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Published by Technical Connection Limited,
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REPORTING LIMITS FOR CHARGEABLE LIFETIME TRANSFERS

Reporting limits set to rise

It is understood that HMRC Inheritance Tax has recently stated that regulations will be laid before Parliament in October 2007 (so no change for this tax year) that will raise the reporting limit for chargeable lifetime transfers (CLTs) in tax year 2007/08 to £200,000 (with a possible increase to £250,000 over 10 years).

It is also understood that this limit will be a "gross" figure e.g. if a discounted gift trust is created with, say, £250,000 transferred to trustees with a discount of, say, £100,000 (which takes the CLT below £200,000) then a form IHT100 would be required as the "gross" transfer exceeds £200,000.

COMMENT

Of course we shall have to wait for official confirmation of this in writing and also the regulations to see the detail. This development though is not unexpected. A system whereby HMRC has to deal with reporting but collect no tax was always going to be reviewed. Until any changes are implemented it should be remembered that the limits above which a CLT has *to be reported are £10,000 in total in a tax year or £40,000 (including the current CLT) cumulatively over the preceding ten years. These limits will apply for all transfers made in 2006/07.*

REGISTERED PENSION SCHEMES - TAX RELIEF ON EMPLOYER CONTRIBUTIONS

The position following HMRC's recent update to the Business Income Manual

The revised pages of the Business Income Manual (BIM) regarding how HMRC will interpret the "wholly and exclusively" provisions with regard to tax relief on employer contributions have now been published.

While the revised BIM pages do provide further clarification in some areas (e.g. with regard to relief where multi-employer schemes are concerned) the position with regard to employer contributions made in respect of controlling directors and connected persons, and contributions paid by investment companies, is still far from clear with the subjective "wholly and exclusively test" still applying.

It is disappointing that after so long a wait there is still no certainty regarding how HMRC will treat employer contributions in respect of a controlling director/connected person. While the revised provisions indicate that any local Inspector who feels that an employer contribution made in respect of a controlling director does not meet the "wholly and exclusively" rules should refer the matter to HMRC in Nottingham there is no indication of how Nottingham may view such situations. It still appears that the position will only evolve as decisions are made in individual cases, which may then be taken to the Courts to resolve. Under the pre A-Day occupational scheme regime there was certainty over the level of contributions that could be paid, so this uncertainty under the new regime is much to be regretted, particularly as we are approaching 31 March, which is a common year end for companies.

When the last draft of the BIM pages was produced, the first indication was given of potentially different rules to apply to contributions made by investment companies. Information was promised on this shortly after the draft provisions had been issued. However, nothing was forthcoming. Although the newly issued BIM pages do refer to the position on tax relief on contributions by investment companies, unfortunately the links to the Corporation Tax Manual and to a further manual do not provide any guidance at all as these pages do not appear to be available. Once again this position needs to be resolved urgently.

KEY SOCIAL SECURITY BENEFIT RATES

The following benefit rates are effective from April 2007. All amounts shown are weekly benefits.

- The single person's State pension - £87.30 (£4,539 per annum)
- The additional State pension for a spouse - £52.30 (£2,719 per annum)

- Jobseeker's allowance age under 18 - £35.65
- Jobseeker's allowance age 18 to 24 - £46.85
- Jobseeker's allowance age 25 and over - £59.15
- Statutory maternity/paternity pay - standard rate - £112.75
- Statutory sick pay - standard rate - £72.55
- Bereavement payment (single lump sum) - £2,000 * and **
- Widow's pension / bereavement allowance (standard rate) (age 55 and over) - £87.30 **
- Age-related widow's pension/ age-related bereavement allowance age 54 - £81.19 - reducing to £26.19 at age 45 **
- Widowed parent's allowance - £87.30
- Child benefit for a couple - only, elder or eldest child - £18.10 *
- Child benefit - second and each subsequent child - £12.10 *
- Child dependency increase - e.g. with short-term incapacity benefit - £11.35 for each child, reduced to £9.00 for the first child if child benefit at the higher rate is being received for that child *
- Long-term incapacity benefit - £81.35 ***
- Short-term lower rate incapacity benefit under pension age - £61.35 *
- Short-term higher rate incapacity benefit under pension age - £72.55.

* *These benefits are tax free.*

** *Bereavement payment/bereavement allowance is available to a man or woman whose spouse dies on or after 9 April 2001.*

*** *Long-term incapacity benefit may be tax free if it replaced invalidity benefit.*

SUBSTITUTIONS AND CHARGEABLE EVENT GAINS - POSSIBLE DOUBLE CHARGE TO INCOME TAX

Change of life assured
Substitution of one policy for a new related policy
Calculation of the chargeable event gain on a subsequent full surrender
An effective double tax charge

HMRC has confirmed to us that an effective double charge to tax can arise on the termination of a non-qualifying life assurance policy that has been issued in substitution for an earlier non-qualifying policy.

The situation put to HMRC involved a single premium investment bond (a non-qualifying policy) under which there had been a change in life assured which is treated as being a fundamental reconstruction of the policy. When a fundamental reconstruction takes place the original policy is deemed to be fully surrendered and substituted by a new related policy on the date of the change.

Applying the general rules for calculating chargeable event gains in section 491 ITTOIA 2005 would produce the following result based on the assumptions made:

Oct 1998 Policy commenced for a premium of £200,000.

Oct 2004 Change of life assured when policy valued at £300,000.

Aug 2011 Policy fully surrendered for £450,000.

The gain on final surrender under section 491 ITTOIA 2005 would be:

	£
Surrender value	450,000
Add: surrender value of the original policy (a relevant capital payment)	300,000
	750,000
Less: total premiums paid [£200,000 plus £300,000]	500,000
Gain on final surrender	250,000

As can be seen, this calculation produces a final gain over the whole currency of the policy of £250,000, which is the true gain.

However, a deemed full surrender of £300,000 occurred in October 2004 which gave rise to a chargeable event gain of £100,000. To prevent this gain effectively being brought into charge to tax again on the final surrender, this gain of £100,000 would need to be deducted on final surrender but section 491 only permits the deduction of gains which have arisen **on previous part surrenders or partial assignments.**

If the two policies were not treated as related (ie there was no substitution) then a gain of £100,000 would arise in October 2004 and £150,000 in October 2011 which is an equitable result. Therefore, if the policy were to be actually fully surrendered and the proceeds reinvested in a new policy this result would follow and an overall chargeable event gain of £250,000 would arise. In doing an actual full surrender, though, on later final surrender the number of years for top-slicing relief would run from the date of the new policy whereas on a substitution the years would be counted from commencement of the original policy. But you would have a bigger premium base for 5% withdrawal purposes.

Under section 527 ITTOIA 2005 there is general relief whereby a chargeable event gain which is taxed under the chargeable event rules can be reduced by any amount which has suffered tax under some other piece of legislation. However, this section would not apply in the situation under consideration as only the chargeable event rules are relevant.

COMMENT

This adds greater force to the undesirability of changing a life (lives) assured under a non-qualifying life assurance policy. Special rules exist for qualifying policies to help deal with this problem.

THE PENSIONS BILL

The Pensions Bill sets the course for the future of state pension provision

The Pensions Bill was introduced in the House of Commons on 28 November 2006 and contains a number of measures to implement the proposals contained in the Government's White Paper on pensions reform "Security in Retirement: towards a new pensions system". The most important changes, in our view, are:

Category A state pension

For men and women reaching State Pension Age from 6 April 2010 onwards, the number of years required to qualify for a full basic state pension is to be set at 30 years. Note that this is a cut-off date and that there is no concessionary treatment proposed for those reaching State Pension Ages prior to 6 April 2010. Where individuals have paid unnecessary voluntary National Insurance contributions since 26 May 2006 they may be entitled to a refund.

Basic state pension increases

The Pensions Bill reintroduces the provision that the basic state pension is to be increased in line with earnings (the link with earnings was broken by the Margaret Thatcher government in 1980). There is no definite date set but there is provision for the link to be restored in 2012 or by the end of the next Parliament. When it happens it will also break the link between the lower earnings limit and the basic state pension.

State Pension Age

The State Pension Age is already increasing for women between 2010 and 2020 to equalise with men at age 65.

The Bill sets out that the State Pension Age will then increase to age 66 between April 2024 and April 2026, to 67 between April 2034 and April 2036 and to age 68 between April 2044 and April 2046.

Personal Accounts Delivery Authority

The Authority is to be set up and will undertake the necessary preliminary work for the implementation of the Personal Accounts scheme. It will be independent of Government and provide advice and recommendations to Government regarding operational and commercial matters. It will also be responsible for drawing up the commercial strategy for Personal Accounts.

INHERITANCE TAX PLANNING WITH PENSION SCHEME LUMP SUM DEATH BENEFITS

IHT and pension scheme lump sum death benefits
The payment of pension scheme lump sum death benefits to a discretionary trust
Fixing the ten-year anniversary date for the periodic charge
Benefits accrued under more than one scheme
Benefits transferred to another scheme

Lump sum death benefit payments from registered occupational or personal pension schemes (including retirement annuities subject to trust) are, generally speaking, free of inheritance tax as long as they are made within two years of death and the deceased has not exceeded his Lifetime Allowance. In this respect, it should be noted that an amendment is to be included in the Finance Bill 2007 in respect of any payment of a lump sum death benefit on or after 6 April 2006. In such cases the lump sum death benefit must be paid within two years of the scheme being notified of the member's death but, if the scheme trustees/scheme administrator could have been reasonably aware of the member's death at an earlier date, the two year period will start from that earlier date.

Clearly then, in most cases, payments from occupational and personal pension schemes will be made free of inheritance tax. However, once the often substantial funds have been paid out from the scheme to the beneficiaries, the funds will then have left an "inheritance tax protected" environment and, as a result, may well at some future time become subject to IHT. If the beneficiary is the surviving spouse, the estate of that surviving spouse will be correspondingly increased for inheritance tax purposes. This will mean that on death of that spouse, 40% of any unspent benefits could be eaten away in inheritance tax.

The spousal by-pass trust, as it is commonly known, offers a solution to this problem. For maximum flexibility the pension scheme member could establish the spousal by-pass trust as a fully discretionary trust for a nominal amount, say £10, having satisfied himself that the scheme trustees/scheme administrator have the power to pay benefits to another trust.

On the member's subsequent death, the payment of the death benefit to the discretionary spousal by-pass trust will be an additional payment to the trust. Provided it is made within the permitted two year period, as amended by Finance Bill 2007, there would be no immediate IHT implications.

As the trust is a discretionary trust then for IHT purposes it will be taxed under the relevant property regime. This means that there may be potential IHT charges

- on every ten-year anniversary of the trust - the “Periodic Charge”, or

- whenever property leaves the trust (eg. when capital is advanced to a beneficiary) - the “Exit Charge”.

In fixing the ten-year anniversary, the deceased member is the settlor of the benefits which are held on the discretionary trusts of the pension scheme. On the member’s death, when the death benefits are appointed to the recipient discretionary trust (ie. the spousal by-pass trust), section 81 Inheritance Tax Act 1984 comes into play. Under this section, the ten-year anniversary date for the recipient discretionary trust will run from the date the member joined the pension scheme and established the initial discretionary trust. This is on the basis that if property in one discretionary settlement becomes comprised in another discretionary settlement, the property is treated as remaining in the first settlement.

Two questions recently arose on the application of section 81.

(i) Where an individual has accrued benefits under, say, 3 separate occupational schemes with the death benefits under each of those schemes payable to the same discretionary by-pass trust, how is section 81 applied? HMRC Inheritance Tax (formerly HMRC Capital Taxes Office) has confirmed to us that the property derived from each scheme would, in effect, need to be treated as a separate settlement, each with a separate ten-year anniversary date fixed by reference to the date the member joined each scheme. Therefore, the trust assets will need to be apportioned to each scheme for valuation purposes in order to determine any periodic or exit charges.

(ii) How is section 81 applied where an individual is a member of an occupational scheme, having transferred the benefits from a previous occupational scheme to that scheme? Here HMRC advocates a pragmatic approach. If there are no funds in the recipient pension scheme at the time of transfer HMRC’s view is that there is only one settlement. On the other hand, if the recipient fund did have funds in it at the time of transfer there would be two separate settlements and the trust assets would need to be apportioned as under (i) above.

It would appear that the apportionment of value between the two settlements is to be made based on the amount of contributions paid to each scheme.

COMMENT

Spousal by-pass trusts are becoming an increasingly popular form of IHT planning with lump sum death benefits. It is, however, important to be conversant with the rules for calculating inheritance tax on a periodic or exit charge so that correct tax returns can be made.

PENSIONS MISCELLANY

- HMRC has issued the final draft version of the Pension Scheme Return together with the completion notes. Also available are links to the final draft versions of the Pension Scheme Tax Registration forms and Event Report forms.

- The Pensions Regulator has now issued guidance for trustees and managers of all occupational schemes which is designed to complement, and be read in conjunction with, the Code of Practice on Internal Controls.

The guidance is designed to be of special interest to trustees of smaller and fully insured occupational schemes.

The guidance is suggesting that the following approach should be followed in the scheme risk-management process:

- Set objectives (ie. to identify the activities that the trustees believe are fundamental to the good running of the scheme and decide what is the desired outcome for each activity).

- Identify risks (and record the identified risks to which the scheme is exposed by means of a listing known as a risk register).

- Determine the categories of risk and the levels of risk that the trustees consider to be acceptable to the scheme in light of the desired outcomes set out earlier in the process.

- Assess each risk on the risk register and categorise it depending on its impact and likelihood of occurring.

- Produce an action plan (ie. set out the responsibilities and timescales for implementing the required controls).

- Implement the action plan (ie. ensure that those people accountable for activities in the action plan carry out the plan in accordance with the agreed timescales).

- Monitor and review. Although by now the scheme will have agreed internal controls in place to mitigate its main risks, this stage is designed to monitor the effectiveness of the controls and to make changes to them if they prove inadequate or new risks arise.

COMMENT

While the new guidance is very good, many trustees of smaller occupational schemes (and insured arrangements) may find it very daunting to have to meet the internal control requirements.

BUDGET 2007

The Budget 2007 speech has been scheduled for 12:30pm on Wednesday 21 March. If you would like to receive details of our Budget services, please give us a call on 020 7405 1600 or email us at host@technicalconnection.co.uk