CONTENTS

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BARE TRUSTS AND INHERITANCE TAX

The latest HMRC position on bare trusts for minors

As is well known, following changes made in the Finance Act 2006, property held on bare trust (ie other than a settlement as defined in section 43(2) IHTA 1984) is excluded from the definition of relevant property for the purposes of the IHT discretionary trust regime. This means that:

- gifts to bare trusts continue to be treated as potentially exempt transfers;
- the ten-year periodic charge will not apply to the trust fund; and
- the trust fund will not be subject to exit charges.

We understand that, following legal advice, HMRC Inheritance Tax continues to take the view that a bare trust for a minor is a settlement. This is on the basis that because the trustees may need to accumulate income whilst the child is a minor (whether section 31(2) Trustee Act 1925 applies or not) the trust would fall within section 43(2) IHTA 1984 as a trust to accumulate the whole or any part of any income.

It would therefore, in the view of HMRC, be a settlement for inheritance tax purposes. The effect of section 31(2) is that any income not used by the trustees for the education, maintenance or benefit of a minor beneficiary has to be accumulated.

Many (including a number of leading Tax Counsel) feel that HMRC is misguided in this interpretation and discussions are continuing. In the meantime, though, it would be advisable to exercise caution in establishing bare trusts for minor beneficiaries as, under the current HMRC interpretation, gifts to such trusts will be chargeable lifetime transfers and the periodic and exit charges under the relevant property rules would apply.

Until this issue is resolved serious consideration should be given to avoiding the establishment of bare trusts for minors if the main intention is to avoid the relevant property regime for IHT. It is **essential** that potential donors are made aware of this current state of affairs.

We will update you further when we have more information.

HMRC CLARIFIES POSITION ON PIPELINE PTA CASES

HMRC has indicated that pension term assurance (PTA) policies applied for on or before 6 December 2006, but not issued by that date, will continue to benefit from tax relief and be unaffected by the announcement in the Pre-Budget Report provided the following conditions are met:

- the application for the PTA must have been fully completed on or before 6 December 2006, and submitted to the insurance company and receipt recorded by that insurance company by midnight on 13 December 2006. For this purpose applying for the PTA does not mean merely applying for a quotation with no other commitment

- the "sum assured" issued is no greater than that applied for on or before 6 December 2006

- the insurer must process the business by no later than 5 April 2007

The treatment of increases will be considered as part of the wider consultation into the future of pensions term assurance.

TRANSFER INDUCEMENTS TO BE TAXED

Inducement payments made either to encourage scheme members to give up future pension rights or to move from one pension scheme to another will be subject to income tax and National Insurance

HMRC has published a note concerning inducements or incentives being given to members of salary related pension schemes to agree to a reduction of benefits or to agree to a transfer out to a money purchase scheme. The inducements being offered are a higher transfer value, a cash payment to the member or a combination of both.

HMRC has had further legal advice and states that all future inducement payments must be subject to income tax and National Insurance. They will be taxable as employment income under section 394 ITEPA 2003 and “earnings” within the meaning of section 3(1)(a) of the Social Security Contributions & Benefits Act 1992 and so liable for Class 1 NICs, under section 6(1) of that Act.

This treatment will not apply where the transfer value is enhanced and the enhancement is included in the transfer of the funds between the schemes. This enhancement of the transfer value will be treated for tax and NICs purposes in the same way as employer contributions.

Guidance will be included within the Employment Income Manual and the National Insurance Manual at a future date.

HMRC is aware that transactions have been entered into which relied on previous advice that they were not taxable or liable for NICs. It will not seek to alter this treatment where transactions have been carried out or where offers have been made to scheme members as follows:

Inducement payments have already been paid before the date of the announcement ie 24 January 2006.

HMRC will not seek to tax or apply NICs to the inducement payment. This assurance applies only to the extent that the payments were not taxable and NICs was not applicable to them under the former view of the law. If in any particular transaction it was assumed by the payer or confirmed by HMRC that the payments were taxable or liable for NICs, then that treatment will continue to apply.

Where HMRC has confirmed that the inducement payments in point are not taxable or liable for NICs and the employer has made an offer to scheme members before the date of this announcement but no inducement payments have yet been made.

Subject to there being no material changes to the original offer, HMRC will not seek to tax or apply NICs to the inducement payments paid in relation to that transaction after the date of this announcement. This assurance applies only to the extent that the payments were not taxable or liable to NICs under the former view of the law.

Where an employer has made an offer to scheme members before the date of this announcement and can show that they relied on HMRC’s former view of the law.

HMRC will not seek to tax or apply NICs to inducement payments paid after the date of this announcement. This assurance applies only to the extent that the payments were not taxable or liable to NICs under the former view of the law.

Where an employer has made an offer to scheme members before the date of this announcement but is unable to demonstrate that it relied on HMRC’s former view of the law.

HMRC will apply its revised understanding of the correct tax and NICs treatment of the inducement payments and expects them to be taxed under PAYE and for NICs to apply.

Where an employer has not made an offer to scheme members before the date of this announcement.

HMRC will apply its revised understanding of the correct tax and NICs treatment of the inducement payments and expect them to be taxed under PAYE and for NICs to apply.

UK-REAL ESTATE INVESTMENT TRUSTS

UK-REITS not capable of qualifying as an HMRC-approved investment trust
UK-REITS not a permitted direct investment for a Personal Portfolio Bond
UK-REITS available as an investment for an HMRC-approved investment trust
UK-REITS available as investments for ISAs, PEPs and CTF accounts

Since 1 January 2007 it has been possible for a UK resident company to establish itself as a Real Estate Investment Trust - a so-called UK-REIT. To qualify as a UK-REIT a company must satisfy three sets of conditions, set out in sections 106 to 108 Finance Act 2006, which relate to:

- the form of the company. For example, it must be UK resident for tax purposes and not be a close company;
- the nature of the activities that can be carried on which are regarded as qualifying tax-exempt business. For example, throughout an accounting period the company must conduct a "property rental business" and have a minimum of three properties;
- the balance between qualifying tax-exempt business and non-qualifying businesses. For example, at the beginning of an accounting period the value of assets involved in the tax exempt business must be at least 75% of the total value of the assets held by the company.

By being a qualifying UK-REIT, certain commercial and taxation advantages are conferred on the company and its shareholders. For example, the profits and gains from the "property rental business" are not subject to corporation tax; and to the extent that the dividends paid by the UK-REIT derive from tax-exempt profits and gains they are taxed as property income rather than dividends in the hands of the shareholders.

Although the words "investment trust" appear in the title of a UK-REIT, a UK-REIT cannot be an HMRC-approved investment trust in accordance with section 842 Income and Corporation Taxes Act 1988 for a number of reasons, the main one being that the underlying assets of a UK-REIT are primarily commercial and rental properties, whereas to be an HMRC-approved investment trust a company must have an income which consists wholly or mainly of eligible investment income. Eligible investment income means income derived from shares or securities so a UK-REIT will not own assets of a type that will permit it to be an HMRC-approved investment trust. However, dividends paid from the tax-exempt business of a UK-REIT will be treated as income from shares and securities and a UK-REIT could therefore be a suitable asset for an HMRC – approved investment trust.

A UK-REIT is not a permitted direct investment for the funds underlying a life assurance policy, which means that a fund holding shares in a UK-REIT direct would be classified as a Personal Portfolio Bond (PPB) which would, in turn, for a UK resident policyholder, give rise to a deemed chargeable event gain each policy year based broadly on 15% of the premium paid plus previous deemed PPB chargeable event gains. The reason why a UK-REIT is not a permitted asset for a direct investment is that it is neither an authorised unit trust, an open-ended investment company as defined nor an HMRC-approved investment trust. However, shares in a UK-REIT could be held via a qualifying collective or internal linked fund of the life company, so that the policy would not be a PPB provided certain other conditions are satisfied.

A UK-REIT is an eligible investment for an ISA, PEP and Child Trust Fund account subject to the existing limits and rules.

ECJ RULING ON ASW CASE

The European Court of Justice (ECJ) has recently ruled that the UK Government had failed to safeguard the pension benefits of the ASW members. ASW was a steel group, based in Wales and Kent, which went out of business. It operated a final salary pension scheme that was found to have insufficient funds to provide members of the scheme with their pension benefits when it was wound up.

Although the ECJ found the Government in breach of the Directive (the 1980 EC Insolvency Directive) it did not follow the Advocate-General's suggestion that full protection of the pension benefits was required. Instead, it appears that providing between 50% and 100% of the pension benefits would be sufficient.

It is now down to the High Court to decide whether the breach warrants compensation.

COMMENT

Overall, this is a good outcome for the Government although a very disappointing one for the pension members affected. The ECJ's decision also seems largely to endorse the approach taken by the Pension Protection Fund (PPF), which provides sufficient benefits for most members. However, in the longer term the PPF may need to be amended as it operates a cap on pension benefits (currently of £26,050) and this will mean that some members may end up with less than 50% protection.

PRE-BUDGET REPORT 2006

In last month's bulletin we gave prominence to the changes that were made/proposed for pensions. This month we include details of the main personal income tax allowances and the NI contribution rates for 2007/08, which may be helpful in year-end tax planning which would frequently involve some consideration of the position in the next tax year (2007/08). The inheritance tax nil rate band for 2007/08 had earlier been fixed at £300,000.

Income tax

The main personal allowances applicable for tax year 2007/2008 are as shown in the table below.

	2006/2007	2007/2008
	£	£
Personal Allowance – standard	5,035	5,225
- Age 65 – 74	7,280	7,550
- Age 75 and over	7,420	7,690
Married Couple's Allowance – minimum amount	2,350 (B)	2,440 (B)
- Age 65 – 74	6,065 (C)	6,285 (C)
- Age 75 and over	6,135 (A)	6,365 (A)
Age-related Allowances reduced if total income exceeds (D)	20,100	20,900
Maintenance to former spouse for all orders provided one party was 65 or over before 6 April 2000	2,350(A)	2,440(A)

(A) Relief at 10%.

(B) Minimum amount of MCA for age allowance purposes only.

(C) Relief available at 10% only if at least one of the couple was aged 65 before 6 April 2000.

(D) For 2007/2008 the reduction is £1 for every £2 additional income over £20,900 [£20,100 for 2006/2007]. Standard allowance(s) **only** are available if total income exceeds:

	2006/2007	2007/2008
	£	£
Taxpayer aged 65 - 74 [personal allowance]	24,590	25,550
Taxpayer aged 65 - 74 [married couple's allowance]	32,020	33,240
Taxpayer aged 75 and over [personal allowance]	24,870	25,830
Taxpayer aged 75 and over [married couple's allowance]	32,440	33,680

National Insurance

Contribution rates are unchanged for 2007/08. The Primary and Secondary thresholds have been increased to £100 per week, and the Upper Earnings Limit to £670 per week (£34,840 per annum). The Lower Earnings Limit is raised to £87 per week.

The Class 2 flat rate weekly contribution is increased to £2.20 and the lower profits limit to £4,635. Class 4 contributions will be payable on profits between £5,225 pa and £34,840 pa.

The Class 3 voluntary contribution rate is raised to £7.80 a week.

EMPLOYER-FINANCED RETIREMENT BENEFITS SCHEMES

Provision of non-cash benefits after 5 April 2006
An anomalous situation is rectified

The introduction of the simplified pensions tax regime from 6 April 2006 allows employers to provide unlimited pensions and removes the need for employers to establish separate additional schemes to top up pensions. Therefore, from 6 April 2006 unapproved retirement benefits schemes [both funded (FURBS) and unfunded (UURBS)] will no longer be necessary unless the employer wishes to provide benefits of the sort that would not be permitted under a registered pension scheme. A FURBS or UURBS equivalent set up on or after 6 April 2006 will be an employer-financed retirement benefits scheme (EFRBS) provided it satisfies certain conditions.

Unlike under a FURBS, where if income and gains have been brought into charge to tax and the employee has been assessed to tax on the employer's contributions there would be no tax on emerging benefits, under an EFRBS benefit payments are taxed on the employee on receipt at which time the employer will obtain a deduction.

Pensions Tax Simplification Newsletter No 21 examines the position when a non-cash benefit is paid under an EFRBS. According to the Newsletter, before 6 April 2006 "if only non-cash benefits were provided no tax charge arose on retired individuals". This stemmed from the fact that before 6 April 2006 only if relevant benefits included cash benefits could those relevant benefits be taxed.

This distinction has been ended from 6 April 2006 by widening the definition of relevant benefits to include all benefits (cash or non-cash). This has therefore ended the anomalous situation that existed before 6 April 2006 whereby if a retired individual received cash benefits as well as non-cash benefits he would pay tax on his non-cash benefits, but if he only had non-cash benefits he would pay no tax. It also makes the rules on deductibility for the employer easier to apply from 6 April 2006.

PROPOSALS FOR NEW MONEY LAUNDERING REGULATIONS PUBLISHED FOR CONSULTATION

The Economic Secretary has published draft money laundering regulations for consultation. The regulations are designed to ensure that the UK response to money laundering at home and abroad is effective and proportionate. The public consultation is open until 2 April 2007 and the Government will implement the regulations by December 2007.

PENSIONS MISCELLANY

- After conducting a consultation on pension transfer values from final salary schemes (the consultation paper was issued on 27 June 2006), the Government has broadly decided to accept the current status quo.

- HMRC has written to representative bodies concerning consultation on the planned changes to ASPs and related measures set out in the 2006 Pre-Budget Report. There are four specific areas on which views are being sought:

  - the treatment of members who schemes are unable to trace by the time of their 75th birthday

  - anti-avoidance measures (ie to prevent other pension options being used as a route to pass on tax-favoured savings)

  - the start date of the ASP changes to the "transfer lump sum death benefit" rules and the guarantee facility

  - the interaction of the IHT and ASP charges

  Meetings with interested parties concerning the first two of the above areas were held on 19th and 23rd January.

- Following its announcement in the 2006 Pre-Budget Report that it intended to consult on practical changes to BCE 3 and dependants' scheme pensions, HMRC has issued a very short consultation paper on which comments are requested by 28 February 2007.

- In its Simplification Plan the Department for Work and Pensions has announced that it is working on a long-term project to consolidate primary legislation dealing with private pensions which is contained in five Acts of Parliament.

- The Government has set out its proposals for personal accounts in a recently issued White Paper.