Technical Connection

CONTENTS

- **ABSOLUTE TRUST CLARIFICATION**
- **PENSIONS AFTER THE FINANCE BILL 2007**
- **THE DISCLOSURE OF TAX AVOIDANCE SCHEMES**
- **PRE-OWNED ASSETS TAX – CHANGE TO THE OFFICIAL RATE OF INTEREST**
- **UNDECLARED INTEREST ON OFFSHORE BANK ACCOUNTS**
- **NIL RATE BAND DISCRETIONARY WILL TRUSTS**

Published by Technical Connection Ltd,
7 Staple Inn, London, WC1V 7QH.
Tel: 020 7405 1600 Fax: 020 7405 1601
E-mail: host@technicalconnection.co.uk
www.techlink.co.uk

ABSOLUTE TRUST CLARIFICATION

Absolute trust for a minor not a settlement for IHT purposes

HMRC Inheritance Tax has confirmed, after taking legal advice, its view that an absolute (bare) trust for a minor will not be treated as a settlement for inheritance tax (IHT) purposes.

This means that the use of an absolute trust for minors can be continued in the knowledge that transfers to such a trust will be treated as PETs and that the trust will not be subject to the IHT relevant property regime with the attendant potential entry, exit and ten-year periodic charges.

PENSIONS AFTER THE FINANCE BILL 2007

The Pre-Budget Report 2006 (PBR) heralded changes in the treatment of Alternatively Secured Pensions (ASP), dropped the pension term assurance bombshell and proposed a number of technical changes to improve the working of the new simplified pension tax regime. Further details of these changes have been set out in the papers accompanying the 2007 Budget, and the Finance Bill 2007.

1. Alternatively secured pensions (ASPs)

A number of changes will be made to the ASP rules with effect from 6 April 2007.

Minimum and maximum amounts of income

With effect from the first "ASP year" starting on or after 6 April 2007, a member (or dependant taking dependant's ASP) must take a minimum income of at least 55% of the "basis amount" (i.e. the annuity based on GAD rates for an individual aged 75) in each ASP year. The maximum income is 90% of the "basis amount" (as defined earlier).

Treatment of lump sum death benefit

Under the existing rules where a member (or dependant) taking ASP dies without leaving a dependant it is possible for the deceased member's (or dependant's) ASP fund to be paid as a "Transfer Lump Sum Death Benefit" to enhance the benefits of another scheme member. With effect from 6 April 2007 this will no longer be an authorised lump sum payment. Instead it will be subject to unauthorised payments charges of up to 70% where the deceased member's or deceased dependant's residual ASP fund is transferred to the pension fund of another member(s) of the scheme. Rights payable in these circumstances will be renamed as "alternatively secured rights". These provisions will not apply where the member died on or before 5 April 2007.

It will be the recipient of the "alternatively secured rights" who will have to find up to 55% of the value of these rights from their own resources to meet the unauthorised payments charge and unauthorised payments surcharge. Presumably, the scheme administrator will deduct the remaining 15% from the "alternatively secured rights" to meet the scheme sanction charge.

The only authorised payments in respect of the residual ASP fund will be where it is paid either:

- to provide dependant's benefits
- as a "charity lump sum death benefit", or
- in limited circumstances is repaid to a non-connected employer

Changes are made by the Finance Bill 2007 to sections 151A to 151C of the IHT Act 1984 so that for deaths occurring on or after 6 April 2007, IHT will be calculated on the basis that the IHT nil rate band will be set in priority against the estate of the deceased member excluding ASP funds. Further amendments are made in the Finance Bill 2007 to introduce a special calculation for cases where there is an amount of nil rate band available to offset against the value of the ASP funds.

Charity lump sum death benefit

The Finance Bill 2007 amends the legislation concerning who can nominate where a charity lump sum death benefit is paid, giving greater power to the scheme administrator. The Bill enables a scheme administrator to select a charity to which a charity lump sum death benefit may be paid, in the absence of a member nomination (in respect of the member's ASP funds) or in the absence of a member or dependant nomination (in the case of lump sums paid to a charity out of a dependant's ASP fund).

2. Pension term assurance (PTA)

Individuals will no longer have the right to pensions tax relief on personal contributions to new personal life insurance policies under both personal and occupational schemes. Such contributions will no longer be regarded as "relievable pension contributions" as defined in section 188(2) of the Finance Act 2004. These are defined as "life assurance premium contributions" paid as premiums under a "non-group life policy".

(a) PTA under an occupational scheme

Relief will not be available on personal contributions to such PTA policies under occupational schemes where these are paid on or after 1 August 2007.

However, where a PTA policy was applied for on or before 20 March 2007 but was not issued by that date, it will continue to benefit from tax reliefs on and after 1 August 2007 provided the following conditions are met:

- the application for the PTA must have been fully completed on or before 20 March 2007 and submitted to the insurance company and receipt recorded by that insurance company by midnight on 28 March 2007

- the "sum assured" issued is no greater than that applied for on or before 20 March 2007

- the insurer must process the business by no later than 31 July 2007.

(b) PTA under a registered scheme (other than an occupational scheme)

Relief will not be available on personal contributions to PTA policies under registered schemes, which are not occupational schemes falling within the above definition, where these are paid on or after 6 April 2007.

However, where a PTA policy was applied for on or before 6 December 2006 but was not issued by that date, it will continue to benefit from tax relief on and after 6 April 2007 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

- 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 31 July 2007.

(c) PTA applications to a personal pension scheme received after 13 December 2006

Where a PTA has been sold as part of a personal pension scheme (and the insured individual is also obliged by the terms of the pension scheme to have pension benefits under that scheme), the PTA will continue to benefit from tax relief on or after 6 April 2007 provided the following conditions are met:

- the application has been fully completed and submitted to the insurer and receipt recorded by that insurer before midnight on 12 April 2007

- the "sum assured" under the policy is no greater and the term no longer than that applied for on or before 12 April 2007

- the insurer must process the business by no later than 31 July 2007.

3. Scheme pensions

Having closed the door on the ability to pass on ASP funds to younger generations the Government has issued a consultation paper "Tax relief for pensions: Inheriting tax-relieved pension savings", which considers how to stop scheme pensions and annuities being used as a means to pass on tax-relieved pension savings. The Government intends to introduce the proposed measures as soon as possible. These will impose similar tax and IHT charges on scheme pensions and annuities in payment that enable remaining pension funds to be passed onto a person(s) connected with the deceased member (other than where the funds are used to provide authorised dependants' benefits).

4. Untraceable members at age 75

New provisions have been included in the Finance Bill 2007 in respect of those scheme members who cannot be traced by their scheme provider by age 75. These will apply where the scheme has taken reasonable steps to trace the member but has been unable to do so and none of the benefits under the arrangement are member designated funds (ie. income withdrawal benefits already in payment). Rather than, as at present, having their benefits placed in ASP by default the benefits of these untraceable members will be held in suspense and not become ASP funds. As such there will be no requirement to provide a minimum income in these cases.

Where schemes are currently holding members' funds in ASP as they could not be traced by the time they reached age 75, they will from 6 April 2007 cease to be so held and will instead be held under the separate provisions (ie. in suspense) for untraced members. The Finance Bill 2007 also provides that such monies will be treated as if they have not been held under the ASP provisions at all (ie. for the period up to 6 April 2007) but instead have effectively been held in suspense.

5. Investment regulated pension schemes and REITS

If an investment-regulated pension scheme is to avoid having its investment in a UK-REIT, on or after 1 January 2007, treated as creating an indirect holding in any taxable property held by the UK-REIT, it together with any associated persons must restrict the holding to less than 10% of the UK-REIT. The appropriate legislation to implement is included in the Finance Bill 2007.

6. Transitional protection from the lifetime allowance charge

Provisions are included in the Finance Bill 2007 to safeguard a member's transitional rights to an enhanced lifetime allowance where individuals make partial transfers, 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.

7. Ill-health pensions

An amendment is included in the Finance Bill 2007 to allow scheme pensions paid early on ill-health grounds to be reduced at the discretion of the scheme administrator. Previously the legislation had permitted an ill-health pension to be stopped (but not reduced) if a member's health recovers.

8. Pension commencement lump sum (PCLS)

An amendment is included in the Finance Bill 2007 to permit a PCLS to be paid within 12 months of a member becoming entitled to a scheme pension, lifetime annuity or income withdrawals under an unsecured pension. The PCLS can also be paid where part of the 12 month period falls after the member's 75th birthday. This change will apply retrospectively to 6 April 2006.

9. Review of income withdrawal - unsecured pension

Provision is included in the Finance Bill 2007 for more frequent reviews of the annual maximum allowable income withdrawal than the current 5 yearly basis. Such reviews may in future be undertaken at the end of each unsecured pension year, but only at the direction of the member/dependant and subject to the scheme administrator's agreement. The requirement that the maximum withdrawal needs to be reviewed at least every 5 years will remain. This change will apply to notifications given on or after 6 December 2006.

10. Two year time limit – payment of lump sum death benefit

An amendment is included in the Finance Bill 2007 in respect of any payment of a lump sum death benefit on or after 6 April 2008 in respect of a member who died on or after 6 April 2006. In such cases the lump sum death benefits must 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 the 2 year period will start from that earlier date.

THE DISCLOSURE OF TAX AVOIDANCE SCHEMES

Disclosure regime extended to cover National Insurance contributions from 1 May 2007

Legislation on the disclosure of tax avoidance schemes has generally been effective since 1 August 2004 for income tax, capital gains tax, corporation tax and VAT purposes. The regime was extended in 2005 to include stamp duty land tax, and is now extended to include National Insurance contributions from 1 May 2007.

PRE-OWNED ASSETS TAX - CHANGE TO THE OFFICIAL RATE OF INTEREST

Increase in the official rate of interest to 6.25% from 6 April 2007
Maximum value of assets necessary to avoid a POAT charge reduces

The pre-owned assets tax (POAT) rules can apply an income tax charge on a donor when he makes a disposal of land, chattels or intangibles for less than full consideration (or makes a contribution to the purchase of land or chattels) and enjoys (or can enjoy in the case of intangibles) a free benefit from that asset. For the POAT rules to apply there must be no gift with reservation for inheritance tax purposes.

There will only be a tax charge where the value of the benefits in a tax year for any one individual exceeds £5,000 (the de minimis amount) but where the value does exceed this amount, the whole amount of the benefit is subject to income tax not just the excess.

In the case of land the chargeable amount of the benefit is based on the rental value. To obtain the chargeable amount for chattels and intangibles (such as a life assurance policy) it is necessary to apply a deemed rate of return to the value of the asset in question. The deemed rate of return is prescribed as being HMRC's official rate of interest which is fixed for the whole tax year unless there are significant changes in interest rates in that year in which case it may be changed. For tax year 2006/07 the official rate of interest was 5%. From 6 April 2007 the official rate of interest is increased to 6.25%.

If the total of chargeable amounts for one individual does not exceed £5,000 in a tax year the POAT charge will not apply - see above. For tax year 2006/07 this meant that if the value of an intangible, such as a life assurance policy, did not exceed £100,000 no income tax was due. For tax year 2007/08, with the increase in the official rate of interest to 6.25%, it will mean that the value of an intangible must not exceed £80,000 if a POAT charge is to be avoided. For example, if a life assurance policy in a trust fund is subject to the POAT charge then it is valued on 6 April each year to calculate the chargeable amount. From 6 April 2007, when the value of the policy exceeds £80,000 the settlor will be subject to the charge at 6.25% on the full value of the asset as its value will exceed the de minimis amount which is £80,000 x 6.25% = £5,000.

UNDECLARED INTEREST ON OFFSHORE BANK ACCOUNTS

"Partial amnesty" for tax evaders who have not declared interest earned on offshore accounts
HMRC publishes arrangements for a "partial amnesty"

The ongoing investigation by HMRC into undeclared interest on offshore bank accounts has taken a new turn. HMRC has published details of an offer to offshore account holders that many regard as a "partial amnesty" although it is officially termed the "Offshore Disclosure Facility".

Investors with undisclosed interest-bearing offshore accounts will be given incentives to come forward. The main incentive is a promise by HMRC that the penalty charged on undisclosed tax will be limited to 10 per cent of the amount due, instead of a maximum of 100 per cent. But investors will be expected to make full payment of all unpaid taxes over the past 20 years, together with interest. There will be no penalty on disclosures of untaxed amounts totalling less than £2,500. It is important to note that to take advantage of the offer a **full disclosure of all undeclared liabilities,** not just those connected with an offshore account, will need to be made.

The offer is only open for a short period, with payments due by 27 November 2007 and with an earlier declaration of intent to make a disclosure required by HMRC by 22 June 2007. A final decision from HMRC on whether or not a disclosure has been accepted will be made by 30 April 2008. The offer is accompanied by a warning of much harsher treatment if individuals fail to come forward voluntarily. Penalties will then be at least 30 per cent and could be significantly higher.

Some advisers warn that individuals with complex affairs would get more legal protection if they made a disclosure outside the scheme. Apparently the terms of the disclosure initiative are only a little more generous than the deal that can normally be negotiated by an individual who has come forward voluntarily to disclose unpaid tax. Furthermore, it does not promise immunity from prosecution and lawyers warn that taxpayers vulnerable to prosecution may have less protection under this initiative than they would if they came forward under the normal rules.

COMMENT

This is a development that all financial advisers should be aware of and make their clients aware of.

For those who wish to legitimately hold offshore deposits without the need to pay tax or declare income, an offshore capital investment bond would offer a tax effective solution. The bond offers the prospect of tax deferment with the potential for future (legitimate) avoidance or at least reduction of tax. The capability to so avoid or reduce tax when accessing funds will, of course, depend on the personal circumstances of the investor. It may be that the investor can encash in a year of low or no other taxable income.

NIL RATE BAND DISCRETIONARY WILL TRUSTS

Phizackerley -v- Special Commissioners
Care needed on deductibility when loans from nil rate band discretionary Will trusts made

One of the most effective forms of inheritance tax planning for a husband and wife or couple in a registered civil partnership, who wish to keep control of their assets during their lifetime, is to establish nil rate band discretionary trusts in their Wills. Such a trust will come into effect on the death of the first of the couple to die and will mean that

- the deceased can use his/her nil rate band on the first death which will save inheritance tax because the assets are then not part of the taxable estate of the survivor

- the deceased's widow/widower will have potential access to the assets in the discretionary Will trust by virtue of him/her being a beneficiary under the trust.

This type of planning has been used successfully in the past by many couples and, where investments are held in the trust, the IHT benefits can be enhanced by paying any amounts out of the trust to the surviving spouse in the form of interest-free (or interest-bearing) loans repayable on demand. Provided the surviving spouse spends the money his/her taxable estate will not increase but on his/her death the loan would be repayable to the trust which would mean that the deceased's estate would be reduced and so any resulting IHT liability would also reduce.

The reduction in the surviving spouse's taxable estate available is subject to a caveat. By virtue of section 103 Finance Act 1986, if property is transferred by a person ("A") to the deceased (whilst alive) ("B") and, at a later date, this property (or property derived from it) is lent back to A, that loan is not deductible for IHT purposes on A's subsequent death.

Section 103 was the subject of the recent Special Commissioner's decision in the Phizackerley case. Dr and Mrs Phizackerley bought a house in 1992. Although the house was in joint names (owned on a joint tenancy basis) Dr Phizackerley (as the only one of the couple working) provided all the funds. In 1996, Dr and Mrs Phizackerley severed the joint tenancy so they both owned the property as tenants in common. Mrs Phizackerley died in 2000 leaving a nil rate band legacy to discretionary trusts with the balance absolutely to her husband.

At the date of her death, the assets in her estate fell fully within her available nil rate band. Part of this property was her half interest in the family home worth £150,000. Following her death her husband agreed to purchase the deceased's interest in the property from the discretionary Will trust trustees for £150,000 index-linked. The property was transferred into his name and he gave the trustees an IOU for the purchase price.

On his subsequent death, it was argued that the outstanding debt of £156,013 (£150,000 before indexation) due to the discretionary Will trust should be deductible from his taxable estate. However, HMRC raised the issue of section 103 Finance Act 1986 which precludes the deduction of a debt that was made out of property derived from the deceased – see above. It should be noted that the meaning of "derived from the deceased" in this context is extremely wide. In this particular case because Dr Phizackerley had previously made a gift of the property to his wife out of which the debt arose, that debt was not fully deductible and needed to be reduced to the extent it arose from that disposition.

Counsel on behalf of the taxpayer, (Dr Phizackerley's daughter), raised the argument that there was no transfer of value (which is necessary for section 103 to apply) because the original gift from Dr Phizackerley to his wife was covered by section 11 IHT Act 1984 – dispositions for the maintenance of the family – because the house "provided a roof over his wife's head". However, the Special Commissioner rejected this argument on the basis that this exemption did not apply and dismissed the appeal.

COMMENT

This case demonstrates that one has to be extremely careful when advising clients, who are surviving spouses, to take an interest free-loan from the trustees of a Will trust established on the death of the first spouse to die in order to create a debt on that surviving spouse's taxable estate. In cases where the borrowing spouse had made lifetime gifts to the now deceased spouse, depending on the facts that debt may not be allowed as a deduction.

Concern has been raised that the outcome of this case could impact on the IHT advantages of debt, charge or IOU schemes using a discretionary Will trust of the family home.

It will be appreciated that the Phizackerley case was decided on its own unusual facts and there are unlikely to be many cases like this. Most couples will have bought their homes in joint names some years ago and this would have involved a joint financial contribution from them each at different times and so should not be affected.

It is, we think, worth bearing in mind the HMRC quote on the matter as reported in the Telegraph that "The decision was on the basis of the ***individual facts of the case****. The Special Commissioners found that the* ***particular circumstances*** *fell foul of long-standing anti-avoidance provisions in the IHT regime" (our emphasis).*