Technical Connection

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A QUESTION OF DOMICILE

Domicile of origin and domicile of choice
Displacement of a domicile of origin
The importance of domicile for inheritance tax purposes

A Court of Appeal judgment earlier this year addressed the issue of domicile of origin and domicile of choice.

This case was not about inheritance tax but about who should inherit on a person's death. However, because the issues turned on the deceased's domicile it is clearly relevant to inheritance tax as a person who is UK domiciled, or deemed UK domiciled, is liable to inheritance tax on his worldwide assets. The fiancée of the deceased argued that her Cypriot born deceased fiancé was domiciled in the UK in order that she could take advantage of the Inheritance (Provision for Family and Dependants) Act 1975 which only applies to people who die domiciled in the UK. Under the Act she hoped to get more of her fiancé's estate than he had left her in his Will.

The deceased was born in Cyprus in 1939 and died in England in 2003. He had left Cyprus on two occasions to live in London because of threats to his personal safety. He set up a hotel business in England and lived with his fiancée for 10 years up to the time of his death in 2003.

The Court of Appeal put forward three principles on which they judged his domicile.

1. His domicile of **origin** will continue – unless it is displaced by satisfactory evidence of the acquisition and continuance of a domicile of **choice**.

2. The burden of proof of a change in domicile falls on the party that asserts that the domicile of origin has been lost.

3. The Court must make its decision after careful examination of the deceased's entire life – not on snapshots that appear to lean one way or the other.

In this particular case the Court of Appeal overturned the High Court's decision that the deceased had acquired a domicile of choice in the UK and found that his domicile of origin continued.

COMMENT

Domicile is a key factor in determining a person's liability to inheritance tax. A UK domiciled person is subject to inheritance tax on his worldwide assets; a non-UK domiciled person is only liable to inheritance tax on assets situated in the UK. For some people, domicile can be difficult to determine. This case demonstrates that it is not easy to shake off a domicile of origin for a domicile of choice. Of course, for inheritance tax purposes there is the notion of deemed domicile where a person of foreign domicile has been UK tax resident for at least 17 of the past 20 tax years. This will, for inheritance tax purposes, override domicile of origin or choice. Non-UK domiciled persons approaching the end of the 17 year period should take planning action whilst they remain non-UK domiciled.

SURRENDER DILEMMA?

Single premium investment bonds
Segmentation
Chargeable event rules -part surrenders and full surrenders
Strategies for large part surrenders

The chargeable event rules apply to all non-qualifying life assurance policies which includes single premium investment bonds.

Nowadays most single premium investment bonds are issued as segmented policies which means that a bond with a premium of, say, £100,000 might be issued as a cluster of 1000 identical stand-alone policies each for a premium of £100. It should be possible to deal individually with each policy in the cluster, for example to surrender 100 policies out of 1000 leaving 900 in force.

When a large part surrender is to be taken then the choice might lie between encashing a number of whole policies or taking an equal part surrender from each policy. Each option can give rise to different tax implications and so it is important to consider both carefully. Before examining these options, let's remind ourselves of the relevant chargeable event rules.

(a) Part surrenders

Under a non-qualifying policy, part surrenders can be taken with no immediate liability to income tax under the "5% withdrawal" rule. Under this rule, for each policy year for 20 years, 5% of the initial premium can be withdrawn from a policy by way of part surrender with no immediate liability to income tax. Any part of the 5% withdrawal allowance not used in a policy year can be carried forward for use in a later policy year. For example, if no withdrawals have been taken from a policy which commenced on 1 October 2000 for a premium of £200,000, a part surrender of £60,000 could be taken before 1 October 2006 with no immediate income tax liability as 6 years of unused 5% allowances are available.

(b) Full surrenders

A full surrender gives rise to an immediate chargeable event. The chargeable event gain is calculated using the formula [surrender value + previous withdrawals] less [initial premium + previous chargeable event gains].

Part surrender or whole policy encashments?

In basic terms, if the amount to be withdrawn does not exceed the cumulative unused 5% allowances then a part surrender will not give rise to any income tax charge at that time. On the other hand, if a whole bond needs to be encashed then the surrender of whole policies will be involved which may give rise to an immediate income tax charge.

In some cases, a policyholder may need a substantial sum from his policy. If this need is in the early years of the policy, the cash required may exceed the 5% allowances available. If the policyholder nevertheless proceeds with a part surrender this could, in certain circumstances, produce a chargeable event gain bigger than the actual investment gain made on the policy and some surprising tax results.

Consider, for example, Bill who invested £100,000 in a bond with a UK insurer on 1 November 2003. The bond was issued as 100 equal policies of £1,000 each and it is now worth £110,000.

On 10 October 2006 Bill needs £75,000 from the bond. Bill's other taxable income (ie. total income less personal allowance) for tax year 2006/07 is £31,300. He has two ways of obtaining the £75,000 - either by way of a part surrender or an encashment of a number of whole policies:-

(1) Part surrender

Bill requests a part surrender for £75,000 and finds that the part surrender is made equally from each £1,000 policy (which is standard practice). Tax on the part surrender is calculated as follows:-

	£
Part surrender	75,000
Less: cumulative 5% allowances (3 years)	15,000
Chargeable event gain	60,000
Top-sliced gain = £60,000 ÷ 3	20,000
Tax on top-sliced gain = £18,000 (the excess of £20,000 over the higher rate tax threshold of £33,300) x 20%	3,600

Tax on the whole gain = £3,600 x 3 = **£10,800**

(2) Whole policy encashments

Alternatively, Bill could have encashed sufficient whole policies to give him his £75,000. Here tax would be as follows:-

	£
Value of each policy	1,100
Need to encash 75,000 ÷ 1,100 segments = 69	
Total gain on 69 segments	6,900
Top-sliced gain £6,900 ÷ 2	3,450
Tax on top-sliced gain = £1,450 x 20%	290
Tax on the whole gain = £290 x 2	**580**

It will be seen that Bill has reduced his immediate income tax liability by the significant amount of £10,220 (£10,800 less £580). He has also preserved the accumulated 5% allowances on the remaining 31 policies (but has had to take total withdrawals of £75,900 because he needs to encash fully a number of policies).

There are some points to note.

(i) Years for top-slicing relief total 3 on the part surrender and 2 on the full surrenders. The reason for this is that generally when 5% withdrawals are taken the chargeable event occurs on the last day of the policy year i.e. 31 October 2006 in Bill's case. With a full surrender, though, the chargeable event occurs on the day of surrender which is 10 October 2006 at which time the policy has only been in force for two whole years.

(ii) Whenever possible bonds should be issued in segmented format so as to afford the maximum flexibility to the policyholder to choose the best option for encashing at the time.

(iii) On a subsequent full surrender where there has been an earlier part surrender that has produced a high artificial chargeable event gain, there may be some relief from tax at 20% (that is higher rate tax [40%] less lower rate tax [20%]) for both a UK and non-UK policy on the deficiency that arises.

By way of example, were Bill to take a part surrender across all his policies in the bond to generate the £75,000, and then fully encash his bond for £75,000 in July 2009, the chargeable event position would be as follows:-

[£75,000 (surrender value) + £75,000 (previous withdrawals)] less [£100,000 (initial premium) + £60,000 (previous chargeable event gains)] = loss of £10,000.

The loss (called a deficiency in the legislation) can be set off against income subject to higher rate tax in the year of encashment but with relief, as mentioned earlier, restricted to 20%. In addition, the amount of the deficiency that can be set off is restricted to the amount of previous chargeable event gains (whether or not they actually gave rise to a tax liability) that the current policyholder has suffered.

COMMENT

When deciding whether to take whole policy surrenders or a part surrender equally from all policies it is clearly important to consider all the tax implications first. Where a large amount of cash is required early on in the life of a bond and growth has not been significant, whole policy encashments are generally likely to minimise the amount of tax payable at that time and the existence of a number of policies will aid planning to tax efficiently encash the remaining policies in the future.

ALTERNATIVELY SECURED PENSIONS

FSA publishes top tips on ASP
A change to the ASP provisions?

(i) The FSA has published some top tips and frequently asked questions on unsecured and alternatively secured pensions (ASP) which includes guidance on the action that advisers should be taking in relation to advising clients on ASPs.

It is important to note that the FSA has stopped short of requiring advisers to ask questions regarding religious beliefs. However, it does require advisers to warn their clients that the Government may take action to restrict the availability of ASPs and that such action may adversely affect the client.

(ii) It has been reported that Ed Balls, the Economic Secretary to the Treasury, indicated at the Financial Services Forum in London on 16 October that a change to the ASP provisions will be announced in the pre-Budget Report later this year.

COMMENT

There has been much comment on whether the Government will decide to remove the ASP facility, or apply additional taxes to it. It is to be hoped that the Government will leave the ASP facility alone as it represents one of the most enterprising changes under the new pension tax regime. However, it seems likely that the Government will take some action to curb the potential abuses of relief they see to a facility that was designed to accommodate the Christian Brethren but which has been promoted widely to members of registered schemes generally.

If the Government do seek to remove the ASP facility it will be interesting to see what action they take in respect of individuals who have already arranged such benefits. On the face of it *there would be a strong argument against the Government if they tried to remove it from such individuals as it would be seen as retrospective legislation particularly because the current legislation fully permits the use of ASP, and does not limit this to members of the Christian Brethren.*

PENSIONS MISCELLANY

Lump sum death benefits
SMPI illustrations
Scheme abandonment
Pension scheme newsletters

- The Pensions Regulator has updated its guidance on the circumstances where lump sum death benefits can be provided for members of occupational schemes and where such benefits can be provided in the absence of the provision of the pension benefits.

- The Actuarial Profession has now released the latest version of Technical Memorandum 1 concerning the basis on which SMPI illustrations should be prepared. This will apply to SMPI illustrations with illustration dates from 1 November 2006.

- The Pensions Regulator has expressed concerns about some proposed transactions involving final salary occupational schemes where the primary intention is for the employer to abandon the scheme.

  The Regulator has indicated that it does not consider that "abandonment of a scheme by its employers is usually likely to be in the best interests of scheme members unless the full section 75 debt is paid". The Regulator believes that the best means of delivering the scheme's benefits is for it to have the support of a viable employer.

  The Regulator has also indicated it will look critically at any such cases and where it feels the members' benefits have been threatened will consider using its anti-avoidance powers.

- HMRC has issued Pension Tax Simplification Newsletters 19 and 20.

  Newsletter 19 covers the following:

  (i) Interest paid with lump sums
  (ii) Overpayments of pension/annuity made in error
  (iii) Winding-up lump sums and employer undertakings
  (iv) Pre A-Day PS Forms
  (v) Accounting for Tax Return - 30 September 2006

  Newsletter 20 is a special one and has been issued together with an online guide to provide further advice on filing the Accounting for Tax Return and other forms online.

THE REGULATION OF PERSONAL PENSIONS (INCLUDING SIPPS)

The FSA issue Policy Statement 06/07
The regulation of personal pension schemes (including SIPPs) from 5 April 2007

The new FSA regulated activity of "establishing, operating or winding up a personal pension scheme" and the consequential arrangements of "dealing in, arranging and advising on rights under such schemes", are due to take effect from 6 April 2007. This new regulated activity was introduced by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2006 – SI 2006/1969.

In April 2006 the FSA issued its consultation paper CP06/5 on how it proposed to regulate personal pension schemes from 6 April 2007 and has now set out its feedback to that consultation in its Policy Statement 06/7, "The regulation of personal pension schemes including SIPPs". This Statement sets out how it will regulate such schemes from 6 April 2007 and includes appropriate amendments to the perimeter guidance manual and Conduct of Business Rules to enable this to be achieved.

Although the new provisions take effect from 6 April 2007 some changes to the perimeter guidance manual and the Handbook Glossary took effect from early this October. In addition, changes to the fees and commission statement (the "menu") can be made from 1 November 2006, while firms may apply for authorisation under the new regulated activity, or apply for a variation of permission to include this new regulated activity with effect from 2 October 2006. The latter is to give the FSA sufficient time to consider such applications, which should take around 3 months on average, prior to the implementation of the new regulated activity on 6 April 2007.

FOREIGN DIVIDEND INCOME CHARGEABLE ON THE REMITTANCE BASIS

Tax law rewrite
Dividend income taxed on the remittance basis
Reduction in top rate of tax to 32½%

HMRC issued a press release in early August on the remittance basis of taxation for foreign savings and dividend income. Broadly speaking, the remittance basis applies to non-UK domiciliaries who are UK tax resident and means that foreign income of such individuals is assessable to UK income tax only to the extent it is remitted, directly or indirectly, to the UK.

HMRC notes in the press release that the rewrite of the part of the income tax legislation which led to the Income Tax (Trading and Other Income) Act 2005 has changed the rate of tax applicable to foreign dividend income. From 6 April 2005, the top rate of tax on foreign dividend income chargeable on the remittance basis has been 32.5% and not 40%. As this change did not come to light until after HMRC's self assessment return and tax calculator had been compiled and issued, the self assessment system will automatically apply the former tax rate of 40% for higher rate taxpayers. It is likely the software for the tax calculator will do the same.

For those affected by this, HMRC has advised that they should use the additional information section of the main return (box 23.9) to give details of the amount of foreign dividend income included in the return on the remittance basis and to say what rate of tax has been applied if they have self assessed the amount of tax due.

TRUSTEES' POWERS AND DUTIES

Do trustees need express power to pay tax?
Is tax payable out of trust income or capital?

Following the recent changes to the taxation of trusts, and in particular the "alignment" of the IHT treatment of trusts, the tax liabilities of trustees have become more topical. Some trustees and advisers alike may be concerned that a particular trust deed does not grant the trustees a specific power to pay tax, in particular the periodic (ten-yearly) IHT charge.

Generally speaking, a power to pay taxes, indeed to properly incur any expenses, is implied. After all, you could not imagine a trustee refusing to pay taxes on the grounds that the trust document does not expressly allow him to do so!

However, a perfectly reasonable question would be whether taxes can be paid out of income or out of capital of the trust. For example, trustees may be concerned as to whether they can sell shares, or take a partial withdrawal from an investment bond, in order to pay the tax or whether they should pay the tax out of trust income.

The general rule under common law has been that capital expenses (such as taxes) should be paid out of capital while revenue expenses should be paid out of income. To override this rule and to make the position clear (where trustees may not be sure whether particular expenses should be paid out of income or capital) , some trusts include an express power to pay capital expenses out of income, e.g. "The trustees may pay taxes and other expenses out of income although they would otherwise be paid out of capital" *(and possibly the other way round).*

This was certainly the position before the Trustee Act 2000 came into effect. Now the considered opinion is that the trustees have discretion in this respect. This is because section 31 Trustee Act 2000 authorises a trustee to be reimbursed out of "trust funds" for any expenses properly incurred when acting on behalf of the trust (this would include any tax payable by the trustees). "Trust funds" is defined as "income or capital funds of the trust" (s.39(1) Trustee Act 2000). Of course, where beneficiaries include a life tenant and a remainderman, the trustees would still be subject to the general duty to hold a fair balance between the life tenant and the remainderman - so their discretion is not absolute - and that would be the case regardless of any express power being included in the trust. There will be fewer constraints in the case of a discretionary trust.

For the above reason it is generally not considered essential to include an express power dealing with trustee expenses, although of course some, when drafting the trust, will prefer to include such a power, if only to avoid any doubts in this area and the need to clarify the position later.