2003 BUDGET MEMORANDUM

Summary of Main Tax Provisions

This Memorandum summarises the Chancellor's Budget proposals as they affect:

Personal Taxation ◆ Capital Gains Tax
Inheritance Tax ◆ Taxation of Companies and Businesses
Share Schemes ◆ Stamp Duty ◆ VAT
Miscellaneous Proposals ◆ Status of Memorandum

INTRODUCTION

In his Budget Speech, the Chancellor dropped his estimate of forecast growth in Gross Domestic Product for 2003 to 2.5%. Sustaining the increase in public spending announced last year will lead to an expected Public Sector Borrowing Requirement ('PSBR') of £27 billion in 2003-2004. The Chancellor still expects economic growth to increase to 3/3.5% in 2004 and 2005. A noticeable recession in Central London and a general slackening of economic growth in the regions may indicate that the Chancellor's forecasts, including an expected PSBR of £24 billion in 2004-2005, may prove optimistic, as they were last year. What's clear is that there will be plenty of gilt edged investments for sale for those investors who are fed up with the equity markets.

There were no significant changes to taxation even though last year's big hike in National Insurance Contributions by employers and employees is currently kicking in. Some esoteric loop holes have been blocked and minor relieving provisions introduced which are set out below. One important change for many clients is the extension of 'business assets taper relief' from CGT to trading premises occupied by unconnected individuals and partnerships which will benefit many landlords in the future.

A background paper has been released reviewing residence and domicile rules so far as United Kingdom tax on migrants is concerned. No tangible suggestions have yet been advanced by the Government.

PERSONAL TAXATION

1. Income Tax

The basic rate of income tax remains 22%. The starting rate continues to be 10%, but from 6 April 2003 it applies to the first £1,960 of taxable income (previously £1,920). The higher rate is still 40%, and this applies from 6 April 2003 to taxable income in excess of £30,500 (previously £29,900).

(a) Personal Allowances

	2002-03	2003-04
	£	£
Personal allowance	4,615	4,615
Personal allowance for people aged 65-74	6,100	6,610
Personal allowance for people aged 75 and over	6,370	6,720
Income limit for age allowance	17,900	18,300
Blind person's allowance	1,480	1,510

(b) Savings Income

The rate of income tax deductible at source from most savings income, including bank and building society interest, remains 20% for 2003-04. For taxpayers liable at 22%, no additional tax is payable. Taxpayers liable at 40% pay the difference between 40% and 20%.

2. National Insurance Contributions ('NICs')

From 6 April 2003, the main rates are as follows:

Employee's (primary) rate	11% of £89.01 to £595 per week. 1% above £595 per week
Employer's (secondary) rate	12.8% above £89 per week
Self-employed	8% on profits between £4,615 and £30,940 per annum. 1% on profits above £30,940 per annum

3. Benefits in kind for Employees

There are a number of developments here. Some of these are considered separately under 'Share Schemes'.

(a) Congestion charge

The Inland Revenue have confirmed that a reimbursement of the London congestion charge to an employee in connection with the use of a company car will be tax-free, irrespective of whether it relates to a journey for private purposes or for business purposes.

(b) Employer-provided vans

At present, a flat-rate charge of £500 applies if an employee has private use of a van (£350 if the van is four or more years old). The Government will in due course be reforming this area of the law, to take account of ‘fairness’, modern working practices, etc.

(c) Home-working

If an employer contributes to the additional household costs of an employee who works at home (some or all of the time), the contribution will be tax-free as from 6 April 2003, subject to various criteria being met. The employer can pay up to £2 per week on this basis without provision of supporting evidence. These reimbursements were already free of NICs, and this situation will continue.

(d) Annual party

It is proposed to increase the amount allowed for the tax-free provision of an annual party from £75 to £150 per employee.

(e) Third party benefits

At present, if an employee receives a non-cash gift from a third party (e.g. a customer of the business), this escapes tax if the value is £150 or less. It is proposed to increase this limit to £250.

4. Personal Pension Scheme contributions

The personal pensions earning cap will be increased from £97,200 in 2002 to £99,000 in respect of the 2003-2004 tax year.

In addition, the definition of earnings for the purposes of this tax relief, which are themselves subject to an earnings cap, has been refined with effect from 9 April 2003. Subject to the Finance Bill 2003, this is probably an attempt to counter schemes which double-counted earnings for personal pension and retirement annuity purposes in different years of assessment.

5. Life Assurance

In the run up to the Budget, there were fears that the Chancellor might withdraw the rule whereby holders of certain investment bonds can withdraw every year up to 5% of the premiums paid, without triggering an immediate tax charge. In fact, this has not occurred, although the Budget contains an anti-avoidance provision to ensure that the deferred gain accrues on all policy maturities in these circumstances. This change affects policies which mature on or after 9 April 2003. It was previously possible to avoid the deferred charge in certain situations.

From the same date, there are some new rules correcting ‘defects’ in the tax position on maturity/surrender of a second-hand life policy, i.e. where a person has acquired an existing policy relating to the life of another person. It was previously feasible in certain situations to obtain a larger capital loss on disposal than the amount of the actual loss incurred. In addition, a gain on ultimate disposal escaped tax if the disposer was treated as receiving the policy as a gift. This tax-free status ceases to apply for disposals on or after Budget Day, but subject to three exceptions:

- If the transfer was between husband and wife, but was not a gift.
- If the transfer was between husband and wife in accordance with a divorce settlement.
- If the transfer was between two members of the same group of companies (but was not a gift) and qualified for the usual tax neutral treatment in these circumstances.

6. Domestic Workers

It has been possible to avoid tax and NICs when employing nannies, etc. by ensuring that they operate through the medium of a company. This will no longer be possible for 2003-2004 onwards: in effect, the intermediary company will need to apply PAYE and NICs to the ‘salary’ from the company to the worker, largely eliminating any tax advantage.

7. Tax Credits

As previously known, there has been a major change to the social security system as from 6 April 2003.

The Working Tax Credit has been introduced to assist working adults. This takes over from Working Families’ and Disabled Persons’ Tax Credits. The basic amount is £1,525 per annum, and there are various supplements for disability, childcare, etc.

Child benefits continue to be payable but, in addition, Child Tax Credits are now available for families with incomes (broadly) below £58,000 per annum.

In addition, the Chancellor gave more details of the Pension Credit, which will apply from October. This will benefit a single pensioner with income below £139 per week and a pensioner couple with income below £203 per week.

CAPITAL GAINS TAX ('CGT')

1. Annual Exemption

For 2003-2004 the annual CGT exemption for individuals will be increased from £7,700 to £7,900. This exemption also applies to bare trusts, estates in the course of administration for the first three years and certain trusts for disabled persons. Other types of trust are entitled to an annual exemption of £3,950 in 2003-2004.

2. Relaxation in Reporting Requirements

To relieve the self assessment compliance burden for 2003-2004 onwards, individuals and trustees will not have to complete the CGT section of a tax return if their chargeable gains, after taper relief, are exceeded by the relevant annual exemption, unless either their proceeds from disposing of assets that are liable to CGT exceed four times the amount of the exemption, or they have allowable losses to set off against gains for that year. 'Proceeds' of normal no gain/no loss transactions between spouses will not count towards the proceeds limit.

3. Extension to the definition of business assets for taper relief purposes

With effect from 6 April 2003, an asset owned by individuals, trusts, and estates in the course of administration will qualify as a business asset if it is used wholly or partly for the purposes of a trade carried on by:

- any individual, or any partnership which has an individual as a member;
- the trustees of any settlement, or any partnership whose members include any person acting in the capacity of a trustee of a settlement;
- the personal representatives of any deceased person, or any partnership whose members include any person acting in the capacity of a personal representative;
- a partnership whose members include a company which is a 'qualifying company' by reference to the owner of the asset; or
- a partnership whose members include a company which belongs to a trading group whose holding company is a qualifying company by reference to the owner of the asset.

Paragraph 6 of Schedule A1 of the Taxation of Chargeable Gains Act 1992 defines 'qualifying company'. For example, all unlisted trading companies and unlisted holding companies of trading groups are qualifying companies.

By way of example, an investor or property owner who lets to otherwise unconnected trading tenants who would otherwise pay CGT at a maximum rate of 40% will have the benefit of a 75% taper relief reduction to an effective rate of 10% after acquiring such an asset and holding it for two years. It is likely that assets owned on 16 March 1998, or acquired subsequently but before 6 April

2003 which come within the new definition will have their period of ownership apportioned between the ‘non business assets’ period and ‘business assets’ period so that the 75% reduction will not be available until 2013. Affected clients should contact us to see if tax planning steps could eliminate the apportionment problem.

4. Carry back of losses on rights to unascertainable deferred consideration

This is a new relieving provision with effect from 10 April 2003 that applies when the sale of an asset includes consideration that cannot be definitely measured at that time. Common examples are sales of development land where extra consideration may be paid depending on the extent of future planning consents, or sales of companies where ‘earn out’ rights to cash and/or securities are granted to the vendor of shares depending, for instance, on the extent of future profits. Under the rule in Marren v Ingles, this element of the consideration will be valued at the disposal date and CGT paid at that time.

Hitherto, if the ultimate consideration on eventual disposal is less than the value of the deferred consideration on the original disposal, a loss for CGT purposes will usually arise which can only be carried forward.

Under the new provisions, a person may elect, if certain conditions are met, that an allowable loss that so arose in a tax year should be treated for CGT purposes as if it arose in an earlier year. The main conditions will be:

- the loss must arise on a disposal of a right to unascertainable deferred consideration;
- the person must not have acquired the right second-hand;
- a disposal of the original asset for which the right was received must have given rise to a chargeable gain; and
- the person must have had a CGT liability for the tax year in which that disposal was made.

The carry back will also be facilitated where there have been part disposals of the original asset in different tax years. The loss can be carried back either to the tax year in which the right to future consideration arose, or to the earliest tax year following the year the right was received in which the taxpayer realised a gain on the disposal of the original asset and had a CGT liability.

5. Treatment of ‘earn out’ rights as securities

When companies are sold, ‘earn out’ rights are often defined as being the right to acquire additional shares or debentures, as opposed to cash (mentioned in 4. above). In relation to such rights that arose on 10 April 2003, or thereafter, the new provision will automatically treat the contingent right to shares or debentures as the same asset as the original shares disposed of. Therefore the future acquisition of the additional security will not be an acquisition for CGT purposes and no CGT liability will arise until the additional shares or debentures are sold.

Hitherto such treatment required a positive election by a taxpayer. Such treatment will in the future be automatic. However, taxpayers will be able to elect to displace the new statutory rules applying to their disposal. This would mean that the 'earn out' right would be valued at the original disposal date and CGT would be payable. In practice, the election is more likely to be exercised when there is little or no gain on the original disposal (due to a high base cost), or when the gain is covered by capital losses.

6. Preventing avoidance of CGT using offshore trusts

(a) In 2000, legislation was introduced to counteract what were know as 'flip flop' schemes. The new rules inadvertently suspended anti-avoidance rules when trustees made a transfer of value to a second trust when they had subsisting debts. Trustees of offshore trusts with historical gains free of CGT who wished to distribute to UK resident and domiciled beneficiaries, were triggering the Finance Act 2000 legislation by carrying out a 'flip flop' transaction. This enabled a tax free distribution from the second trust. This scheme has now been blocked with effect from 9 April 2003.

(b) Payments to all beneficiaries from offshore trusts can 'frank' gains in a gains pool. From 9 April 2003, only payments to beneficiaries who are charged to CGT will reduce the pool.

INHERITANCE TAX ('IHT')

The IHT zero rate threshold has been increased by £5,000 from 6 April 2003 in accordance with the statutory indexation allowance to a new threshold of £255,000.

The Revenue estimate that there will be 29,500 tax paying estates, representing 5% of all deaths, this year, compared with the estimate of 24,000 in 2002. This reflects the widespread enhancement in residential property values over the year.

TAXATION OF COMPANIES AND BUSINESSES

1. Corporation Tax rates

There have been no changes to the rates of Corporation Tax for the year ending 31 March 2004.

The Chancellor has also confirmed that the standard rate of Corporation Tax will be 30% for the year ending 31 March 2005.

2. Construction Industry Tax Deduction Scheme ('CITDS')

Late last year, the Government published a consultation document on this topic. The chief proposals were:

- The current Inland Revenue computer system would be replaced with an improved system.

- Periodic returns would take the place of vouchers.

- Registration cards and ‘gross payment’ certificates would cease to be necessary and would be replaced by a verification service, to help the construction industry to ascertain the correct status of each worker.

The industry has broadly welcomed the proposals and the Inland Revenue is proposing to work towards an implementation date of April 2005, in conjunction with further input from the construction industry.

3. Capital Allowances

The Budget contains some important changes in this connection.

- The 100% first year allowance on capital expenditure by small businesses on computers and similar information technology equipment expired on 31 March 2003. However, the Chancellor has decided to extend this until 31 March 2004.

- There will also be a 100% first year allowance for expenditure after 31 March 2003 on certain specified items of equipment which are designed to reduce water use and to improve water quality.

- There are proposals to change the definitions which apply for determining whether a business is ‘small’ or ‘medium-sized’. The change is likely to occur in the late summer, and it will increase the number of businesses which are eligible for the 40% or 100% first year allowance.

- Anti-avoidance rules are being introduced with effect from 26 March 2003 to block a scheme which enabled taxpayers to take advantage of the 100% first year allowance by the ‘artificial’ use of a partnership combined with a technology exploitation company.

- There have also been some recent attempts to exploit the rules on industrial buildings allowances by artificially depressing the value of a building in order to generate an accelerated balancing allowance. It is proposed to legislate against transactions of this kind, in relation to events occurring on or after 27 November 2002.

SHARE SCHEMES

Employee Share Ownership - Summary

The Budget introduced, or confirmed the introduction of, a number of changes affecting the taxation of employee shares. These changes bear upon four areas –

- A broader basis for obtaining Corporation Tax relief where shares are allotted to employees;

- Some simplification and improvement to the rules governing approved schemes for employee share ownership;

- A measure to reverse the effect of the Court of Appeal decision in the case of Mansworth v Jelley;

- Anti-tax avoidance measures.

1. Corporation Tax

Previously, in order to get Corporation Tax relief for the cost of granting employee shares, a company would need to enter into expensive arrangements involving the creation of an employee trust.

The proposed new arrangements were subject to extensive consultation in 2002 and come into force for all accounting periods commencing on or after 1 January 2003. They provide in a broad range of circumstances for a relief to Corporation Tax for the employer company matching the liability to Income Tax of the employee (or the liability to Income Tax which would obtain were the liability not relieved by, for example, the Enterprise Management Incentives provisions).

2. Improvements to Approved Schemes

The improvement measures affect the statutory Share Incentive Plan ('SIP'), the approved Company Share Option Plan ('CSOP') and Save as You Earn ('SAYE') schemes. The measures are detailed, but have the general intention of simplifying the operation of the approved schemes for the employer company, and reducing costs.

3. Mansworth v Jelley

The Court of Appeal's decision in this recent case changed what had previously been thought to be the law in relation to the taxation of those share options, under "unapproved" or Enterprise Management Incentives ('EMI') arrangements, where the option was granted by an Employee Benefit Trust, or by another existing shareholder. The new measure restores the position prior to the Court of Appeal's judgement.

4. Anti Avoidance Measures

Certain artificial tax avoidance arrangements, notably the granting of options under a CSOP, with exercise within the first three years, in order to obtain exemption from National Insurance contributions and PAYE treatment for what were effectively unapproved options, have now been outlawed.

STAMP DUTY

In last year's Budget, the Chancellor said that he would be including legislation in the Finance Bill 2003 aimed at 'modernising' Stamp Duty. This year's Budget has put flesh on these proposals. The following are the main points.

1. As from 1 December 2003, the duty will apply only to land, shares and interests in partnerships.

2. The anti-avoidance measures relating to group relief and acquisition relief claw back will be strengthened for land transactions falling on or after 15 April 2003. The claw back period is being extended from two to three years.

3. There will be further consultation on the treatment of complex commercial transactions, to ensure that duty is not avoided in such cases.

4. There will be new compliance, enforcement and anti-avoidance rules for transactions involving UK land and buildings occurring on or after 1 December 2003.

5. The Chancellor has introduced major changes to the rules for charging duty on commercial and residential leases, and - as will be seen - these will have a punitive impact in many cases. The liability will be based on the term of the lease multiplied by the initial annual rental. The expected rentals over the entire lease will then be discounted at a rate of 3.5% per annum to give a 'net present value' ('NPV') of the lease. Lease Duty will be payable at 1% of the NPV if over the exemption limits. The proposals come into force on 1 December 2003. Commercial leases will be exempt from Stamp Duty if their NPV is £150,000, or less. (It is estimated that this will take about 60% of new commercial leases out of Stamp Duty.) Residential leases will be exempt if their NPV is £60,000, or less.

   At present, the duty is based on the first year's rent, rather than the NPV of future rentals. The change is likely to result in shorter leases in future.

6. In addition to the duty described at 5. above, any premium received on the grant of a lease will be dutiable at the same rates that apply to freehold transfers. The combination of liabilities under 5. and 6. will frequently have a penal effect on commercial property leases.

7. The dutiable consideration for a new lease will, from 1 December 2003, exclude VAT, if the landlord has not opted to charge VAT by the time the lease is granted.

8. Again from 1 December 2003, there will be a provision which will remove the double charge to duty which can arise in connection with 'Islamic Finance' and similar arrangements.

VAT

Many VAT changes are being proposed by the Chancellor. A number of these changes will be beneficial for small businesses.

1. Thresholds

As from 10 April 2003 the threshold for registration becomes £56,000 (previously £55,000), and a person may apply for deregistration if taxable turnover is £54,000 or less (previously £53,000).

2. Flat Rate Scheme

Last year the Chancellor introduced an optional 'flat rate scheme' for small businesses, designed to ease the paperwork. The scheme is available only if certain turnover limits are met. As from 10 April 2003, the annual taxable turnover must be £150,000 (previously £100,000) or less, and the total annual turnover must be £187,500 (previously £125,000) or less. These amounts are tax exclusive.

3. Annual Accounting

As from 10 April 2003 a business with annual taxable turnover of £150,000 or less can opt for annual accounting as soon as it becomes VAT registered. The previous limit was £100,000.

4. Fuel Scale Charges

A business which provides free or subsidised fuel for private use of a motor vehicle incurs a VAT liability in this connection. A new scale of charges applies from the start of the first accounting period beginning on or after 1 May 2003.

5. Anti-avoidance: Property

It has been possible to gain a VAT advantage by deferring payment of the consideration for a new commercial building for more than three years. This advantage ceases to be available from 9 April 2003.

MISCELLANEOUS PROPOSALS

1. Buy-back of Shares

An interesting change has been made to the rules here. A company will sometimes buy shares back from one or more shareholders, especially in a case where the company has surplus funds and the shareholder wishes to come out of the company. At present, it is normally necessary for the company to cancel the shares in these circumstances, as a result of a company law requirement. This requirement is going to be relaxed, so that a company can choose whether to cancel or reissue the shares. (If the company retains these shares, they are known as 'treasury shares'). Tax law will now be aligned to reflect this change so that 'treasury shares' will be notionally treated as cancelled on their acquisition. While such shares are held in treasury they will be treated as if they did not exist.

This change applies only to shares listed on the Stock Exchange (or AIM) or an equivalent market in the European Economic area.

2. Charities

From 6 April 2003, an individual can nominate in his (or her) tax return that all or part of a tax refund due to the taxpayer should be passed by the Inland Revenue to a specified charity as a gift aid donation. This will be possible in tax returns for 2003-2004 onwards. (This relief was foreshadowed in last year's Budget.)

3. The Child Trust Fund

A radical proposal is the introduction of Government sponsored capital trusts for children. These will be backdated to all children in the United Kingdom born from September 2002 onwards and will benefit the estimated 700,000 born every year. The initial endowment paid by the Government will be either £250 generally or £500 for children from low income families who also qualify for the optimum Child Tax Credit. The Government will review the question of additional state contributions during the life of the Trust Fund which will become available to be drawn upon freely when the child becomes 18.

These Trust Funds will allow contributions by parents, family members, friends and children themselves up to an aggregate annual limit of £1,000.

A review will be conducted this summer on suitable investment products, their terms, proposed providers and the extent of any incentives for non Government contributions. There are, as yet, no proposals for the internal tax structure of Child Trust Funds.

STATUS OF MEMORANDUM

This Memorandum briefly summarises the main changes announced in the Chancellor's Budget Speech on 9 April 2003. Full details of the new provisions will not be available until the Finance Bill is published and even then uncertainty will continue until the Bill completes its passage through Parliament. The content of this Memorandum has been influenced by the Inland Revenue's Technical Press Releases which, on more than one occasion in recent years, have omitted significant details.

This Memorandum is not intended to cover every aspect of the Budget, nor is it intended to provide exhaustive coverage of the aspects included. It is written for information purposes only. It is recommended that no decisions are taken based on the information contained herein without first seeking professional advice. This Memorandum must be viewed as general comment rather than specific advice.

10 April 2003