

December 2007

A BRAVE NEW WORLD?

A remarkably wide-ranging package of tax reforms will come into force in April 2008. Some were announced by Gordon Brown in his Spring 2007 Budget, others by his successor, Alistair Darling, in his Autumn Pre-Budget Report. The headlines included a reduction in the basic rate of tax, to 20% for 2008/09, and new rules for taxing people from overseas who come to work in the United Kingdom – though the latter will affect high-earning City executives rather than plumbers and chambermaids from eastern Europe. Some of the news was wholly bad – notably the phased abolition of capital allowances for agricultural and industrial buildings. And some of the changes, although straightforward at first sight, turned out to have surprisingly complex consequences.

Accordingly, in this newsletter we would like to focus on the two most significant changes for small business owners and for investors – the new ‘Annual Investment Allowance’ for purchases of machinery and vehicles, and the reform of capital gains tax.

CAPITAL ALLOWANCES FOR MACHINERY AND VEHICLES

One of the highlights of the Spring 2007 Budget was Gordon Brown’s announcement that a new ‘Annual Investment Allowance’, to be introduced in April 2008, will allow traders to claim 100 per cent first-year tax allowances for most purchases of machinery, equipment and vehicles, to a ceiling of £50,000 a year. (As usual, the principal exception will be motor cars.)

The new ‘AIA’ will be available for purchases on or after 6 April 2008 for sole traders and partnerships, and on or after 1 April 2008 for companies. However, this does **not** mean that every trader will be able to go out on 6 April and spend £50,000 on equipment which will qualify for the 100% AIA. This is because the allowance is an allowance for the trader’s accounting year, and so will be time-apportioned where the trader’s accounting date is other than 5 April (31 March for companies). For example:

- Andy’s accounting date is 30 June. He may claim an Annual Investment Allowance on expenditure up to £11,748 (86/366ths of £50,000) for purchases in the period 6 April to 30 June 2008. In his next accounting year (the year to 30 June 2009) he will be able to claim AIA on purchases up to £50,000.

- Bob's accounting date is 31 December. He will be able to claim AIA on expenditure up to £36,885 (270/366ths of £50,000) for purchases in the period 6 April to 31 December 2008.
- Central Garage Ltd's accounting date is 30 September. It will be able to claim AIA on expenditure up to £25,000 (183/366ths of £50,000) for purchases in the period 1 April to 30 September 2008.
- Diane's accounting date is 5 April. She will be able to claim AIA on expenditure up to £50,000 for purchases in the year 6 April 2008 to 5 April 2009.

Returning to the example of Andy, suppose he intends to buy a new van which will cost £20,000. His choices are:

- To buy the new van before 6 April 2008, in which case he will be able to claim the current 50% first-year allowance (for the 2008/09 tax year, as the purchase is made in his accounting year ending 30 June 2008). Thus £10,000 of the cost will be written off in 2008/09 and the balance (by way of writing-down allowances) in future years.
- To buy the van between 6 April and 30 June 2008 (both dates inclusive). In this case he will be able to claim the slightly higher AIA of £11,748 for 2008/09, and again the balance will be written off by way of writing-down allowances in future years.
- To wait until 1 July 2008, when the whole cost of the van can be written off by way of the new AIA. This looks like the best solution, but there are two points to watch. The first is that tax relief for expenditure incurred in the new accounting year will not be enjoyed until 2009/10. The second is that Andy's profits for the year to 30 June 2009 may not be high enough to absorb the full 100% allowance, so he may anyway be forced to reduce his claim.

It will be apparent that, even in this very simple and straightforward example, there are many factors to bear in mind. In real life, the situation is likely to be more complicated – for example, the trader may be intending to purchase more than one vehicle or item of equipment – and it may be possible to 'have your cake and eat it' – to claim the full cost as an AIA, but to enjoy tax relief in 2008/09 – by changing your accounting date, though this would have other implications which would have to be carefully considered. Also, the purchase date, for tax purposes, is the date expenditure is incurred (as defined by the tax legislation), which is not necessarily either the date the order was placed, or the date the supplier issued an invoice, or the date payment is made.

Accordingly, we would strongly recommend clients, who are considering significant machinery, equipment or vehicle purchases and wish to maximise the benefit to be obtained from capital allowances, to discuss their plans with us as soon as possible.

Finally, remember that where a purchase is made by an individual trader (rather than through a company), the Annual Investment Allowance will reduce his income not only for income tax purposes, but also for Class 4 National Insurance and (where appropriate) Tax Credits. That said, of course, there is no point in buying equipment that is not needed just for the sake of the tax allowance.

CAPITAL GAINS TAX REFORM

In his October 2007 Pre-Budget Report, the new Chancellor of the Exchequer announced a fundamental reform of Capital Gains Tax. This will apply to disposals by individuals (including sole traders), partnerships and trusts, but not to disposals by companies.

Shortly put, where an asset is sold (or otherwise disposed of) on or after 6 April 2008, taper relief will not be given (and nor will indexation allowance, which is now due where the asset was acquired before April 1998), and all gains will be charged at a new standalone capital gains tax rate of 18%, irrespective of the rate of income tax paid by the vendor. There will be some other more technical changes, but it has been confirmed that the ‘principal private residence relief’ will not be affected and that there will still be an annual exemption.

How does this affect people planning to sell their businesses?

After taper relief, the effective rate of capital gains tax paid on the sale of business assets is currently, in most cases, 10% of the chargeable gain. From 6 April 2008 this will rise to 18%. Very broadly speaking, business assets, subject to capital gains tax, include buildings used for the purposes of the owner’s trade or profession, farmland, goodwill and shares in family trading companies.

Where assets were purchased before April 1998, their base cost for capital gains tax purposes is currently increased by indexation allowance, which reduces the chargeable gain. From 6 April 2008, indexation allowance will not be available, so the chargeable gain will be higher. Other, more technical, changes may deny reliefs which are currently available and so increase the chargeable gain further.

Accordingly, the prospect from 6 April 2008 is that a higher rate of tax will be charged on a larger taxable gain. One obvious solution is to sell the business, or the business asset, before the end of the current tax year. However, it may well not be possible to arrange a sale in the time available, and any prospective purchaser is likely to know of the 5 April 2008 deadline and use it as a bargaining counter.

It is theoretically possible to ‘freeze’ the accrued indexation allowance and taper relief by transferring business property to a family trust before 6 April 2008. The transfer to the trust will benefit from the accrued indexation allowance and taper relief, and the trust will benefit from a higher base cost for the asset. However, it is not possible *both* to freeze the taper relief *and* to claim the usual hold-over relief for a gift into trust, and so the stratagem is likely to trigger an immediate capital gains tax charge – in other words, the owner has to pay something now in order to save more later. Other possible tax implications must also be considered (for example, stamp duty and inheritance tax), as well as practical matters. For example, if the property in question is mortgaged or charged to the bank, will the lender accept the change of legal ownership?

A final point to bear in mind is that, following widespread protests against the 80% increase in the headline tax rate (from 10% to 18%), the Chancellor has hinted that he may amend his proposals to include an exemption for (say) the first £100,000 of gains made on a retirement sale.

If you have a business, or a substantial business asset, or shares in a family trading company, which you are considering selling, we recommend that you discuss your options with us as soon as possible. It is not possible in this newsletter to give any general advice, as so much depends on the facts and figures of the case.

And how does it affect portfolio investors?

A lower rate of taper relief currently applies to non-business assets, such as shares quoted on the Stock Exchange and units in a Unit Trust. Depending on the length of time for which the shares or units have been held, this may reduce the chargeable gain by up to 40% and the effective rate of capital gains tax paid by a higher rate taxpayer to a minimum of 24%, and by a basic rate taxpayer to a minimum of 12%. However, the position is further complicated by the fact that indexation allowance, which may be available in addition to taper relief, will be abolished for sales on or after 6 April 2008.

If a useful amount of taper relief (or taper relief plus indexation allowance) is currently available on a particular holding, an investor may wish to consider making a disposal within his 2007/08 annual exemption, to take advantage of the accrued taper relief and indexation allowance before it is lost forever. ‘Double bed-and-breakfasting’ (sale by a husband and repurchase by his wife, or *vice versa*) may be used to crystallise a gain within the annual exemption. However, we would recommend you take advice before entering into any such transaction which creates or utilises a capital gains tax loss, as the *Finance Act 2007* included some complex anti-avoidance legislation which may deny relief in these circumstances.

An alternative is that a straightforward gift or sale between husband and wife (or between civil partners) on or before 5 April 2008 will have the effect of preserving any accrued indexation allowance (but not any taper relief). This might be worth considering where the investment has been held for a long time, so that a substantial amount of indexation allowance is at stake.

Finally, many Alternative Investment Market (AIM) shares count as business assets for taper relief purposes. If they have been held for at least two years, and are sold by 5 April 2008, they will qualify for maximum taper relief, so that the effective rate of capital gains tax will be 10% for a higher rate taxpayer and only 5% for a basic rate taxpayer. From 6 April 2008, both will pay tax at 18% on their gains.

And what about buy-to-let landlords?

The classic buy-to-let – a house or flat let to a tenant who occupies it as his home – is not a business asset. If it is sold on or before 5 April 2008, the profit on sale is likely to make the owner a higher-rate taxpayer, even if he is not one already, and so the rate of capital gains tax will vary between 24% and 40%, depending on how long the landlord has owned the property. Other things being equal, therefore, the vendor would do better to delay the sale until the 18% flat rate comes into effect on 6 April 2008. However, if you are considering selling a property, please do discuss the position with us, as in some circumstances the facts may produce a different answer (tax is never straightforward!). Also, of course, a firm sale now may be worth more than the hope of a sale later

Depending on the circumstances, commercial property (for example, a shop) which is owned and let out may qualify as a business asset for taper relief purposes, as may cottages, *etc*, used for furnished holiday lettings. The position is complex, so personal advice, tailored to your own circumstances, is essential.

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.
