A.C.MOLE & SONS CHARTERED ACCOUNTANTS

proactive

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Budget 2007

A Change of Format

We have changed the layout of Proactive this time, concentrating exclusively on Budget and tax issues. The summer 2007 issue will return to our usual mix of tax and business issues, news about the firm and a feature on one of our clients.

New tax year: new tax issues

Some important tax changes will take place on 6th April. The **new construction industry scheme** requires contractors to verify the employed or self employed status of workers with H M Revenue & Customs (HMRC). It also introduces a monthly return containing a statement that the employed/self employed status of workers has been considered. Failing to make the return on time will incur a penalty even if it is a nil return.

New rules increase the benefit in kind for **employer provided vans** where there is anything other than insignificant private use: the taxable benefit rises from £500 to £3,000 with an extra £500 charge if fuel is available for non business use. Employers providing vans should review the rules and consider varying employment terms to forbid private use.

The Budget Report indicated that the long running review of the **residence and domicile** rules is ongoing. If you believe that you are non-resident however you need to be aware of two recent tax cases in which HMRC succeeded in classifying individuals as UK resident even though they had complied with the rules set out in HMRC's own published guidance.

Budget 2007

Gordon Brown, the longest serving Chancellor of the Exchequer in 200 years, presented his eleventh – and probably final – Budget on 21st March.

Mr Brown has been quoted as saying that there are two types of Chancellor: those who fail and those who get out in time. It would appear that he will fall into the second category. Over the last ten years he has maintained economic stability (with 58 successive quarters of economic growth) and overseen a period of low inflation and low interest rates. The amount of income tax, inheritance tax and capital gains tax raised has doubled and the amount of stamp duty and stamp duty land tax has tripled. The tax system has also become far more complex, the volume of tax legislation having doubled in a decade.

The introduction to the Budget Report says that "The Government's economic objective is to build a strong economy and a fair society where there is opportunity and security for all." It is hard to reconcile this statement with some of the Budget measures, which appear to stand on their head the principles that inspired Robin Hood. The 2007 Budget has redistributed tax benefits from smaller businesses to larger businesses and from less well off individuals to the better off.

The main changes are described on pages two and three.

Tax Planning

Macdonald's Farm

A number of our farming clients have had the opportunity to sell former farm workers cottages or barns for conversion, but have been fearful of the tax consequences. Many though have been pleasantly surprised by what a little tax planning can achieve.

Where a barn that has been used in the business - for animal housing or machinery storage for example - is sold for conversion, it should qualify for business asset taper relief. This means that if the building has been owned and used in the business for more than a year, 50% of the gain will escape tax and if for more than two years, 75%. For a higher rate tax payer, this represents an effective rate of tax of 10%.

As an example, Macdonald inherited his farm from his father in 1980. Following a recent change in farming policy, planning permission was granted on a barn that Macdonald no longer needed in the business. He has agreed a sale price of £150,000 with a local developer. Assuming a value in March 1982 of £5000 and selling costs of £5,000 his tax bill will be less than £10,000. Further reductions in the liability can be achieved if the barn is jointly owned with Macdonald's wife, who will also be entitled to the capital gains tax annual exemption of £8,800.

If the barn had been used for a non-business purpose, then business asset taper relief would not apply, but a lesser relief (non-business asset taper relief) would be available. In this case the capital gains tax payable by Macdonald would amount to just under £30,000. Ensuring that assets are actively used in the business can therefore make a huge difference to the tax bill.

And with some careful tax planning, Macdonald's tax bill can be reduced even further. He has been milking for many years, and has purchased milk quota at various times (and at great expense). The cost of the quota now bears no relation to its current value. If the quota ceases to be tradable or Macdonald sells it (and perhaps decides to lease quota in the future), he can create a capital gains tax loss, which can be set against the gain on the barn sale. If Macdonald makes a loss on the quota of £100,000, and the barn only qualifies for non business asset taper relief, the tax bill falls to less than £5,000. If the barn qualified as a business asset then the tax bill would be entirely eliminated.

Advice should be taken at the earliest possible stage as this is a complex area and the timing and sequence of the transactions can be critical: the gain and the loss must for example be in the same tax year.

Not just for farmers

The farm next door to Macdonald was sold a couple of years ago to Giles who retired from a highly paid job in the city and decided that the country life would suit him. While the idea of living in a substantial farmhouse appealed to him, the idea of getting his brand new wellington boots dirty didn't, so he agreed to rent one of his barns to Macdonald. Having been told by Macdonald recently that he no longer needed to rent the barn, Giles has found a developer who wants to buy it. He assumes that he will have a significant tax bill but in fact he too will get the business asset rate of taper relief, exempting 75% of the gain from tax because he has rented the asset to someone who has used it in his trade.

This tax relief can potentially benefit anyone who owns and uses an asset in their own trade or who rents out an asset they own to someone else who uses it in theirs.

Budget Comment
Paul Vaughan France, Farmer

"The abolition of agricultural buildings allowances is a bolt from the blue and is very unwelcome news for farmers"

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A Budget for Business?

It was a mixed Budget for companies, with larger companies gaining and smaller companies losing out. This seems a strange redistribution of the tax burden on business when small businesses employ 50% of the UK workforce and generate half of the UK Gross Domestic Product.

Budget Comment
Richard Lloyd, Chief Executive, Summerfield Developments

"The cut in the main rate of corporation tax is welcome but we will have to look very carefully at the likely effect of the changes to the capital allowances rules"

The Conservatives cut the rate of corporation tax from 52% to 33% and Mr Brown cut it even further - to 30% in 1999 - making it one of the lowest in the EU. Over the past decade, however, the average rate of tax paid by companies in many other countries has fallen significantly. This is beginning to make some international companies question whether the UK is still the best place to do business and some have either already relocated or are considering relocating. The rate of tax paid by companies in the Irish Republic is now astonishingly low at 12.5%. Mr Brown has therefore been under pressure to reduce the rate of corporation tax. On Budget Day he announced that the rate will fall from 30% to 28% from 1 April 2008. This will benefit companies and groups of companies with profits in excess of £300,000 per annum chargeable at the main or marginal rates of corporation tax.

For small companies with profits below this level, however, the rate of corporation tax will increase in stages from the current 19% to 20% from 1st April 2007, 21% from 1st April 2008 and 22% from 1st April 2009.

The Government has sought to justify this as promoting "fairness between the self employed and the incorporated."

It is clear from the Budget Report that the Government believes that small businesses incorporate in order to avoid tax by extracting profits by way of dividend and they have given warning that they will keep this area under review.

The Chancellor also announced improvements in the allowances companies can claim for expenditure on research and development (R&D) from 2008/09. Small and medium size enterprises (SMEs) spending more than £10,000 will benefit from an increase in the amount they can claim from 150% of the actual expenditure to 175% and large companies will see an increase from 125% to 130%. In a further relaxation of the rules, companies with fewer than 500 employees will now be able to claim the SME rates of R&D tax relief. The facility to claim the relief by way of partial repayment of PAYE tax will remain. An opportunity to remove the £10,000 hurdle and to simplify the complex definition of R&D (a regular issue in negotiations with HMRC over claims) has again been missed.

Another shock was the announcement that capital allowances are to be reformed. The full details have yet to be announced, but we know that the main features will be:

- Phasing out of Industrial Buildings Allowances and Agricultural Buildings Allowances over the next four years, with the rate falling from the current 4% to 3% from April 2008, 2% from April 2009, 1% from April 2010 and then zero from April 2011. Balancing adjustments were done away with on Budget Day.
- A £50,000 annual investment allowance for investment in plant and machinery (but not cars) allowable at 100%
- Reduction of writing down allowances from 25% per annum to 20% per annum (10% for certain equipment installed in buildings) from April 2008
- An increase in the writing down allowances on "long life" assets from 6% to 10% from April 2008
- An extension of the 50% first year allowance for small enterprises for a further year (to April 2008)
- A payable tax credit for investment in certain "green technologies" from April 2008

These changes will impact on manufacturing businesses, agriculture, any business investing significant amounts in equipment and the commercial property sector.

In 2002, the Government actively encouraged businesses to trade as limited companies by introducing a zero rate of corporation tax for the first £10,000 of profit. Within two years, however, they began introducing tax barriers to discourage profit extraction before finally abandoning the zero rate in 2006. This year's measures will result in many small companies paying more tax and they represent further unwelcome tinkering with small business taxation.

Overall, this was a Budget that will be welcomed by some businesses and that will have a negative impact on others.

The 2007 Budget:

Individuals

Here again, the Chancellor has given with one hand and taken with the other. The 10% band for the first £2150 of income is being withdrawn from 6 April 2008 and from the same date the basic rate of income tax will fall from 22% to 20%. This will hit those on low incomes and intriguingly the 10% rate will remain for those with investment income.

Budget Comment

Rob Perkins, director, Sonic Systems Limited

"As a company engaged in research and development we are pleased with the increase in R&D tax relief but the increase in the lower rate of corporation tax will hit many small firms"

There will be an alignment of the upper national insurance limit with the higher rate tax threshold (which will rise by more than the amount required to keep pace with inflation). This will increase the amount of earned income on which employees and the self employed pay national insurance and the Government will begin collecting additional national insurance a full year before the higher rate tax threshold is lifted.

Pensioners will see their tax free allowances grow steadily over the next few years to the point where by 2011, no pensioner over 75 will pay any tax on income of less than £10,000. While this is welcome, many pensioners will find themselves affected by the withdrawal of the 10% rate of tax.

The investment limits for Individual Savings Accounts (ISAs) will rise from £7,000 to £7,200 but with an increase in the permissible cash element from £3,000 to £3,600.

In an unexpected announcement, the Government has confirmed that individuals who own property outside the UK through an overseas company will not have to pay tax on the "benefit in kind" of living there. Unusually, this announcement is fully retrospective and anyone who has paid tax in the past will be able to reclaim it.

Individuals receiving dividends from foreign companies will, in most cases, benefit from a notional 10% tax credit from 6th April 2008. This will be welcome news for many people including for example those who previously held shares in Abbey National and who now have Banco Santander shares. Dividends of up to £5,000 will be treated in this way.

The inheritance tax (IHT) allowance rises to £300,000 from 6th April and will rise in stages to £350,000 in 2010/11. As the major asset in most estates is the family home, this will not even begin to compensate for the increase in house prices over recent years.

The Budget Report mentions the proposed Planning Gain Supplement (which would tax development gains) and says "If after further consideration it continues to be deemed workable and effective, PGS would be introduced no earlier than 2009". This sounds like an unpopular and complex tax proposal being parked in the long grass; previous attempts to tax development potential have all been short lived.

One piece of very welcome news was the announcement two days after the Budget that HMRC have now agreed that bare trusts (used by many grandparents and godparents) do not fall within the discretionary trust regime. This change of heart came after intensive behind the scenes lobbying by the tax profession.

The Budget also confirmed that the Government has fully accepted Lord Carter's revised recommendation on tax return filing dates: for those who file electronically, the filing date will remain as 31 January but from 2008, those who wish to file paper returns will have to file by 31 October or face a penalty.

Originally Lord Carter had proposed that the filing dates should be changed to 30th November for electronic returns and 30th September for paper returns. He revised his proposal after intensive lobbying by a coalition of professional bodies led by A C Mole & Sons tax partner Paul Aplin, in his role as deputy chairman of the Institute of Chartered Accountants Tax Faculty.

It was also confirmed that the time that HMRC has to enquire into a tax return will now be reduced in most cases so that it will, from 2008, run for twelve months from the date a return is filed rather than twelve months from 31 January following the end of the tax year.

All in all this was a very mixed Budget for individuals.