. The good news, however, is that the tax payment dates of 31 January and 31 July will not be changed and the new arrangements should give HM Revenue & Customs plenty of time to confirm tax calculations and send out statements of the amount payable on 31 January.

INHERITANCE TAX CHANGES

The second major surprise in the Budget was the extension of the special inheritance tax rules for discretionary trusts to most other family trusts. This is a very technical subject, but the practical consequences are dramatic and wide-ranging. For example:

- There will be an immediate inheritance tax charge when a trust is established by a living person, unless the amount settled is within the settlor's nil rate band (currently £285,000). There will be only a few exceptions to this rule – for example, very small settlements within the £3,000 annual exemption and trusts for disabled people.

- To the extent that the amount settled by a living person is within the nil rate band, it will use up that band permanently, so that it will not be available to be set against the settlor's estate on his eventual death. Hitherto, if the settlor survived for at least seven years, the amount settled was written off his inheritance tax 'clock'. This is important because many estate planning arrangements – including some 'off-the-shelf' plans offered by life assurance companies – have depended on the client making a settlement and surviving for seven years.

- Where property is left, by Will, to a child or young person, additional tax charges will apply if the beneficiary does not take full control over the capital on attaining age 18. At present, it is usual for the beneficiary to be paid the income from age 18 and then to receive the capital at age 25.

- Over time, the majority of trusts – whether set up during life or by Will, and including those set up before the new rules came into force on Budget Day – will become subject to a periodic charge to inheritance tax, charged as 6% of the fund's value, once every ten years.

These changes will make effective estate planning even more difficult and will require all existing Wills to be reconsidered and possibly redrafted. They will also require all existing trusts and settlements (including life assurance policies and 'bonds' issued by life assurance companies as part of an off-the-shelf inheritance tax plan) to be reviewed – broadly speaking, there is a two-year transitional period during which action, if necessary, should be taken.

Another point to watch is that trusts are often created as part of a divorce settlement or by order of the Divorce Court. Trusts are also frequently used when a claimant receives substantial compensation for personal injury. On current information, it appears that trusts imposed by Court Order will be subject to the new tax régime in the same way as other trusts.

All current arrangements incorporating trusts will need to be reviewed – which will be particularly difficult where the trust was used to settle contested property rights on divorce. However, unless there are exceptional circumstances, it would probably be better to defer the review until the final legislation is enacted, probably at the end of July. This is because the draft has attracted so much adverse comment, especially from the legal profession, that it is possible significant, if highly technical, changes will be made.

REFORM OF SMALL BUSINESS TAXATION

In December 2004 the Government published a 'discussion paper' on the taxation of small business profits, which concluded that it was unfair that two similar businesses could be liable to pay very different amounts of tax and National Insurance contributions, simply because one traded as a company and the other as an individual or partnership – though the paper did recognise that the company does not always enjoy the more favourable treatment.

The solution suggested was a special tax régime for owner-managed small companies which, reading between the lines, meant charging National Insurance contributions on profits distributed as dividends. The paper also suggested replacing tax-based investment incentives – for example, first-year allowances for equipment purchases – with grants or subsidies.

Since then, nothing much has happened, except that the zero per cent 'starting rate' of corporation tax has been abolished with effect from 1 April 2006 (having been restricted to profits retained within the company since April 2004). However, the March 2006 Budget Report makes it clear that the treatment of small businesses is still 'under review', with the intention of ensuring that 'all individuals and businesses pay their fair share of tax and National Insurance contributions, irrespective of legal form'. For 'fair share' read 'the amount now paid by whoever is paying the most'.

The first stage of this review will concentrate on 'action to tackle disguised employment through managed service company schemes'. This is the area already targeted by the notorious 'IR 35' legislation – the Government's attempt to tax as employees IT consultants and other contractors who work through their own one-man (or one-woman) personal service companies. 'Managed service companies' are simply personal service companies where the administration – often including the provision of directors and a company secretary – is carried out on the contractor's behalf by a business set up to provide this service. Such businesses may also operate 'composite' or 'umbrella' companies, each of which services a number of unrelated clients. The Revenue are already challenging some of the ‘composites’ on technical grounds, but clearly the ‘IR 35’ legislation is still not, from the Government’s point of view, fully effective.

STILL SCOPE FOR ‘TURBOCHARGED’ PENSIONS

In one recent tax change, the bad news is in the headline and the good in the small print. Last December, the Chancellor announced that he would take steps to block ‘pension turbocharging’, which had been identified as a tax planning opportunity opened up by the new tax régime for pension funds, operational from 6 April 2006. Basically, ‘turbocharging’ (also referred to as ‘recycling’) means taking a tax-free lump sum from a pension fund – available from age 50 even if the individual does not retire – and reinvesting it in a second pension fund. The reinvestment counts as a further pension contribution, which qualifies for tax relief. Alternatively, an individual wishing to make a pension contribution could anticipate the lump sum it would create – as we said in the August 2005 edition of this newsletter:

> ‘It will be possible for an individual, aged 50 or more, to make a substantial contribution to a pension plan and then immediately withdraw 25% of that contribution as a (tax-free) lump sum, leaving the remaining 75% to accumulate to produce a pension at a later date. For example, if a higher rate taxpayer contributes £20,000, the nett cost of a pension fund worth £15,000 will be only £7,000 (after 40% tax relief – £8,000 – and a £5,000 lump sum) – though this simple example does ignore the effect of the pension company’s charges.’

The bad news is that ‘turbocharging’ will indeed be blocked by new legislation, which will impose a special tax charge on the ‘recycled’ lump sum. But the good news is that the charge will not apply unless the pension lump sums taken in a twelve-month period exceed £15,000 – and in some circumstances even more generous recycling ceilings may be available. Thus the example we gave last August would still work, because it uses only a third of the maximum permitted ‘recycle’.

The downside, of course, is that the tax-free lump sum may only be taken once, so that if it is used for ‘recycling’, it will not be available when the individual finally retires.

HOME COMPUTER INITIATIVE

One of the Chancellor's smaller but still unwelcome surprises was the closing of the Home Computer Initiative, which had allowed employees and their families private use of computers belonging to their employers without paying extra tax by way of a benefit- in-kind charge. Employees who had already been allocated a computer may continue to use it tax-free, but the scheme is now closed to new entrants.

Amongst those most surprised was the Department of Trade and Industry, which was about to introduce a Home Computer Initiative scheme for its own staff!

VAT: SCALE CHARGES FOR PRIVATE MOTORING

The Budget increased the VAT scale charges on fuel used for private motoring by approximately 11% for petrol and 10% for diesel. With effect from your VAT quarter beginning 1 May, I June or 1 July 2006 (or from 1 May 2006 if you make monthly Returns), the VAT payable per car will be:

	Quarterly Returns		*Monthly Returns*	
	Petrol	*Diesel*	*Petrol*	*Diesel*
	£	£	£	£
Up to 1,400cc	40.66	38.72	13.55	12.81
1,401 to 2,000cc	51.53	38.72	17.13	12.81
Over 2,000cc	75.66	49.30	25.17	16.38

. . . . . AND A COUPLE OF REMINDERS

Small businesses are able to claim 50% first year allowances on most purchases of plant and machinery during 2006/07 – this includes purchases of vans and other commercial vehicles, but not ordinary motor cars. For small companies, 50% first-year allowances are available for purchases in the year 1 April 2006 to 31 March 2007.

For 2006/07, the lowest wage that will frank an employee's National Insurance record for pension and benefit purposes is £84 a week or £364 a month. However, no contributions are payable until earnings exceed £97 a week or £420 a month.

Paying a family member a wage between those figures can therefore be a very cheap way of increasing his or her National Insurance Retirement Pension!

This newsletter deals with a number of topics which, it is hoped, will be of general interest to clients. However, in the space available it is impossible to mention all the points which may be relevant in individual cases, so please contact us for personal advice on your own affairs.