Technical CONNECTION

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"SPOUSAL REMUNERATION"

Arctic Systems
House of Lords hearing

In December 2005 the Court of Appeal allowed the taxpayer's appeal against the High Court decision in the case of Jones –v- Garnett (otherwise known as the "Arctic Systems" case). HMRC subsequently successfully petitioned the House of Lords for leave to appeal the decision. The House of Lords hearing has been scheduled for 5-7 June 2007.

COMMENT

That the hearing is not sooner is unfortunate. There is a need for certainty on this important issue. As it stands (post the Court of Appeal judgment) it looks as if there is scope for legitimate, properly thought through and executed planning opportunities for couples that can avoid the settlement provisions in section 660A ICTA 1988. However, while the uncertainty exists, it would be inadvisable to implement such planning. Advisers to small family businesses should keep this in mind when advising their clients on remuneration strategies.

DISCLOSURE OF AN INTEREST TO A BENEFICIARY

Beneficiary under a trust attaining age 18
Notification of a beneficiary's entitlement

With all lifetime trusts established after 21 March 2006, apart from bare trusts and trusts for the disabled, being subject to the "relevant property" regime for IHT purposes, gifts into such trusts will be treated as chargeable lifetime transfers. This means that if the total chargeable lifetime transfers of a donor exceeds the then nil rate band on a seven year cumulative basis, IHT will be suffered immediately on the gift, at the lifetime rate of 20%, on the excess. To avoid an immediate IHT charge on larger gifts, it may be necessary to use a bare trust so that all or part of a gift is classified as a PET which means that IHT can only be payable on the death of the donor within seven years of establishing the trust.

There is a cost to pay for PET treatment because of the inflexible nature of a bare trust which does not allow for any change in beneficiary or the shares in which beneficiaries are entitled. In addition, the beneficiary has an absolute interest in the trust from day one which means that at age 18 the beneficiary, if of sound mind, can ask the trustees to transfer the trust property to him and effectively terminate the trust under the rule in Saunders -v- Vautier. If there is more than one beneficiary then a beneficiary who is age 18 can demand his share. This begs the question of what the position would be if, say, a beneficiary attaining age 18 was kept in the dark over the existence of his interest.

The position on disclosure of an interest to a beneficiary was considered in Hawkesley -v- May (1956). The decision in that case means that trustees are required to tell any beneficiary of his or her interest under a trust on their 18th birthday. This requirement will normally apply where the beneficiary has a vested right under a trust, such as a bare trust or a vested right to income under an interest in possession trust.

If a beneficiary is not told of his or her entitlement, clearly the beneficiary could later argue that the trustees were in breach of trust and if the beneficiary suffers a loss (eg. where the knowledge of the trust interest could have saved him from acting to his detriment), he could take personal action against the trustees. After all, the fundamental principle that a trustee must be accountable to a beneficiary must imply that a beneficiary needs to know that he is a beneficiary before he can enforce any duties of the trustee and make the trustee account for his trusteeship.

The need for disclosure to a beneficiary is, in any event, clearly important in cases where the trust fund is held in income-producing assets because at age 18 the beneficiary will need income details so as to be able to complete the self assessment tax form.

Of course, where the trust investments consist of a life assurance policy, (such as a single premium bond), there will be no income for the beneficiary to declare (unless a chargeable event gain arises and the beneficiary is an adult) but trustees must still be aware of the possible need to disclose the beneficiary's interest to him.

Also, it needs to be borne in mind that in certain special cases adult beneficiaries will not find it easy to enforce their interest in the trust because of the nature of the trust property. A good example of this is a discounted gift trust where the settlor's rights are to part surrenders from a bond. Clearly the trustees could not encash the bond whilst the settlor (donor) is alive because this could defeat the settlor's (donor's) interest. Finally, HMRC are currently reviewing the position of bare trusts.

PENSIONS UPDATE

- The Pensions Regulator laid the "Modification of Subsisting Rights Code of Practice" before Parliament on 7 November 2006. If no representations are made within 40 days, the Code will be brought into force.

  Changes brought in by the Pensions Act 2004 enable employers/trustees to make amendments to a member's subsisting rights under occupational pension schemes in certain circumstances. The Code sets out how modification of a member's past service rights will be governed by these changes.

- HMRC has issued Pensions Tax Simplification Newsletter No. 21. It covers a number of areas the main ones of which are pre 6 April 2006 "surpluses" in annuity policies, block transfers and the meaning of "single transaction", and employer contributions and tax relief. On the final point, it states that the long-awaited finalised guide on the application of the "wholly and exclusively" provisions will be issued shortly in a new chapter of the Business Income Manual.

- The Employment Equality (Age) (Amendment No.2) Regulations were laid on 10 November 2006 and will come into force on 1 December 2006. These regulations introduce amendments to the age discrimination provisions as they relate to occupational and personal pensions and have clarified a number of areas.

  The Government had been pressed by the CBI and others for a transitional period in order to give trustees and employers more time to consider and implement these changes. However, it has been reported that the DWP has now sent a letter to firms indicating that it cannot introduce a "compliance window" as it would be "allowing unjustified discriminatory practice to continue for a period of time after which, due to our European obligations, we are required to prevent it".

ISAs

Reforms to ISAs announced

On November 1 the Economic Secretary to the Treasury made a speech at the PEP and ISA Manager's Association annual conference explaining the Government's continuing policies and plans for savings. During the speech he announced an end to the Government's internal review of the ISA. This means that the availability of ISAs will not definitely end in 2010. Below is a list of the salient points in relation to the ISA to emerge from the speech.

The proposed reforms

- Until now the Government had committed to run the ISA only until 2010. It is now to be made a permanent feature and will therefore run beyond 2010.
- The Pre-Budget Report will confirm that the overall annual contribution limit will continue to be at least £7,000 for each individual.
- The Government intends to remove the mini/maxi distinction within the ISA to make it easier for savers to understand and use ISAs.
- The Government intends to bring PEP schemes within the ISA wrapper with the funds held in PEPs continuing to enjoy tax advantages.
- Child Trust Fund accounts, when matured, will be capable of being rolled over into an ISA.
- There is no intention to offer a new savings vehicle for all.

In a more recent speech the Economic Secretary stated that it is proposed that in future it will be possible to switch from a cash ISA to a stocks and shares ISA.

The above confirms that, in the Economic Secretary's own words, "ISAs are the Government's primary savings vehicle outside pensions." More details on these proposals will be given in the Pre-Budget Report.

RETIREMENT ANNUITY CONTRACTS

Change to method of payment from 6 April 2007

Currently, retirement annuity pensions are paid to UK residents gross provided form R89 is completed satisfactorily, or with tax deducted by the provider at 22% (the basic rate of income tax). The annuity can be paid gross to a non-UK tax resident provided the annuitant makes a claim to relief under a double taxation treaty or form AF is completed satisfactorily (in the same way as for form R89, the completion of form AF is confirmation that no UK tax will be paid on any UK source income including the retirement annuity pension).

From 6 April 2007, retirement annuity income will be classified as pension income to be taxed under PAYE. HMRC states that some 1.2 million people receive income from retirement annuities, half of whom receive gross payments. Some 200,000 people who have tax deducted at source at 22% are either not liable to tax, are liable at only 10% or pay basic rate tax on only part of their income.

With a new PAYE scheme being created for each provider, this should aid HMRC in identifying those pensioners who have overpaid tax in the past.

At the other end of the spectrum, some people who completed form R89 in the past are now liable to tax. In these cases HMRC will take no action unless they suspect deliberate avoidance.

In February of next year every annuitant, include non-residents, will receive a notice of coding form P2 telling them how their PAYE tax code number has been worked out.

COLLECTIVE INVESTMENTS

Gross interest payments from Authorised Investment Funds
Start date for gross interest payments to non-taxpayers postponed

HMRC has announced that in response to representations from the retail investment industry, the Government has decided to defer the proposed 6 April 2007 start date of the facility to enable non-taxpaying UK investors to receive interest from Authorised Investment Funds gross.

As part of the consultative process, it has become clear that there are a number of administrative issues which are still to be resolved. Further discussions between HMRC and industry will now take place before the Government confirms the next steps in the process.

The Authorised Investment Funds (Tax) Regulations 2006 (SI 2006/964) extended the existing facility for gross payments of interest distributions to certain recipients with no liability to tax by adding a new category "UK residents with no net tax liability".

HMRC states that in recent months it has become clear that problems were likely to arise in cases where investments are held through fund supermarkets or other types of indirect arrangement. In exploring this with industry representatives it has also recently become clear that there may be wider difficulties for industry in implementing systems to allow payments to be made gross.

Rather than deal piecemeal with each of these areas HMRC wants to work with stakeholders to address all the issues around the gross payment of interest distributions.

To allow time for further consultation, a Treasury order removing the 6 April 2007 start date for gross payment to UK-resident investors who are not liable to tax will be laid. This will not alter or affect other existing requirements to pay gross to, among others, non-residents and managers of ISAs and PEPs.

INHERITANCE TAX AND TRUSTS

Schedule 20 clarifications

Schedule 20 Finance Act 2006 contains the legislation whereby all lifetime trusts established after 21 March 2006, with the exception of bare trusts and trusts for the disabled, are subject to IHT under the relevant property (discretionary trust) regime.

The Society of Trust and Estate Practitioners/The Chartered Institute of Taxation have published questions and answers, agreed with HMRC, giving further clarification on how

Schedule 20 operates in connection with

- transitional serial interests
- administration of estates
- immediate post-death interests
- trusts for children
- bare trusts
- disabled trusts
- deeds of variation
- various points of interests

This information is extremely useful. Take transitional serial interests (TSIs) for example. A TSI is an interest in possession (IIP) that arises after 21 March 2006 on a pre 22 March 2006 trust but does not take the trust into the IHT relevant property regime. It was previously generally thought that to qualify as a TSI a new IIP not only had to arise as a result of the termination before 6 April 2008 of a pre-Budget IIP but also that the whole of the pre-Budget interest had to end at once even though this could fragment into a number of TSIs. However, it seems now that a pre-Budget IIP doesn't have to terminate as a whole and at one time for the succeeding interest to be a TSI.

For example, say 50% of the pre-Budget IIP is appointed to a new IIP beneficiary in one appointment and the other 50% to another beneficiary later then both new IIPs would be TSIs provided each appointment was made before 6 April 2008.

As a TSI the relevant proportion of the property supporting that interest would then be treated as being in the estate of the new IIP beneficiary(ies) for IHT and not subject to the relevant property regime. The previous beneficiary who is losing his interest would be treated as making a potentially exempt transfer. It is still important nevertheless that the IIP being terminated existed pre-Budget if the succeeding interest is to be a TSI. Also, any later change in ownership of the TSI that arises during the TSI owner's lifetime would then cause the property to be subject to the relevant property regime.

COMMENT

The exchange adds to the slowly growing bank of knowledge on the new provisions. Most practitioners are broadly familiar with when and how the relevant property rules apply but applying the transitional provisions to particular circumstances, and attempting to ascertain with certainty how and whether they apply, is not without its difficulties. The detail of these questions and answers is therefore welcome.

PRE-BUDGET LIFE POLICY TRUSTS

Premiums paid under pre-Budget life policy trusts
Care needed if somebody other than the settlor pays the premiums

As readers will know, the main thrust of the IHT trust changes in the Finance Act 2006 is to treat most new lifetime trusts as discretionary trusts for IHT purposes. Those trusts created before 22 March 2006 will continue to be taxed under the old pre-Budget rules provided either:-

- no more property is added to them

or

- the beneficiaries are not changed (although certain exceptions exist here in relation to transitional serial interests - see below)

For life policies in trust certain exceptions exist to these general rules. If premium payments are maintained within what is permitted by the terms of the policy, even if they are increased, this will **not** amount to "added property". Also, a beneficial interest that changes before 6 April 2008 (but only one) or on death at any time, will be regarded as a transitional serial interest and not give rise to a change in the inheritance tax treatment of the trust.

However, when a different person (from the original settlor) makes a payment, HMRC may well regard this as a new settlement with a new settlor. Therefore in a case where, say, a parent has effected a policy in trust for the benefit of his adult children and it is decided that the children will take over premium payments, they should not pay premiums direct to the life office or the trustees. Instead they should make payments to the settlor who can continue premium payments (without it costing him anything). By approaching the issue in this way the policy and trust will definitely remain within the old pre-Budget IHT legislation.

THE NORMAL EXPENDITURE EXEMPTION

Steps to take to assist in securing the normal expenditure exemption

Under the new inheritance tax legislation that applies to trusts, virtually all lifetime gifts to post-Budget trusts will be chargeable lifetime transfers.

Premium payments made to protection policies or regular savings plans will not be chargeable lifetime transfers if they fall within the settlor's IHT exemptions, the most relevant of which are the annual exemption and the normal expenditure out of income exemption. For persons paying premiums over and above the annual exemption with high levels of income, the normal expenditure out of income exemption can be particularly useful to prevent chargeable lifetime transfers arising.

To be eligible for this exemption, gifts made (ie. premium payments) must be

- paid regularly
- paid out of income and
- not cause the donor's standard of living to reduce

Income includes both earned and investment income.

In determining whether Form 100 (reporting a chargeable lifetime transfer) needs to be completed, the donor decides whether the normal expenditure exemption applies to prevent a chargeable lifetime transfer arising that exceeds the disclosure thresholds. This is all well and good whilst the donor is alive but if HMRC challenges the availability of the exemption following the donor's death, this could be a difficult matter for the legal personal representatives who can no longer consult with the donor over his financial circumstances when he made the payments.

COMMENT

To prevent difficulties, the donor should keep records of the circumstances of such payments ***whilst he is alive.*** *An ideal way of keeping such records is the completion of HMRC Form D3a which is the form used to claim the normal expenditure exemption on a person's death. Rather than only completing this form after death, it should be completed whilst the donor is alive as it is designed to enable income and expenditure to be recorded and so compared.*

CHARITIES ACT 2006

Charities Bill 2006 receives Royal Assent

The Charities Bill received Royal Assent on 8th November 2006. Except for some technical provisions the Act has not yet come into force. A timetable for when each part of the Act comes into force will be issued.

FSA PROVIDE UPDATED CONSUMER FACTSHEET ON CONTRACTING OUT

The FSA has issued an update of its consumer factsheet "The State Second Pension - should you be contracted out"? This provides a balanced analysis of the pros and cons of contracting out and has been updated to allow not only for the changes in the timing of payment of protected rights benefits (and the ability to take a Pension Commencement Lump Sum in respect of them) but also the changes which the Government proposes to make regarding State pension benefits. The factsheet, which analyses the position on contracting out for tax year 2006/07, indicates:

"Independent analysis that has been done for us suggests that most consumers are likely to be financially worse off by contracting out or staying contracted out during 2006/07. This position may change in future years".

COMMENT

This seems a well-balanced document produced by the FSA which not only considers the financial implications of contracting out but also the non-financial aspects.