

2006 Pre-Budget Report

PRE-BUDGET REPORT NOTES

6 December 2006

Pre-Budget Report Notes contain technical information additional to the press notices issued by HM Treasury with the Pre-Budget Report. They are not the same as press notices, which are primarily used as brief explanations of new policy for the media, but rather contain additional, more detailed information on the finer points and application of taxation changes announced in the Pre-Budget Report. As such they are designed to assist businesses that may be immediately affected by the changes, and to provide more technical information to those with a specialist interest such as tax consultants and advisers, City financial institutions and local HM Revenue and Customs offices. This information is also published on the Treasury and HM Revenue and Customs internet sites.

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HM REVENUE AND CUSTOMS PRESS OFFICE

Press enquiries: 020 7147 2310 / 2311 / 2312
020 7147 0798 / 2324 / 2328 (Business Tax Desk)
020 7147 2318 / 2333 / 2319 (Personal Tax Desk)
020 7147 2337 / 0051 / 0452 (Social Tax Desk)
020 7147 2314 / 2331 / 0052 (Law Enforcement Desk)
(out of hours: 07860 359544)

GOVERNMENT DEPARTMENT INTERNET SITES

Further information and all published documents relating to the Pre-Budget Report may be found on the Internet at the following addresses:

HM Treasury: www.hm-treasury.gov.uk

HM Revenue and Customs: www.hmrc.gov.uk

CONTROLLED FOREIGN COMPANIES

Who is likely to be affected?

1. UK resident companies that control foreign companies within the scope of the Controlled Foreign Companies (CFC) tax rules.

General description of the measure

2. Draft legislation for inclusion in the next Finance Bill is being published today that will amend the CFC rules following the recent European Court of Justice judgment in the Cadbury Schweppes case, while maintaining the effectiveness of the rules in protecting tax revenues.
3. The changes will relax UK CFC rules by enabling UK companies to apply to HMRC to disregard those profits of their CFCs that arise from genuine economic activity in business establishments in other European Union Member States or certain other states in the European Economic Area (EEA).
4. A highly artificial avoidance scheme will be closed off by abolishing the public quotation exemption in the current rules. CFCs currently claiming the public quotation exemption that are not involved in avoidance will be able to claim other exemptions in the current rules.

Operative date

5. The new rules will have effect on and after 6 December 2006. Where a company's accounting period straddles this date, for the purposes of applying the changes it will be treated as two separate periods, one covering the period before 6 December 2006, and one starting on that date. The repeal of the public quotation test will also have effect on and after 6 December 2006.

Current law and proposed revisions

6. The CFC charge is provided for in section 747(4) of the Income and Corporation Taxes Act 1988 (ICTA). It is calculated by reference to the amount of the chargeable profits of a CFC apportioned to a UK Company under section 747(3). The new rules will enable a UK company to apply for this amount to be reduced, to the extent that it represents the net economic value created directly by work carried out by individuals working for the CFC in business establishments in other European Union member states, or in other EEA states with which the UK has International Tax Enforcement Arrangements. Companies will have a right of appeal in any circumstance where such an application is refused.

7. Section 748(1)(b) and Part II of Schedule 25 ICTA provide for an Exempt Activities exemption in respect of certain CFCs. The new rules apply a new “effectively managed” condition to CFCs resident in another European Union Member State, or in an EEA state with which the UK has International Tax Enforcement Arrangements. In all other respects, the new rules confirm that the Exempt Activities exemption applies in the same way to all CFCs, whether resident inside or outside the EEA.
8. The public quotation exemption provided for in Section 748(1)(c) ICTA will be repealed.

Further advice

9. If you have any questions about these changes, please contact Mary Sharp on 020 7147 2656. Draft legislation and guidance on these changes is available on the HM Revenue & Customs website at www.hmrc.gov.uk

INTERNATIONAL ACCOUNTING STANDARDS

Who is likely to be affected?

1. Companies that use International Accounting Standards (IAS) or UK equivalent standards in relation to financial instruments.

General description of the measure

2. Regulations, which are subject to approval by the House of Commons, were laid on 15 November 2006 to bring in a permanent regime for securitisation companies that hold financial assets.
3. An Order amending Schedule 26 to the Finance Act 2002 will be laid, clarifying the rules dealing with embedded derivatives in particular, and making other changes.
4. Amendments to the “Disregard” regulations and “Change of Accounting Practice” regulations will be made to clarify and correct the rules.

Operative date

5. The securitisation company regulations will apply for periods of account beginning on or after 1 January 2007.
6. The Schedule 26 Order will have effect for periods ending on or after the day it comes into force.
7. The amendments to the “Change of Accounting Practice” regulations will have effect for accounting periods ending on or after the date of coming into force.
8. The amendments to the “Disregard” regulations will apply to periods of account beginning on or after 1 January 2006 and ending after the date of coming into force.

Current law and proposed revisions

9. Legislation in 2005 and 2006 ensured that companies involved in securitisations were able to continue to use UK Generally Accepted Accounting Practice as it stood at 31 December 2004 (“old UK GAAP”) for accounting periods beginning on or after 1 January 2005. This was to avoid disruption to the markets as a result of the increased volatility brought by the wider use of fair value accounting under IAS.

10. The securitisation regulations provide permanent tax rules, for 2007 onwards, under which such companies will be taxed on a similar basis to that which applied under old UK GAAP. The regulations apply principally to special purpose companies involved in the securitisation of financial assets.
11. Legislation will be introduced in Finance Bill 2007 to amend the powers under which regulations for such companies are made to deal with consequential changes.
12. The “Change of Accounting Practice” regulations deal with the taxation of adjustments arising on the transition to IAS. Changes will be made to correct these transitional rules in two cases and make it absolutely clear that the transition rules apply whenever a company adopts IAS.
13. The regulations also defer the corporation tax treatment of unclaimed balances arising on the transition to IAS pending the outcome of discussions with the banks about the future use of those balances.
14. The “Disregard” regulations contain rules dealing with the taxation of financial instruments used for hedging purposes. The changes provide two new elections that permit companies to follow the income statement for tax purposes in a wider range of circumstances.
15. Schedule 26 of Finance Act 2002 deals with the taxation of derivatives. The changes will be made to the rules dealing with embedded derivatives to clarify certain definitions and to prevent double counting when chargeable gains rules apply. The rules dealing with occasions when a contract becomes or ceases to be a derivative contract will also be amended. These changes are to be made by secondary legislation that will amend Schedule 26.

Further advice

16. If you have any questions about these changes, please contact Sarah Weston on 020 7147 2575 (sarah.weston@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

UK REAL ESTATE INVESTMENT TRUSTS

Who is likely to be affected?

1. Companies and groups of companies whose main business is property investment and which intend or are considering joining the Real Estate Investment Trust (UK-REIT) regime, and charities that invest in shares of such companies.

General description of the measure

2. The measure will make changes to the UK-REIT regime that exempts income from and gains made on property from tax, provided the company or group meets certain conditions.
3. The conditions to be met when giving notice and on joining the regime will be relaxed, to make it easier for newly-established companies to become UK-REITs. Other changes will be made to respond to problems that have been identified as companies and HMRC have been working towards implementing the regime.

Operative date

4. The changes will have effect on and after the start date of the regime, 1 January 2007.

Current law and proposed revisions

Current law

5. The rules for the UK-REIT regime are contained in Part 4 of Finance Act (FA) 2006 and in regulations laid on 1 November 2006.
6. Provided the company or group meets certain conditions and has given notice to join the UK-REIT regime, the profits of its property rental business are exempt from tax. One condition is that 90% of the income of the tax-exempt business is distributed to shareholders within twelve months of the end of the accounting period.
7. Before a company (principal company in the case of a group Real Estate Investment Trust) can give notice to join the regime, the company must not be 'close' (controlled by five or fewer shareholders) and its shares must be listed on a recognised stock exchange. An entry charge of 2 per cent of the market value of their investment properties is chargeable at the date

the company or group joins the regime.

8. From the day the company or group becomes a UK-REIT, 75 per cent or more of its assets must be investment property and 75 per cent or more of its income must be rental income (the Balance of Business Conditions). Property that is owned and occupied by the company or group, and rental from it, does not count towards the 75 per cent asset or income test. For the purposes of the Balance of Business Conditions, the measure of income excludes a range of large or unusual items, such as unrealised capital gains.
9. There are limits on the nature and amounts of funding. The company (principal company in the case of a group) must not borrow money on terms that are linked to its profits. Additional tax is payable if the ratio of profits to financing costs falls below 1.25 (the interest cover test).
10. If a UK-REIT de-merges its business into two separate parts, both parts might meet the conditions for being in the regime. One (or possibly both) would not be a UK-REIT for the accounting period in which the de-merger took place and would face fresh entry charges if they subsequently chose to join the regime in their own right. Where one UK-REIT takes over another UK-REIT, the rules that cause these administrative problems and double entry charge are set aside.
11. In the hands of the shareholders, distributions of a UK-REIT's tax-exempt income are treated as income from UK property. The charitable exemption from tax on property income depends on the income arising from an interest in land owned by the charity. Property income distributions paid by a UK-REIT are taxable in the hands of a charity, because the charity derives the income from ownership of shares, and not from an interest in land.
12. There are limits on the nature and amounts of funding. The company (principal company in the case of a group) must not borrow money on terms that are linked to its profits. Additional tax is payable if the ratio of profits to financing costs falls below 1.25 (the interest cover test).
13. Where a UK-REIT carries on a joint venture via a limited company, the activities of the joint venture company can be taken into account in deciding if the UK-REIT meets the regime conditions. To the extent of the UK-REIT's involvement, the joint venture company's property rental business is tax-exempt and an Entry Charge is payable.

Proposed revisions

14. The first proposed revision is to make it easier for a newly-established company to become a UK-REIT. This is done by relaxing the conditions that must be met before giving notice to join the regime and extending the rules for minor breaches of the Balance of Business Conditions for newly-established companies.

15. The company (principal company of a group) will no longer need to have its shares listed on a recognised stock exchange (Company Condition 3 in section 106 FA 2006) on the date they give notice. Instead the company must affirm that it reasonably believes it will meet that condition on the day they actually join the regime, and must meet that condition continuously thereafter to remain in the regime.
16. The consequences of breaching the Balance of Business Conditions are in regulation 7 SI 2006/2864, and the necessary extensions will be made as amendments to these regulations. The extensions will affect newly-established companies that breach the 75 per cent tests during the first accounting period after they join the regime.
17. Where the asset test is failed on the first day in the regime, an additional amount of tax will be charged for that accounting period that equates to 2 per cent of the excess of the market value of investment property at the end of the first accounting period over its market value at the start. If the 75 per cent asset test is not met at the end of the first accounting period, the company or group will be treated as though it never had been in the regime.
18. The other proposed revisions fall into three broad areas:
 - definition of various terms used in the UK-REIT legislation, including
 - ‘owner-occupied’ for the purposes of tax-exempt income and excluded income,
 - ‘profits’ and ‘financing costs’ as used in the interest cover test, measure of profits of the tax-exempt business and the Balance of Business Conditions, and
 - ‘profit-linked loans’ that are prohibited;
 - extension of the UK-REIT take-over rules to de-mergers; and
 - ensuring charities are exempt from tax on distributions from UK-REITs in the same circumstances that are exempt from tax on UK dividends.
19. Currently there are slightly different definitions of ‘owner-occupied’ for the two purposes, in section 107 and Schedule 16 FA 2006 respectively, but both are intended to achieve the same result of excluding owner-occupied property from the tax-exempt ring fence. The proposed revision will remove Tax-exempt business Condition 3 in section 107 (no owner-occupied property) and the associated definitions and amend the definition in Schedule 16 that sets out the kinds of property business that are excluded from the ring fence, to reflect the nuances of the definition that were in section 107.
20. The definition of ‘profits’ for the interest cover test in section 115 FA 2006 is slightly ambiguous about the role of losses brought forward from previous periods. The proposed revision will make clear that these are excluded.
21. In computing the profits of the tax-exempt business, deductions are allowed for ‘financing costs’ which includes debits and credits from derivative contracts that hedge risk in relation to assets of the property

rental business (section 120(3) and (4) FA 2006). The proposed revision will make it clear that this includes derivative contracts that hedge risk in relation to rent and expenses related to an asset, as well as to the asset itself.

22. In the Balance of Business income test in section 108(2) FA 2006, the intention is to exclude 'lumpy' or exceptional items from the measures of profits so that companies do not face exclusion from the regime as the result of a one-off event that skews the outcome. The current range of exclusions in section 108(2)(b) and in regulation 7 SI 2006/2866 can give different results depending on the accounting treatment adopted for some items, such as fair value changes in interest rate swaps. The proposed revision will remove this anomaly.
23. The definition of 'financing costs' used in the top line of the fraction for the interest cover test in section 115(4) FA 2006 differs slightly from the definition for the purposes of computing profits of the tax-exempt business in section 120(3) FA 2006. The proposed revision will bring the section 115 definition into line with the section 120 definition.
24. Where a UK-REIT de-merges in to two parts, both of which meet the conditions for being a UK-REIT, the proposed revision will set aside the rules that result in termination and re-entry, in the same way that the rules in paragraph 33 Schedule 17 FA 2006 do when one UK-REIT takes over another UK-REIT.
25. It is proposed to extend the provisions that apply to joint ventures carried on via a limited company to apply also to those carried on by more complex structures. This will be done by extending the existing Joint Venture Regulations (SI 2006/2866).
26. The final proposed revision will extend the exemption from tax on property income for charities in section 505 of the Income and Corporation Tax Act 1988 to property income distributions received from a UK-REIT.

Further advice

27. If you have any questions about this change, please contact Rosemary Danielian on 020 7147 2623 or Claire Gough on 020 7147 2548. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

THE TAX TREATMENT OF GENERAL INSURERS' RESERVES

Who is likely to be affected?

1. General insurers, including: general insurance companies, firms carrying on general insurance business which operate in the UK through a branch, controlled foreign companies that carry on general insurance business, and members of Lloyd's.

General description of the measure

2. The Government proposes to repeal the current rules dealing with the tax treatment of general insurers' reserves.
3. The Government also announces continuing informal consultation with industry to develop, in place of the current legislation, a narrowly targeted measure to protect the Exchequer against tax loss, and to deal with transition.

Operative date

4. The existing rules will be repealed for, and the new rules will apply to, periods of account ending on or after the date that Finance Bill 2007 receives Royal Assent.

Current law and proposed revisions

5. The current tax rules are at section 107 Finance Act 2000 and Statutory Instrument No. 1757 of 2001. They were introduced to limit any tax advantage if general insurers set aside ("reserved") more funds than were necessary to meet claims by policyholders.
6. The rules require general insurers to compare the amount that they originally reserved to pay claims made by policyholders with the later cost of settling those claims, and make a tax adjustment if there is a difference.
7. The rules contain an election ("the disclaimer election"), the intention of which was to enable general insurers to mitigate the effect of the tax adjustment that would otherwise arise. The disclaimer election has also been used to accelerate the use of tax losses in groups of companies, which causes a significant loss of tax.

8. Following a Budget announcement, the Government informally consulted with industry about repealing the disclaimer election in the context of a review of the rules as a whole. The review concluded that the current rules are disproportionately complex for the tax risk that they seek to address.
9. The Government proposes therefore to repeal in Finance Bill 2007 all of the current tax rules dealing with the tax treatment of general insurers' reserves. The tax treatment of general insurers' reserves would then follow the commercial accounting treatment subject to a new measure that the Government proposes to introduce, which will be narrowly targeted, proportionate and better focussed on protecting the Exchequer against tax loss.
10. The Government will continue informal consultation with industry to determine the precise scope of the new rules, and transition.
11. Further information on the precise scope of the new rules and any transitional arrangements will be announced as soon as possible.

Further advice

12. A partial Regulatory Impact Assessment for this measure is available on HMRC's website.
13. If you have any questions about this change, please contact Simon Claydon 020 7147 2545 (simon.claydon@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

TRANSFERS OF BUSINESS IN A GROUP RECONSTRUCTION

Who is likely to be affected?

1. Corporate members of the Lloyd's insurance market.

General description of the measure

2. The measure adapts the rules which govern the transfer of trading losses by Lloyd's corporate members from one company to another company under the same control, typically as part of a group reconstruction.
3. It will enable Lloyd's corporate members to benefit from these rules in the same way as other companies. They have not previously been able to do so because Lloyd's special accounting arrangements mean that there is no single point in time at which the trade may be said to be transferred.
4. Up to now, corporate members could achieve a similar result by postponing, for tax purposes, adjustments to their reserves. That mechanism will be withdrawn - see PBR Note 04 "The Tax Treatment of General Insurers' Reserves".

Operative date

5. The measure will apply to periods of account ending on or after the date that Royal Assent is given to the Finance Bill 2007.

Current law and proposed revisions

6. The relevant tax rules on transfer of trading losses are at section 343 of the Income and Corporation Taxes Act 1988. They apply where one company ceases to carry on a trade and another company under the same control begins to carry it on.
7. The three year accounting system used by Lloyd's members means that the successor may have started to trade before the predecessor company has ceased the same trade. This is possible because the predecessor company's underwriting results are not declared until after the successor has taken up the underwriting business.
8. Special rules for Lloyd's corporate members are at sections 219 to 230 of the Finance Act 1994. In particular, section 227 deals with cessation and the final underwriting year. The measure will adapt the descriptions of the various conditions that apply where a transfer of underwriting business takes place so that they are consistent with the approach of the main legislation.

Further advice

9. If you have any questions about this change, please contact Simon Claydon on 020 7147 2545 (simon.claydon@hmrc.gsi.gov.uk) or Victor Baker on 020 7147 2616 (victor.j.baker@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

AVOIDANCE OF CORPORATION TAX

Who is likely to be affected?

1. Companies that enter into certain types of arrangement designed to avoid corporation tax.

General description of the measure

2. These measures block six avoidance schemes that have been notified to HM Revenue and Customs under the disclosure rules introduced in Finance Act 2004.
3. Legislation will be introduced to block the following schemes:
 - a) Arrangements whereby certain companies create artificial tax losses by claiming exemption from tax on annual payments paid by individuals, but seek a deduction in computing their profits for the cost of acquiring the rights to the payments.
 - b) The use by banks and other financial traders of authorised investment funds (AIFs) to avoid restrictions on claiming double taxation relief.
 - c) Arrangements to avoid the manufactured payment unallowable purpose rule by characterising such a payment as a fee.
 - d) Arrangements involving guarantees and thinly capitalised companies to hedge currency exposure that result in tax relief where there is a loss on a loan relationship but no tax charge when there is a gain.
 - e) Arrangements involving lease and leaseback of plant and machinery whereby the company claims tax relief for paying rents that are in substance a loan but is not taxable on what is, in substance, the repayment.
 - f) Arrangements whereby companies seek to shift profits offshore and return them to the UK without incurring a tax charge.
4. Draft clauses and draft explanatory notes giving effect to items (a) and (c) to (f) above are published today. Regulations giving effect to item (b) are laid today.

Operative date

5. The changes apply to scheme (a) where an annual payment is made on or after 6 December 2006.
6. The changes apply to scheme (b) where a distribution is made by the AIF on or after 6 December 2006.
7. The changes apply to scheme (c) where a manufactured payment is made on or after 6 December 2006, but only to the extent that the scheme has

not already given rise to income or chargeable gains within the charge to corporation tax.

8. The changes apply to scheme (d) in relation to accounting periods that end on or after 6 December 2006, except where the company has already ceased to be party to the loan relationship.
9. The changes apply to scheme (e) in relation to arrangements entered into on or after 6 December 2006. The changes also apply to existing arrangements where rentals are receivable on or after 6 December 2006:
 - in respect of any period beginning on or after 6 December 2006; or
 - in respect of a period that straddles or ends on 6 December 2006, but only to the extent they refer to the part of the period that begins on 6 December 2006.
10. The changes in (f) apply to schemes where any relevant tax is paid, or any relevant income received, on or after 6 December 2006.

Current law and proposed revisions

11. The proposed changes will block each scheme as follows:
 - (a) Section 347A of the Income and Corporation Taxes Act 1988 (ICTA) exempts from corporation tax certain annual payments received by a company that have been made, or treated as made, by individuals, where the individual is not entitled to a deduction for the payment. This exemption will be removed by Finance Bill 2007.
 - (b) Section 798A ICTA 1988 restricts relief for overseas tax on dividends received by financial traders to the UK tax on the amount of those dividends less the expenses of earning them. There is corresponding provision in section 804C for general insurance business. Where a banking or similar financial concern receives a distribution from an AIF, the distribution is currently treated by regulations as having had UK income tax deducted. This allows them to avoid the section 798A and 804C restrictions. The regulations will be changed so that the tax is treated as overseas tax to the extent the distribution represents overseas income. This treatment will apply only for the purposes of section 798A ICTA and section 804C ICTA. The rule will not apply unless the business holds rights to more than 50 per cent of the net assets of the AIF, nor will it apply to rights in an AIF held as assets of an insurance company's long-term insurance fund. The regulations making this change have been laid today and will be published on the HMRC website.
 - (c) The manufactured payment unallowable purpose rule in paragraph 7A of Schedule 23A ICTA 1988 will be amended by Finance Bill 2007 so that it is also capable of applying to any manufactured payment that is treated by paragraph 7(1) of Schedule 23A as a fee.
 - (d) Paragraph 11A of Schedule 9 of Finance Act 1996 will be amended by Finance Bill 2007 to ensure that exchange gains are taxed in

circumstances where exchange losses would have been tax deductible.

- (e) The principal function of section 228D of The Capital Allowances Act 2001 is to restrict the taxable amount of rent receivable by the lessor where the amount which the lessee may deduct is restricted. In the case of a lease and leaseback the deduction for rents payable by the lessee is restricted to the finance charge element of the rents and accordingly only the finance charge element of rents received by the lessor is taxed. These rules were based on arrangements under which lessees under the head lease paid a premium for which no deduction would be available, and the rules worked symmetrically.

Schemes have been notified under the disclosure rules whereby the lessee under the head lease pays rentals, sometimes in advance, and seeks a deduction for the full amount of the lease rentals it pays while only being taxed on the finance charge element of income it receives under the leaseback and so the rules do not work symmetrically. Amendments will be made so that section 228D no longer applies to lease and leaseback transactions and so the full amount of the rentals receivable by the lessor under the leaseback will be taxable.

- (f) Section 804ZA reduces or eliminates claims to double taxation relief (DTR) where there is an avoidance scheme or arrangement. Amendments will be made in order to put beyond doubt that it applies to schemes involving underlying tax, where the relief relates to underlying UK tax.

Further advice

12. If you have any comments or questions about these changes, please contact Richard Rogers on 020 7147 2625 or Richard Thomas on 020 7147 2558 (schemes (a) to (d)), Paul Lane on 020 7147 2637 (scheme (e)) or Martin Brooks on 020 7147 2651 (scheme (f)). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

LIFE INSURANCE COMPANIES – AMALGAMATION OF CATEGORIES

Who is likely to be affected?

1. Life insurance companies and friendly societies writing life assurance business.

General description of the measure

2. This measure is a simplification of the corporation tax computation for life insurance companies, achieved by reducing the number of categories of business requiring separate computations.
3. In May 2006, HM Revenue & Customs (HMRC) published "Life Assurance Company Taxation: A Technical Consultative Document" to solicit views on how to simplify certain aspects of the tax law relating to life assurance companies. The consultation was divided into five strands and for each of them a working group was established consisting of HMRC officials and representatives from the insurance industry and its advisers. This measure is a product of that work. Consultation continues for Budget 2007 and beyond on this measure and on other issues identified by the consultation process.

Operative date

4. This measure will have effect for accounting periods beginning on or after 1 January 2007.

Current law and proposed revisions

5. Basic life assurance and general annuity business (BLAGAB) is the ordinary type of life assurance and is taxed on the unique 'I minus E' basis. There are six other categories of long-term business, the most significant of which by far is pension business (PB). The others are overseas life assurance business (OLAB), life reinsurance business (LRB), individual savings account business (ISAB), child trust fund business (CTFB) and permanent health insurance (PHI). These categories are each charged to tax on their profits calculated on roughly the same basis (using the tax principles applicable to trading profits - Case I of Schedule D) but with a number of relatively minor differences between each, necessitating separate computations and complex apportionment rules. Moreover, losses from one category cannot in general be set against profits from another.

6. Finance Bill 2007 will include legislation to amalgamate the computation of profits of PB, OLAB, LRB, ISAB and CTFB for corporation tax purposes. Computation of PHI will remain on a separate basis, though consultation will continue on further simplifications here. BLAGAB profits will continue to be computed on the 'I minus E' basis as now.
7. In order to reduce the Exchequer cost of this amalgamation, pension business losses that exist at the end of 2006 will be ring-fenced and will only be capable of being set against a corresponding proportion of the amalgamated profits.
8. Draft legislation and explanatory notes have today been published on the HMRC website.

Further advice

9. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

LIFE INSURANCE COMPANIES: TRANSFERS OF BUSINESS

Who is likely to be affected?

1. Life insurance companies and friendly societies writing life assurance business.

General description of the measure

2. The current complex rules for dealing with transfers of business between life insurance companies will be replaced by simplified provisions, including a narrowly targeted anti-avoidance rule and a clearance procedure.
3. In May 2006, HM Revenue & Customs (HMRC) published "Life Assurance Company Taxation: A Technical Consultative Document" to solicit views on how to simplify certain aspects of the tax law relating to life assurance companies. The consultation was divided into five strands and for each of them a working group was established consisting of HMRC officials and representatives from the insurance industry and its advisers. This measure is a product of that work. Consultation continues for Budget 2007 and beyond on this measure and on other issues identified by the consultation process.

Operative date

4. This measure will have effect generally for transfers of business taking place on or after 1 November 2007, but in some cases will apply in relation to transfers on or after 1 January 2007.

Current law and proposed revisions

5. It is a common commercial activity for a life assurance company to transfer all or part of its business to another such company. Such transfers can give rise to tax issues and procedures exist for HMRC to discuss the transactions in advance and give tax clearances in appropriate cases. However, there is a consensus that the current clearance procedures are overly elaborate.
6. While most transfers take place for commercial reasons, there have been several occasions in the last few years when companies have sought to take advantage of business transfers to extract profits that had not been brought into account for tax. As a result, the Government has introduced a substantial amount of very complex anti-avoidance legislation.

7. The Government proposes that legislation will be included in Finance Bill 2007 to replace the current, complex rules by simplified provisions, including a narrowly targeted anti-avoidance rule incorporating its own clearance procedure. The Government also intends that the new provisions will replace section 83(3) to (8), section 83AA and section 83AB of the Finance Act 1989, which currently deal with the computation of losses of the life assurance business where assets are added to the long term insurance fund in connection with a transfer of business. HMRC will continue to consult on the detail of how this will be achieved.
8. Draft legislation and explanatory notes have today been published on the HMRC website.

Further advice

9. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

LIFE INSURANCE COMPANIES: CHANGES TO THE 'CROWN OPTION'

Who is likely to be affected?

1. Life insurance companies.

General description of the measure

2. This measure will clarify the exercise of the Crown's option to require a life insurance company to self-assess its Corporation Tax liabilities using either the 'I minus E' basis or under the provisions of Case I of Schedule D.
3. In May 2006, HM Revenue & Customs (HMRC) published "Life Assurance Company Taxation: A Technical Consultative Document" to solicit views on how to simplify certain aspects of the tax law relating to life assurance companies. The consultation was divided into five strands and for each of them a working group was established, consisting of HMRC officials and representatives from the insurance industry and its advisers. This measure is a product of that work. Consultation continues for Budget 2007 and beyond on this measure and on other issues identified by the consultation process.

Operative date

4. The measure will have effect for accounting periods beginning on or after 1 January 2007.

Current law and proposed revisions

5. Most companies have their trading profits assessed under the rules of Case I of Schedule D. However, in the case of life insurance companies, the Crown has, since 1915, had the option to assess each year on the 'I minus E' basis (income and gains less expenses). In practice most life insurance companies make their self-assessment on the basis that the Crown would otherwise exercise its option to charge it to tax on the 'I minus E' basis. However, in some circumstances the Crown does require a company to self-assess under Case I of Schedule D.
6. Even though the Crown option is rarely invoked, the uncertainty inherent in the process has long been a source of concern to the life insurance industry. Finance Bill 2007 will include legislation that in effect codifies the exercise of the Crown option, to provide greater certainty for the life insurance industry while at the same time protecting the Exchequer.

7. Draft legislation will be published shortly.

Further advice

8. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

FRIENDLY SOCIETIES: TRANSFERS OF TAX-EXEMPT LIFE OR ENDOWMENT BUSINESS

Who is likely to be affected?

1. Friendly societies writing tax exempt life assurance business.

General description of the measure

2. This measure will allow the exemption given to friendly societies writing small premium life insurance business to carry over to life insurance companies to which the exempt business is transferred.
3. In May 2006, HM Revenue & Customs (HMRC) published "Life Assurance Company Taxation: A Technical Consultative Document" to solicit views on how to simplify certain aspects of the tax law relating to life assurance companies. The consultation was divided into five strands and for each of them a working group was established, consisting of HMRC officials and representatives from the insurance industry and its advisers. This measure is a product of that work. Consultation continues for Budget 2007 and beyond on this measure and on other issues identified by the consultation process.

Operative date

4. This measure will apply to transfers of business that take place on or after 1 November 2007.

Current law and proposed revisions

5. Friendly societies, in common with other types of insurance companies, will, for commercial reasons, transfer business to other friendly societies or to insurance companies. However, friendly societies, unlike insurance companies, can write tax exempt life insurance business, using policies commonly known as TESP's (tax-exempt savings policies) providing the premiums payable do not exceed a limit which currently stands at £25 per month.
6. Under current law, if such tax exempt policies are transferred to another friendly society, they retain their tax exempt status. However, on a transfer of business to an insurance company, the business loses its tax exempt status. This can act as a disincentive to friendly societies contemplating transfers of business to an insurance company which would otherwise be in the interests of policyholders.

7. Finance Bill 2007 will contain a provision to allow friendly societies to transfer tax-exempt life or endowment business in force at the date of transfer to a life insurance company while maintaining the tax-exempt status of the business. However, the exemption will be lost if the premiums are increased after the transfer, and the life insurance company accepting the business will not be allowed to issue any new tax-exempt policies.
8. Draft legislation and explanatory notes have today been published on the HMRC website.

Further advice

9. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

LIFE INSURANCE COMPANIES: EXPLOITATION OF FSA VALUATION RULES

Who is likely to be affected?

1. Life insurance companies.

General description of the measure

2. This measure ensures that any difference between the fair value and the admissible value of an asset held in the long-term insurance fund (LTIF) of a life insurance company is brought into tax when the asset leaves the LTIF.

Operative date

3. This measure will have effect for transactions taking place on or after 6 December 2006.

Current law and proposed revisions

4. In arriving at the profits of life assurance business for tax purposes, the computation includes the income from, and the increase in value of, the company's assets that are held in its LTIF. This ensures that there is a proper match between the company's earnings on its investments and the increase in the amount it has eventually to pay its policyholders by way of benefits.
5. For ordinary accountancy purposes, the increase in the value of assets is computed by reference to their market or fair value. In most cases this is also done for life insurance companies. But because what is taken into account for tax purposes is the value of a life assurance company's assets as they appear in its regulatory return made to the Financial Services Authority (FSA) and not as they appear in its Companies Act accounts, there can be circumstances where the assets are valued at less, and in some cases very substantially less, than their fair value.
6. There are three main circumstances in which assets are valued at less than their fair value for the purposes of the FSA return. This measure applies to one of those circumstances, where one life assurance company holds the shares of another in its long-term insurance fund. Under FSA rules, the value, known as the admissible value, that can be put on any such shares is extremely limited.

7. HM Revenue & Customs (HMRC) has recently seen a number of cases where insurance groups have taken advantage of this FSA valuation rule to generate a permanent loss of tax to the Exchequer simply by restructuring the group. The particular arrangements vary, but the main features are these:
- Life assurance company A acquires the shares of another life assurance company B, both of which are in the same group of companies.
 - The shares in B are acquired for their market value.
 - When A makes up its FSA return for the period in which the purchase takes place it must write down the value from fair value to admissible value, as required by FSA rules. It therefore recognises a loss in this period. In the cases HMRC has seen this loss will typically be several hundred million pounds.
 - Were A to sell the shares in B, it would be required to do so for their market value and the write down from fair value would be reversed. But this is not what is done in the cases seen. Instead the shares in B are transferred out of the long-term insurance fund and into another part of the company as a distribution of surplus *in specie* and the rules require that distribution be shown at admissible value, which can be very substantially less than fair value.
8. In carrying out the final leg of this transaction the company is assuming that section 83(2B) of the Finance Act 1989 will not apply to recapture the difference between fair value and admissible value when the distribution *in specie* is made. If that view is correct, then the difference between fair value and admissible value, which has in the cases seen by HMRC been several hundred million pounds, will permanently escape taxation.
9. Another way of seeking to ensure that the loss created by the write down to admissible value is permanent, and that tax is never collected on the full value of the shares in B, is to transfer the business or part of the business of company A to company C (another group company) and to include in that transfer the shares in B. Again this presumes that section 83(2B) will not apply to recapture the difference between fair value and admissible value when the final transfer takes place.
10. On the basis of an opinion by leading Counsel, HMRC does not accept that section 83(2B) does not apply in the circumstances outlined above, and will contend in appropriate cases that section 83(2B) operates to recapture the difference between admissible and fair value for tax purposes. However given the significant amounts at stake and the potential for wider exploitation across the sector, section 83(2B) has been clarified with effect on and after 6 December 2006 to ensure that any difference between fair and admissible value is brought into tax when an asset leaves the long term insurance fund.

11. Draft legislation has today been published on the HMRC website.
12. Paragraph 6 above notes that there are three main circumstances where a value is put on assets, which is less than fair value. The above measure deals with one of these circumstances. The other two are:
- where the assets exceed a certain proportion of total assets (concentration risk) or there is over reliance on one counterparty (e.g. a bank)
 - where the nature of the assets is such that the FSA rules give them no value. Examples of such assets include intangible assets, gold, and some assets which are too contingent to be valued.
13. HMRC has seen instances where companies take advantage of these rules to reduce the value of their investments and to reduce the income they bring into account for tax purposes.
- One arrangement involves deliberately creating counterparty risk by putting all bank deposits into one bank for a short period covering the end of the year.
 - In another arrangement companies change the way they account for recovery of commissions when a policy lapses, moving from accounting for lapses as a reduction of reserves to treating lapses as assets which cannot be given a value.
14. The deferral of tax created by writing down asset values in this way is to some degree temporary, though the first arrangement mentioned in paragraph 13 above can be repeated year on year to give a permanent deferral. However, even temporary deferral for one year can result in losses being created, which can be surrendered as group relief in the year they are created, which would not be available if there were no deferral. This leads to an immediate loss of tax.
15. The Government considers that the effect of the valuation rules for life insurers can be to give a deferral of tax that is not justified and is not available to other businesses, and there can be cases where advantage is deliberately taken of some features of the rules to manufacture a tax advantage. The Government proposes therefore to extend the scope of the current Technical Consultation on life insurance tax rules to consider the extent to which the tax rules should recognise the valuation rules where they give a value lower than fair value.
16. If the outcome of the consultation is that legislation is needed, any necessary legislation will be developed in consultation with the life insurance industry with a view to inclusion of appropriate measures in Finance Bill 2007.

Further advice

17. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

EXTENSION TO LANDLORD'S ENERGY SAVING ALLOWANCE

Who is likely to be affected?

1. Individual landlords who let residential properties and pay income tax, and corporate landlords who let residential properties and pay corporation tax.

General description of the measure

2. A number of changes will be made to the Landlord's Energy Saving Allowance (LESA):
 - Its availability will be extended to 2015;
 - Qualifying expenditure will be extended to include installation of floor insulation;
 - The present cap of £1,500 will be applied to each property rather than to each building; and
 - The allowance will be made available to corporate landlords who let residential properties.
3. This will be subject to the results of a consultation on the proposal to extend the LESA to corporate landlords and on resolving potential EU State Aid implications. If Commission approval is required, there is a possibility that these proposals may need to be amended or withdrawn.

Operative date

4. These changes will have effect on and after 6 April 2007 subject to possible State Aid clearance.

Current law and proposed revisions

5. Under section 312 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), landlords who pay income tax may claim the LESA on the expenditure they incur in installing loft or cavity wall insulation in a dwelling house which they let when computing their taxable profits.
6. At present, LESA only applies to expenditure incurred before 6 April 2009. Legislation in Finance Bill 2007 will extend the lifetime of the allowance to make it available until 2015.
7. The maximum amount of expenditure for which LESA can be claimed is currently capped at £1,500 per building. It is proposed that on and after 6 April 2007, this cap will be applied to each property rather than each building.

8. The scope of LESA has been extended on two previous occasions. Statutory Instrument 2005/1114 allowed landlords to claim the allowance for expenditure on solid wall insulation, and Statutory Instrument 2006/912 enabled landlords to claim it for expenditure to draught proof, and to install insulation for hot water systems.
9. A further Statutory instrument will be made under section 312(5)(c) ITTOIA to enable landlords to claim the allowance on expenditure incurred in installing floor insulation.
10. It is intended that Finance Bill 2007 will also include legislation to extend the LESA to landlords within the corporate sector who let properties for residential purposes.

Further advice

11. If you have any questions about this change, please contact Ruth Curtice on 020 7147 2602 or Craig Mason on 020 7147 2599. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at <http://www.hmrc.gov.uk>

CHANGES TO ALTERNATIVELY SECURED PENSION (ASP) RULES AND RULES TO PREVENT DEVICES DESIGNED TO PASS ON TAX-FAVOURED PENSION SAVINGS

Who is likely to be affected?

1. Pension scheme administrators, members of registered pension schemes and their dependants, insurance companies and financial advisers.

General description of the measure

ASP changes

2. The provisions on members' and dependants' ASPs will be tightened up. There will be a requirement to draw a minimum income from a member's or dependant's ASP fund. A higher maximum annual withdrawal from an ASP fund will also be introduced. A tax charge will be introduced where ASP funds remaining on the death of a member or a dependant of the member are transferred to the pension funds of other members in the scheme.

Preventing other devices designed to pass on tax-favoured pension savings

3. A tax charge will be imposed on those seeking to use other benefit options (for example, scheme pensions) as a means of passing on tax-favoured funds on or before the death of a member.

Operative date

4. These changes will have effect on and after 6 April 2007.
5. HM Revenue & Customs (HMRC) will consult with interested parties to confirm that those members of registered pension schemes who either already have ASP funds, or will shortly be in that position, will on and after 6 December 2006 be able to reorganise their affairs to prevent them becoming liable to the tax charges imposed by the removal of the transfer lump sum death benefit facility as an authorised lump sum death benefit and by the removal of the guarantee facility for alternatively secured pensions.

Current law and proposed revisions

Alternatively secured pension changes

6. Currently, the pension tax rules permit a member of a registered pension scheme who reaches the age of 75 to continue to draw an income directly from the pension fund sums and assets in the form of an ASP. Similarly, dependants of deceased members may also go into an ASP when they reach the age of 75. There is no requirement to draw a minimum income from an ASP fund and the maximum annual withdrawal is 70 per cent of the annual amount of a comparable annuity (for a 75 year old) that could be purchased with the sums and assets in the fund. On death, any remaining funds may be used to provide dependants' pensions. If there are no dependants then the funds may be paid to charity, transferred to the pension pots of other members in the scheme (as transfer lump sum death benefits) or in limited circumstances be repaid to the employer with a tax charge. In Finance Act 2006, an Inheritance Tax charge was introduced on ASP funds remaining on the member's death, which applies to any funds not paid as pension benefits to a relevant dependant or to charity.
7. Changes will be made to the tax rules on members' and dependants' ASPs to:
 - introduce a minimum income requirement of 65 per cent of the annual amount of a comparable annuity (for a 75 year old) that could be purchased with the sums and assets in the fund. Failing to comply with this requirement will mean that the scheme administrator will become liable to a 40 per cent charge on the difference between the minimum income limit and the amount paid as pension income in the year;
 - increase the maximum annual withdrawal of income that is permitted from an ASP fund to 90 per cent of the annual amount of a comparable annuity (for a 75 year old) that could be purchased with the sums and assets in the fund;
 - remove from the authorised payment rules the transfer lump sum death benefit option; this will impose an unauthorised payment charge of up to 70 per cent where, on the death of a member or on the death of a dependant of the member, any remaining ASP funds are transferred to the pension funds of other members of the scheme;
 - remove the facility to make payments under a guarantee from an ASP fund; and
 - allow charity lump sum death benefits to be paid at the nomination of the scheme administrator, where there is no member nomination.
8. The Inheritance Tax charges introduced in Finance Act 2006 on ASP funds will remain in place. The Government is considering how best to ensure the rules work and interact correctly with the new unauthorised payment provisions. HMRC will discuss this with interested parties.

9. Draft legislation has today been published, which sets out further details of these measures. It is intended to include this legislation in Finance Bill 2007. HMRC will discuss with interested parties what alternative provisions are needed for those the cases where providers currently use ASP as a means to hold in suspense the funds of members which they have been unable to trace by age 75. These discussions will take into account the need to minimise the costs of dealing with this group and also to ensure an appropriate outcome for the member.

Preventing other devices designed to pass on tax-favoured pension savings

10. The Government will introduce measures in Finance Bill 2007 to prevent other pension options, such as scheme pensions, being used as a route to pass on tax-favoured pension savings. These measures will have effect on and after 6 April 2007.
11. HMRC will consult with interested parties about the measures to be included in Finance Bill 2007 to ensure they affect only those schemes or arrangements that are designed to pass on tax-favoured pension savings.

Further advice

12. These changes are included in a partial Regulatory Impact Assessment published today covering all changes to the pension tax rules. If you have any questions about these changes, please contact the Pensions Helpline on 0115 974 1600. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

PENSIONS TAX: TECHNICAL IMPROVEMENTS

Who is likely to be affected?

1. Pension scheme providers, insurance companies, pension scheme administrators, members of registered pension schemes and their dependants, and financial advisers.

General description of the measure

2. A range of technical improvements designed to ensure that:
 - the pensions tax rules continue to meet the original intentions of the simplified regime;
 - the generous tax reliefs for pensions are used to encourage individuals to provide for a retirement income; and
 - industry costs in administering the pensions tax rules are reduced, wherever possible.

Operative date

3. Operative dates, where applicable, are outlined with each measure below.

Current law and proposed revisions

4. The tax rules for pension saving are set out in Part 4 of Finance Act 2004, with further measures enacted in Finance Acts 2005 and 2006. The technical improvements, which are explained in detail in a partial Regulatory Impact Assessment issued today (see page 4 below) will introduce easements to the rules on:
 - **transitional protection from the lifetime allowance charge** - in particular, safeguarding transitional rights when: individuals make partial transfers; where there are bulk transfers of employees due to the sale of a business; where members transfer to new occupational death-in-service arrangements; and where the terms of a life policy in an occupational scheme are varied to comply with the Age Directive. These will be included in Finance Bill 2007, and will have effect on and after 6 April 2007, with the exception of the changes on members who transfer to new occupational death-in-service arrangements and the terms of a life policy in an occupational scheme are varied to comply with the Age Directive which will have effect on and after 6 April 2006.
 - **ill-health pensions** - to allow scheme pensions paid early on ill-health grounds to be reduced at the discretion of the scheme administrator to help schemes to manage the costs of paying ill-health pensions in

circumstances when it would not be appropriate under the scheme to stop the pension altogether. This change will be included in Finance Bill 2007, and will have effect on and after 6 April 2006

- **pension commencement lump sums (PCLS)** - so that a PCLS may be paid within 12 months of the member becoming entitled to the related pension and if this 12 month period falls in part after the member reaches the age of 75, the lump sum may still be paid. This changes will be included in Finance Bill 2007, and will have effect on or after 6 April 2006;
 - **the 2 year time limit on the payment of lump sum death benefits where the individual member dies on or after 6 April 2006** - to allow lump sum death benefits to be paid within 2 years of the scheme being notified of the member's death, but if the scheme could have been reasonably aware of the member's death at an earlier date then the time limit will be 2 years from that earlier date. These will be included in Finance Bill 2007. This change will to apply to payments on or after 6 April 2008 in respect of deaths on or after 6 April 2006;
 - **unsecured pension funds** - a review of the annual maximum withdrawal from an unsecured pension fund may be permitted more frequently than every 5 years. Such reviews may be conducted at the end of each unsecured pension year, but only at the direction of the member. The requirement that the maximum withdrawal needs to be reviewed at least every 5 years will remain. The change will have effect on and after 6 April 2006;
 - **winding up lump sums** - a change to the winding-up lump sum rules so that the conditions that need to be met by the employer apply only to the member's current employer at the time the winding-up lump sum is paid and not to any previous employer. This will reduce the administrative burden on schemes winding up and help to speed up the winding up of schemes. The change will have effect on or after 6 April 2006;
 - **the establishment of schemes** - instead of having to belong to one of a number of categories set out in current legislation (bank, insurance company etc), a person will need permission from the Financial Services Authority in order to be eligible to establish a (non-occupational) registered scheme. The Government intends this measure to be included in Finance Bill 2007, and it will have effect on and after 6 April 2007;
5. HM Revenue & Customs (HMRC) will consult on the way in which two of the rules around the Lifetime Allowance operate: for **pension increases (benefit crystallisation event 3)**; and for **the dependants' scheme pension**. The Government intends any changes to be included Finance Bill 2008 and to have effect on and after 6 April 2008.

6. Further details on the above measures are set out in the partial Regulatory Impact Assessment which has also been published today.
7. Over the next few months, HMRC will also discuss concerns raised by the pensions industry over the administration involved in the checks they are required to make when paying **trivial commutation lump sums**. These are paid as wholly or partly taxed lump sums in respect of small pension funds that it would be disproportionately expensive to turn into pensions income. The Government will explore the way in which the current rules impact across a range of interests, bearing carefully in mind both the potential impact on individual pensioners, pension savers, and pension providers and the way the rules fit with the Government's wider objectives in encouraging pension saving to produce an income stream in retirement.
8. The discussions will take carefully into account the following underpinning principles, that the trivial commutation rules:
 - need to ensure that individuals at the lower end of income scales are not adversely impacted;
 - should include a key focus on how to encourage or facilitate amalgamation of an individual's small pension funds in order to produce an economically viable total fund;
 - should balance the needs of scheme administrators and members of both personal and occupational defined benefit and money purchase pension schemes;
 - should take into account the need not to have any additional Exchequer cost;
 - should not be open to manipulation, for example, by allowing individuals to fragment their pension savings between different schemes in order to receive taxed lump sums instead of purchasing annuities that provide an income for life;
 - should not undermine annuitisation policy;
 - should, where possible and where compatible with the above, ensure significant administrative savings for the industry and not result in increased HMRC administrative costs.
9. Over the next few months, HMRC will also discuss with interested parties concerns raised over the tax charge and the administrative burden involved in the **non-cash benefits** that former employers provide to pensioners. The Government will review:
 - how the current £100 lower limit applies to low value benefits across different categories of expenditure for less well-off pensioners; and
 - how the tax treatment for non-cash benefits provided to pensioners compares to the treatment of employee benefits.

Further advice

10. A partial Regulatory Impact Assessment is also published today and is available on the HMRC website at www.hmrc.gov.uk
11. An announcement has also been made on the consultation pages of the HMRC website for the measures on the lifetime allowance test (BCE3) and dependants' scheme pensions:
<http://www.hmrc.gov.uk/consultations/index.htm>
12. If you have any questions about this change, please contact the Pensions Helpline on 0115 974 1600. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

INVESTMENT-REGULATED PENSION SCHEMES AND UK-REITS

Who is likely to be affected?

1. Investment-regulated pension schemes investing in UK-REITS

General description of the measure

2. Regulations laid on 1 November 2006 provide for an additional tax charge on a UK-REIT where a company holds an interest of 10 per cent or more in the UK-REIT. This modifies the position proposed in the draft regulations published for consultation on 2 June 2006, where the tax charge would have applied where any legal person, including an individual or a pension scheme, held an interest of 10 per cent or more in the UK-REIT.
3. As a result of this modification a small consequential change will be made to the rules on residential property held by investment-regulated pension schemes (which include self invested personal pension schemes, or SIPPs).

Operative date

4. This change will have effect on and after 1 January 2007, the date when provisions enabling UK-REITs to be invested in come into effect.

Current law and proposed revisions

5. Registered pension schemes which hold “taxable property” (which includes residential property) are, in certain circumstances, subject to a tax charge of up to 70 per cent on the value of that property, under provisions introduced in Finance Act 2006 to discourage the use of tax-relieved pension funds for investing in residential property or other tangible assets primarily for the personal use of scheme members. This charge may apply where the pension scheme is “investment-regulated” and where the property is held directly or indirectly through an interest in some other vehicle.
6. Investment-regulated pension schemes that, from 1 January 2007, invest in UK-REITS are not under current legislation treated as indirectly holding any item of taxable property held by that UK-REIT unless the investment is made to enable a member of the pension scheme or a connected person to occupy or use taxable property.

7. A further condition will apply on and after 1 January 2007, if a holding by an investment-regulated pension scheme in a UK-REIT is not to be treated as creating an indirect holding by the pension scheme in any taxable property held by the UK-REIT. This condition is as follows.
8. If the holding in the UK-REIT by the pension scheme and associated persons is 10 per cent or more, the investment regulated pension scheme will be treated as having an indirect holding in any taxable property held by the UK-REIT. This will be done by ensuring that the rules in paragraphs 24 and 25 of Schedule 29A, Finance Act 2004 apply to any investment in a UK-REIT as described in paragraph 22 of that Schedule.
9. For the purpose of this test a holding in a UK-REIT will be as defined in paragraph 24(5) of Schedule 29A Finance Act 2004. Legislation to achieve this will be introduced in Finance Bill 2007.

Further advice

10. These changes are included in a partial Regulatory Impact Assessment published today covering all changes to the pension tax rules. If you have any questions about this change, please contact the Pensions Helpline on 0115 974 1600. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

STAMP DUTY RESERVE TAX: EXCHANGE TRADED FUNDS

Who is likely to be affected?

1. Providers of Exchange Traded Funds (ETFs) that are incorporated outside the UK and who wish to list on a UK exchange, and investors in those funds.

General description of the measure

2. The regulations that exempt from stamp duty reserve tax (SDRT) certain Depositary Interests relating to companies incorporated outside the UK will be amended so that ETFs may also qualify.

Operative date

3. Regulations to make the change will be published and laid before Parliament in order that the exemption can take effect from 1 February 2007.

Current law and proposed revisions

4. Transactions in the shares of companies that are incorporated outside the UK but traded in London are normally settled in the form of a Depositary Interest held in CREST (the central securities depository for UK equities).
5. The 1999 Stamp Duty Reserve Tax (UK Depositary Interests in Foreign Securities) Regulations exempt from SDRT Depositary Interests representing shares in overseas incorporated companies. This exemption does not apply if the overseas company is centrally managed or controlled from the UK, keeps a share register in the UK or is a collective investment scheme.
6. The change to the regulations will enable an overseas ETF to qualify for exemption provided that both its central management and control and the location of its share register are outside the UK. Transfers of shares in ETFs incorporated in the UK will continue to be subject to SDRT in the same way as shares in other UK companies. The change will bring into line the SDRT treatment of overseas incorporated ETFs, overseas funds whose shares are not traded on exchange and shares in overseas companies that are traded in London.

Further advice

7. Draft regulations have been published today. If you have any questions about this change, please contact Ian Burton on 020 7147 2788. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

STAMP DUTY LAND TAX: ANTI-AVOIDANCE MEASURES

Who is likely to be affected?

1. Those who are parties to schemes designed to avoid stamp duty land tax (SDLT).

General description of the measure

2. The Treasury have today made Regulations (The Stamp Duty Land Tax (Variation of the Finance Act 2003) Regulations 2006) that make ineffective a number of schemes designed to avoid stamp duty land tax.

Operative date

3. The measure will have effect on and after 6 December 2006. There are transitional provisions to protect those who entered into contractual commitments before 2p.m. on 6 December 2006.

Current law and proposed revisions

4. Stamp duty land tax legislation is currently set out in Part 4 of Finance Act 2003, as amended. The purpose of the Regulations is to counter avoidance of SDLT by changing the legislation in two respects.
5. The first change provides that
 - where one person disposes of a chargeable interest and another person acquires that interest, or one derived from it,
 - a number of transactions (the 'scheme transactions') are involved in the disposal and acquisition, and
 - the stamp duty land tax chargeable on all the scheme transactions is less than that which would have been chargeable on a single land transaction; the chargeable consideration for which is the total consideration given or receivedthen the scheme transactions are disregarded and there is a notional land transaction; the chargeable consideration for which is the total consideration given or received.
6. The effective date of the notional land transaction is the last date of completion of the scheme transactions or, if earlier, the last date on which a contract in respect of the scheme transactions is substantially performed.

7. Examples of schemes to which the Regulations might apply are:
- The grant of a lease that gives the landlord the right to terminate the lease within a set period. The period expires without the landlord exercising the right and in return the tenant pays the landlord a sum of money.
 - A agrees to sell property to B Ltd, a company. On completion B Ltd transfers the property to its parent, C Ltd, by way of a dividend *in specie*.
 - V grants a lease for 999 years at a peppercorn rent to an unconnected nominee N. V assigns the freehold reversion to P. P pays N a sum of money in consideration of an agreement by N to vary the lease by inserting a provision giving P the right to terminate the lease.
8. The second change is to make a number of changes to Schedule 15 of Finance Act 2003 dealing with transfers into and out of partnerships, and transfers of partnership interests. The changes are as follows:
- When calculating the 'sum of the lower proportions' for the purposes of paragraphs 10, 11, 18 or 19 of Schedule 15, partners that are connected with 'relevant owners' but which are not individuals are not treated as 'corresponding partners' in relation to that relevant owner.
 - However, on a transfer into a partnership which is subject to paragraph 10 of Schedule 15, relief similar to group relief can be claimed so that the tax payable is reduced to what it would have been if companies which were members of the same group as a relevant owner were treated as corresponding partners in relation to that relevant owner. There are claw back provisions similar to those applying to group relief.
 - Where there is a transfer of a partnership interest and the transferee is connected with the transferor but is not an individual then there is a charge under paragraph 14 of Schedule 15 regardless of whether consideration is given.
 - The application of the group relief provisions to transfers of partnership interests is clarified to put it beyond doubt that group relief claimed on such a transfer is subject to the claw-back provisions in paragraph 3 of Schedule 7 Finance Act 2003.
9. The Regulations are made under powers contained in section 109 Finance Act 2003. They take immediate effect, but cease to have effect unless approved by the House of Commons within 28 days.

Further advice

10. As the Regulations have effect only for a period of 18 months they will be replaced by legislation in Finance Bill 2007. In order to inform the Finance Bill legislation the Government invites representations on the Regulations.
11. If you would like to make representations, or have any questions about these changes, please contact Michael Lyttle on 020 7147 2792 (michael.lyttle@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

A TARGETED ANTI-AVOIDANCE RULE FOR CAPITAL GAINS TAX

Who is likely to be affected?

1. Persons who take part in schemes or arrangements to gain a tax advantage from capital losses, including individuals, trustees and personal representatives.

General description of the measure

2. A targeted anti-avoidance rule (TAAR) will be introduced to counter schemes to create and use artificial capital losses to avoid tax. The measure will ensure that allowable capital losses are restricted to those arising from genuine commercial transactions.

Operative date

3. The changes will take effect in relation to capital losses arising on disposals on or after 6 December 2006.

Current law and proposed revisions

4. The Taxation of Chargeable Gains Act 1992 (TCGA) provides that, unless there is an express rule to the contrary, a capital loss is computed in the same way as a capital gain, and a loss will be an “allowable loss” if a gain arising on the same transaction would have been a chargeable gain (section 16 TCGA).
5. An express exception to this general TCGA rule was introduced in Finance Act 2006. A loss accruing to a company is not an allowable loss if it arises as part of arrangements which have a tax advantage as their main purpose, or one of the main purposes (section 8 TCGA). The intention of this provision is to deter the creation and use of artificial capital losses by companies liable to corporation tax on their chargeable gains.
6. The measure extends this anti-avoidance rule for companies to persons liable to capital gains tax (individuals, trustees and personal representatives). Where a person has made arrangements, and a main purpose of those arrangements is to gain a tax advantage by creating an artificial capital loss, any resulting loss will not be an allowable loss for the purposes of capital gains tax, income tax or corporation tax.

7. The measure will introduce, in a new section 16A TCGA, a general rule covering capital gains tax, income tax and corporation tax, and hence replacing the corporation tax provisions introduced into section 8 TCGA by Finance Act 2006, without changing their effect.

Further advice

8. Further information on the scope of proposed changes, draft legislation, an explanatory note, draft guidance and a statement of principle are available on the HM Revenue & Customs website.
9. If you have any questions about these changes, or comments on the draft legislation or guidance, please contact Roger Willoughby on 0131 777 4143 (roger.willoughby@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

MICROGENERATION: TAX TREATMENT OF INCOME FROM SALES OF SURPLUS POWER BY HOUSEHOLDERS

Who is likely to be affected?

1. Householders who have invested in microgeneration technology and who receive payments from energy suppliers for sale of surplus power.

General description of the measure

2. Legislation in Finance Bill 2007 will put beyond doubt that where private householders install microgeneration technology in their home for the purpose of generating power for their personal use, any payments they receive from the sale of surplus power to an energy company is not subject to income tax.
3. This exclusion does not apply to cases where surplus power is sold in the course of a trade.

Current law and proposed revisions

4. Under section 5 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), income tax is charged on the profits of a trade. Receipts which arise other than in the course of a trade fall outside this section.
5. Householders are able to make use of microgeneration technology to produce power for use in their homes, reducing their energy bills. In some cases, where households produce power in excess of their own needs, they can sell the surplus back to power companies. Any payments received in respect of such sales are not subject to income tax. Legislation will be included in the Finance Bill 2007 to put this situation beyond doubt.
6. Any individual selling power produced by microgeneration technology in the course of a trade is not covered by this exclusion and is liable to income tax under section 5 of Act 2005 (ITTOIA).
7. Microgeneration refers to the generation of electricity or the production of heat by those sources of energy and technology described in Section 82(7) of the Energy Act 2004 and not exceeding the capacity described in Section 82(8) of that Act.

Further advice

8. If you have any questions about this change, please contact Ruth Curtice on 020 7147 2602 or Craig Mason on 020 7147 2599. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at <http://www.hmrc.gov.uk>

HYDROCARBON OILS: DUTY RATES

Who is likely to be affected?

1. Businesses producing and importing hydrocarbon oils products.

General description of the measure

2. From 7 December 2006, the effective excise duty rates for road fuels will be increased by 1.25 pence per litre (ppl), in line with the inflationary increases announced at Budget 2006. Effective rates of duty (that is, the relevant duty minus the relevant rebate) for non-road fuels will also be increased by 1.25 ppl.
3. In order to maintain the current differentials with main road fuels, the effective duty rates for biodiesel and bioethanol will also be increased by 1.25 ppl. The effective duty rate for natural gas will increase by 1.81 p/kg (equivalent to 1.25ppl) to maintain the differential with main road fuels. The effective duty rate for liquefied petroleum gas will increase by 3.21p/kg (equivalent to 2.25ppl) to reduce the differential with main road fuels by the equivalent of 1ppl.

Operative date

4. The changes will have effect on and after 7 December 2006.

Current law and proposed revisions

5. The Excise Duties (Surcharges or Rebates) (Hydrocarbon Oils etc.) Order 2006 and the Excise Duties (Road Fuel Gas) (Reliefs) Regulations 2006 will be revoked, with effect from 7 December 2006, by the Excise Duties (Surcharges or Rebates) (Hydrocarbon Oils etc.) (Revocation) Order 2006 and the Excise Duties (Road Fuel Gas) (Reliefs) (Revocation) Regulations 2006.
6. The new effective rates of duty are given in the attached table. Changes to the rate for rebated gas oil mixed with biodiesel for the purposes of pilot projects are detailed in a separate PBR Note on biofuels.

7. The new effective rates of duty will be:

Light oils	Effective duty rate per litre (£)
Ultra low sulphur petrol (ULSP)	0.4835
Sulphur-free petrol (SFP)	0.4835
Unleaded petrol that is not ULSP or SFP	0.5152
Aviation gasoline (AVGAS)	0.2884
Light oil delivered to an approved person for use as furnace fuel	0.0729
Other light oil (including leaded petrol)	0.5768
Heavy oils	Effective duty rate per litre (£)
Ultra low sulphur diesel (ULSD)	0.4835
Sulphur-free diesel (SFD)	0.4835
Heavy oil which is not ULSD or SFD (conventional diesel)	0.5468
Marked gas oil and ultra-low sulphur diesel not for road fuel use	0.0769
Fuel oil	0.0729
Kerosene to be used as motor fuel off-road or in an excepted vehicle	0.0769
Biofuels	Effective duty rate per litre (£)
Biodiesel	0.2835
Biodiesel used otherwise than as road fuel	0.0313
Bioethanol	0.2835
Road fuel gases	Effective duty rate per kg (£)
Natural gas (NG)	0.1081
Road fuel gas other than natural gas – e.g. liquefied petroleum gas (LPG)	0.1221

Further advice

8. If you have any questions about these changes, please contact the National Advice Service on 0845 010 9000. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

FACILITATING THE USE OF BIOFUELS

Who is likely to be affected?

1. Businesses producing and using biodiesel.

General description of the measure

2. The current duty rate for mixes of biodiesel with rebated gas oil will be reduced from 54.68 pence per litre (ppl) to 7.69ppl where it is used in specific pilot projects to test the use of biofuels off-road – for example, in railway engines. Eligible pilot projects that offer potential environmental benefits will be approved individually by HMRC, subject to appropriate anti-fraud safeguards.
3. The definition of biodiesel in the Hydrocarbon Oil Duties Act 1979 will be amended to include a new second generation biodiesel, produced by the hydrogenation of biomass, that offers potential environmental benefits comparable to those offered by conventional biodiesel.
4. The duty incentive for biodiesel of 20ppl will be available for a limited pilot scheme early in 2007 to test the use of biomass in conventional fuel production.

Operative date

5. For mixes of biodiesel with rebated gas oil, a statutory instrument will be laid before Parliament shortly, and will come into effect 21 days after being laid.
6. The definition of biodiesel will be amended early in 2007 by Treasury Order. The Order will be subject to the affirmative procedure. Any consequential amendments to primary legislation will be made in Finance Bill 2007.
7. For testing the use of biomass in conventional fuel production, a statutory instrument will be laid before Parliament shortly, and will come into effect 21 days after being laid.

Current law and proposed revisions

8. Statutory instruments will be made under the relevant sections of the Hydrocarbon Oil Duties Act 1979 (HODA). The definition of biodiesel in section 2AA of HODA will also be amended.

Further advice

9. If you have any questions about these changes, please contact the National Advice Service on 0845 010 9000. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

CHANGES TO THE SCHEDULE OF EXCEPTED VEHICLES

Who is likely to be affected?

1. Businesses in the agriculture and construction sectors using rebated gas oil ("red diesel") in excepted vehicles.

General description of the measure

2. The schedule of excepted vehicles entitled to use rebated gas oil will be amended to bring definitions up to date and to improve consistency and clarity.

Operative date

3. The deletion of the road construction vehicle category will have effect on and after 1 April 2008. Other changes, as detailed on the Treasury Order, will have effect on and after 1 April 2007.

Current law and proposed revisions

4. A Treasury Order amending Schedule 1 to the Hydrocarbon Oil Duties Act 1979 will be laid before Parliament in draft today.

Further advice

5. If you have any questions about these changes, please contact the National Advice Service on 0845 010 9000. A full Regulatory Impact Assessment on the changes to the Schedule, together with other information about Pre-Budget Report measures, is available on the HM Revenue & Customs website at www.hmrc.gov.uk

AIR PASSENGER DUTY RATES

Who is likely to be affected?

1. Airlines, travel agents and air passengers.

General description of the measure

2. Air passenger duty (APD) rates will be increased from 1 February 2007, and the scope of the lower rates will be widened.
3. The new rates of duty will be:

	In the lowest class of travel	In other than the lowest class of travel
Passengers flying to destinations in the European Economic Area (EEA), the European Common Aviation Area, countries applying to join the European Union (EU), and Switzerland.	£10	£20
Passengers flying to other destinations.	£40	£80

4. EEA destinations comprise all EU member states, Norway and Iceland. Countries applying to join the EU are Bulgaria, Croatia, Romania and Turkey.
5. With effect from 1 February 2007, following an EU agreement with a number of countries to create an extended European Common Aviation Area, the lower rates of APD will be extended to apply to Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Kosovo under the Interim Administration of the United Nations, Montenegro and Serbia.

Operative date

6. The new rates will come into effect on 1 February 2007 and apply to the carriage of a passenger on an aircraft which begins on or after that date.

Current law and proposed revisions

7. Section 30 of the Finance Act 1994 will be amended to reflect the changes.

Further advice

8. If you have any questions about these changes, please contact the National Advice Service on 0845 010 9000. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

VAT: PARTIAL EXEMPTION

Who is likely to be affected?

1. Businesses seeking the approval of a partial exemption special method to calculate the amount of VAT they can recover. Users of the standard method are unaffected.

General description of the measure

2. A business that makes both taxable and exempt supplies (known as a partly exempt business) must operate a partial exemption method to calculate how much VAT it can recover on its costs. Many large partly exempt businesses operate a 'tailor-made' special method that must be approved by HMRC before use.
3. The measure comprises two changes and was the subject of a recent consultation announced at Budget 2006 (see BN 49 – VAT: Partial Exemption).

Operative date

4. Following consultation, the Government intends implementing the changes with effect on and after 1 April 2007.

Current law and proposed revisions

5. Section 26(3) of the Value Added Tax Act 1994 requires HMRC to make regulations to secure a fair and reasonable recovery of VAT. To this end, regulation 102 of the VAT Regulations 1995 (SI 1995 / 2518) allows HMRC to approve a special method. A special method only provides for the recovery of VAT on costs that relate to taxable supplies made in the UK.
6. The first change (the Method Declaration) will require a business to declare 'to the best of its knowledge and belief' that its proposed special method is fair and reasonable. HMRC will have the power to set aside a method if the person signing the declaration knew or ought reasonably to have known that is not fair and reasonable. The business would then have to recalculate past returns to ensure that it only recovered a fair and reasonable amount of VAT. This change will allow HMRC to approve special methods more quickly, and improve fairness and equity by helping to ensure that all businesses recover a fair and reasonable amount of VAT.

7. The second change (the Combined Method) will give businesses the legal right to apply for a 'combined method' that caters for the recovery of VAT on overseas supplies that confer the right of input tax deduction (for example, supplies of finance and insurance made to customers outside the European Union). This will simplify the rules for partly exempt businesses that make overseas supplies.
8. The introduction of the Method Declaration and Combined Method will require amendments to secondary legislation, in particular, regulations 99, 101, 102, 102A and 103 of the VAT Regulations 1995.

Further advice

9. If you have any questions about this change, please contact Patrick Wilson on 0207 147 0595 (patrick.wilson@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

VAT: TRANSFER OF GOING CONCERN

Who is likely to be affected?

1. Any type of business that sells or acquires a business as a going concern, but mainly small and medium sized enterprises.

General description of the measure

2. VAT record keeping requirements for businesses transferred as a going concern will be brought into line with other tax & regulatory regimes so that the seller retains his records, except in the few cases where because the buyer retains the seller's VAT number it is essential for VAT compliance purposes that the records are passed over.

Operative date

3. The change will have effect on and after the date on which Finance Bill 2007 receives Royal Assent.

Current law and proposed revisions

4. Section 49(1)(b) of the VAT Act 1994, determines who retains the business records following a transfer of a going concern. VAT law will be amended so that:
 - The seller will keep the business records in all but a few specified cases; and
 - The information that must be passed to the buyer is set down in the law.

Further advice

5. If you have any questions about this change, please contact Ian Allen on 020 7147 0009. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

LANDFILL TAX: INCREASE TO STANDARD RATE

Who is likely to be affected?

1. Businesses registered for landfill tax.

General description of the measure

2. The standard rate of landfill tax will be increased from £21 per tonne to £24 per tonne. The lower rate of tax, which applies to inactive wastes disposed at landfill, as listed in the Landfill Tax (Qualifying Material) Order 1996, remains unchanged at £2 per tonne.

Operative date

3. The £24 per tonne rate applies to any standard rated disposal of waste made, or treated as made, on or after 1 April 2007.

Current law and proposed revisions

4. Section 42 of the Finance Act 1996 specifies the rates of landfill tax, and will be amended in the Finance Bill 2007.

Further advice

5. If you have any questions about this change, please contact the HMRC National Advice Service on 0845 010 9000. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk

