Technical CONNECTION

CONTENTS

- CAPITAL GAINS TAX AND CHARGEABLE EVENTS
- PERSONAL ACCOUNTS
- BUY-TO-LET CLAMPDOWN
- DEDUCTIBILITY OF PREMIUMS TO A LIFE POLICY
- DEEDS OF VARIATION
- TAX AVOIDANCE
- INHERITANCE TAX

This document is strictly for general consideration only. Consequently Technical Connection Ltd cannot accept responsibility for any loss occasioned as a result of any action taken or refrained from as a result of the information contained in it. Each case must be considered on its own facts after full discussion with the client's professional advisers.

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

CAPITAL GAINS TAX AND CHARGEABLE EVENTS

Capital gains and chargeable event gains and losses arising in the same tax year
The amount of chargeable event gains and losses taken into account in the capital gains tax computation

Broadly speaking, in determining the amount of tax payable on chargeable capital gains arising to an individual in a tax year, the capital gains are treated as "sitting on top" of income subject to income tax. In turn, a chargeable event gain is treated as forming the most highly taxed part of the taxable income that capital gains sit on. For the purpose of calculating the liability to capital gains tax, only the top-sliced chargeable event gain is treated as forming part of income – section 6(3) Taxation of Chargeable Gains Act 1992.

In contrast, when computing the amount of a person's total income for age allowance purposes it is the whole chargeable event gain that is taken into account, not the top-sliced gain.

When a terminal loss (deficiency) arises under a life policy it can reduce the policyholder's total income for higher rate tax purposes to the extent that previous chargeable event gains have arisen under the policy to that policyholder – sections 539 and 541 ITTOIA 2005. In computing the tax on a chargeable capital gain, the

amount that can be deducted from taxable income is the deficiency restricted to previous chargeable event gains – section 6(2) Taxation of Chargeable Gains Act 1992.

PERSONAL ACCOUNTS

The Government has issued its response to the Personal Accounts White Paper

The Government has now set out its response to the White Paper on Personal Accounts. Overall the response is disappointing with much detail still left to be determined by the Delivery Authority or the scheme trustees. There are, however, a number of changes that should be noted.

Maximum annual limit on contributions

This had been set at £5,000 in the White Paper, while the Government's response indicates this will be £3,600 in 2005 terms with this figure being increased in line with earnings inflation up to the start date of Personal Accounts (ie. expected to be 2012).

While many commentators have indicated that this is a significant victory for those bodies/persons who had petitioned the Government to reduce the maximum allowable contribution in order to protect existing high quality pension schemes, in practice there is likely to be little difference in the maximum level. For example, £3,600 increased in line with earnings inflation from 2005 to date, and by an assumed increased of 4% pa up to 2012, would give a maximum of just over £4,700. This is not far short of the original £5,000 proposed in the White Paper.

Special lump sum contributions

While the Government still wish to consult further on whether to permit a one-off increase in the annual maximum contribution limit in the first year of the scheme's existence (proposed to be £10,000 in the White Paper), the idea has been floated of scheme members being able to pay lump sum contributions subject to a lifetime limit. This is to be considered by the Delivery Authority.

Review of maximum contribution level and ban on transfers

The review of the maximum annual contribution level, and whether transfers from other schemes to or from Personal Accounts will continue to be banned, will be brought forward from 2020 to 2017.

Exempt schemes and waiting period

While eligible employees who are not members of a suitable employer's scheme will be enrolled automatically in a Personal Account, the Government has agreed that this will not apply to members of schemes providing significantly higher contributions/ benefits. In these latter cases a scheme will be able to operate a waiting period of up to three months before

entry to their scheme, without the employees concerned having to be automatically enrolled in a Personal Account in the meantime.

Although the definition of "significantly higher contributions/benefits" is still to be finalised, the Government has indicated that it is considering "that members should be able to accrue a pension of equal or better value to Personal Accounts within the first year of saving". If applied, this is likely to be a very tough test for schemes to meet (ie. the equivalent of 12 months accrual in a 9 month period).

Benefit provision

In the 2007 Budget, Gordon Brown substantially increased the Upper Earnings Limit to apply on or after 6 April 2007. A member's benefits under the Personal Account is to be based on contributions on earnings between the Primary Threshold and the Upper Earnings Limit. As the Government does not wish the contributions to the Personal Account to be based on the substantially increased Upper Earnings Limit that will apply from tax year 2008/09 (as this would increase employer costs substantially), these will be based on earnings between the 2006/07 Primary Threshold (£5,035) and 2006/07 Upper Earnings Limit (£33,540), increased in line with average earnings each year up to the tax year in which contributions are paid. Such earnings will be referred to as the Personal Account Earnings Band.

Phasing in of compulsory employee contributions

The Government has amended the required reduced levels of employee contributions in the first 3 years of the scheme as follows:

	White Paper	Response to White Paper
Year 1	1.33%	1%
Year 2	2.66%	3%
Year 3	4%	5%

In each case the contribution is based on the member's "Personal Account Earnings Band" (see Benefit provision above). However, while the figures in the White Paper appeared not to be inclusive of tax relief, those in the Government's response appear to include basic rate tax relief at 20%.

The phased in reduced rates of employer contributions remain the same as in the White Paper at 1% (year 1), 2% (year 2) and 3% (year 3).

COMMENT

It is disappointing that there are still so many aspects to be clarified.

BUY-TO-LET CLAMPDOWN

HMRC denies it is organising a clampdown on buy-to-let property owners

An article in the Times of 29 May suggested HMRC was organising a clampdown on those taxpayers who had either not paid enough tax or had claimed too much relief.

In response to this claim, HMRC issued a statement in early June which read:

"By way of background, HMRC is not planning a tax crackdown in the way implied by the Times article. HMRC is planning to take a concerted approach to helping landlords of all descriptions (not just in the buy to let market) to understand and comply with their tax obligations in what they recognise to be a complex area. In taking this approach the explicit presumption will be that the majority of landlords want to make a correct return but that many may need some help to understand exactly how to do so. The approach, which was outlined to agent representatives in a recent workshop, will focus on giving landlords improved access to guidance and support so that they can understand how to calculate their own tax liabilities and, where there is tax to pay, using the lightest possible touch to ensure that the correct amount is paid."

COMMENT

HMRC is attempting to get taxpayers to understand their tax liabilities and voluntarily pay-up. The truth is that like a lot of public sector organisations they don't have the manpower to police every single member of the public (taxpayers) and so rely on voluntary disclosures in the main. However, when it comes to buy-to-let it is possible for HMRC to do a trawl through land registry records to see who owns what!

DEDUCTIBILITY OF PREMIUMS TO A LIFE POLICY

Business loan protection
Premiums paid by a company
Deductibility of the premiums for a company

When a lender requires a corporate borrower to protect a business loan with a suitable life assurance policy the company would usually propose for a policy on the life of an employee or shareholder. Under general principles, one requirement for deductibility of premiums under a company-owned policy for corporation tax purposes is that the policy is not taken for a capital purpose. A policy to secure repayment of a loan is taken for a capital purpose so premiums would not be deductible.

From this it would follow that any policy proceeds are a receipt on capital account and should therefore not be regarded as income (although it is prudent to confirm this with the local

Inspector in advance). As capital gains tax does not generally apply to life assurance policies the proceeds are effectively received free of tax.

In its Tax Bulletin of February 1992, at page 13, the Inland Revenue stated "Costs incidental to the taking out of a life insurance policy as a condition of obtaining the loan finance are deductible, but not premiums on such a policy". Such incidental costs, defined in section 58(2) of ITTOI Act 2005, include fees, commission and advertising but not premiums. This practice has been restated in HMRC Business Tax Manual BIM 45815

COMMENT

The Local Inspector could be asked for his view of the tax treatment of premiums in the circumstances of a particular case. If relief is declined, it makes sense to then confirm that any policy proceeds will be treated as a capital receipt.

DEEDS OF VARIATION

The benefits of a variation
The need for investment advice
Capital gains tax planning

Deeds of variation have been in the news again recently because of the revelation that a Cabinet Minister used a deed of variation to save inheritance tax on the house he inherited. There is, of course, nothing wrong with this because this is a permitted strategy under the inheritance tax (IHT) rules but the publicity attaching to the planning has given rise to fears that this area may once again come under the Government's microscope. This is particularly so as it was an area of planning highlighted as tax avoidance by the Government before they came to power 10 years ago. It therefore makes sense to make use of deeds of variation whilst they are available and trusts can often play a vital role here. However, what's often overlooked is the need for specialist investment advice on trust investments to avoid significant tax charges.

The benefits of a variation

The essence of a deed of variation is that it enables a beneficiary to, within 2 years of the deceased's death, vary the provisions of the deceased's Will (or the laws of intestacy), at least in respect of the inheritance received by that beneficiary. Typically, it would mean that if the surviving spouse inherited all the deceased's estate, on (say) her husband's death, she could vary the deceased's Will in order to use part or all of his nil rate band – currently £300,000. Clearly any assets redirected to children via the deceased's nil rate band would not suffer IHT whereas they would if they passed via the estate of the deceased's surviving spouse. This could mean an eventual IHT saving of 40% of the value of those assets.

However, this inter-spouse planning is not the only reason for using a deed of variation. For example, a deed of variation can save IHT in cases:

- where the assets have increased in value substantially since the deceased's death;

- where the assets suffered IHT on death because, say, they passed to children and some of this IHT could be clawed back by a redirection in favour of the deceased's surviving spouse; or

- where the deceased was non-UK domiciled for IHT purposes on death so that an excluded property trust could be established via his Will on death.

Anyway, turning back to the typical husband and wife situation, one of the issues involved in redirecting assets to, say, a child is that the surviving spouse will then lose access to the income and capital from those assets. This objection can be overcome by using a discretionary trust under which the surviving spouse is a potential beneficiary. Although one may, at first glance, feel that this gives rise to a gift with reservation by the spouse who is creating the trust because he/she is also a beneficiary under the trust, this will not be the case because, for inheritance tax purposes, it is the deceased who is treated as creating the trust. Of course, the pre-owned asset tax (POAT) rules operate under income tax principles, and here the surviving spouse will have been treated as establishing the trust. Fortunately, the POAT rules in Schedule 15 Finance Act 2004 provide an exemption in cases where the trust is created by the variation of a deceased's estate.

The need for investment advice

Notwithstanding the above, the surviving spouse has definitely created the trust for the proposes of the settlement rules generally and this means that because he/she is a potential beneficiary, any income or capital gains of the trust will be taxed on that surviving spouse because this would be a settlor-interested trust. In particular, this means that the trust will not have an annual capital gains tax (CGT) exemption available.

All of this needs to be taken into account when consideration is being given to the investments that should be held in the trust.

For example, if the surviving spouse has a part or all of the annual CGT exemption (of £9,200) available, the trustees could invest in capital growth oriented investments and make encashments from time to time with a view to realising cash that can be used to advance capital to the surviving spouse. Capital gains may well fall within the spouse's annual exemption but, of course, any income generated would be taxed on the spouse.

If, on the other hand, the spouse was likely to be using his or her annual CGT exemption elsewhere and/or didn't want trust income assessed on him/her, the trustees could consider an investment into a single premium investment bond. The benefits of this would be:

- the bond is a non-income producing investment so no income arises that will be assessed on the spouse;

- switches between different investment funds can be made without tax at that time;

- the 5% tax-deferred allowance offers an attractive way for the trustees to realise cash that can be used to advance capital to the spouse; and

- when it is desired to encash the bond – say after the spouse's death – the bond can first be assigned out of the trust to an adult beneficiary (without a chargeable event arising) and that beneficiary can later encash. This may well give rise to a lower tax

charge on the encashment of the bond than would arise if the trustees made the encashment.

Using loans

Where the trust gives the trustees power to make payments to the surviving spouse out of the trust, it may be worth them considering making these payments by way of interest-free loans. On the basis that the loan is spent by the spouse as income, this can yield inheritance tax advantages on the surviving spouse's subsequent death on the basis that those loans will be deductible debts against his/her taxable estate. However, there will be no deduction to the extent that the surviving spouse made gifts to the deceased during their joint lifetime because the loan will be treated as a return of his/her own money under section 103 Finance Act 1986. This was the basis of the recent Phizacklerley court decision and, although this case concerned the gift of a residential property, it needs to be borne in mind when planning is being considered with loans.

Capital gains tax (CGT) planning

There may be some CGT planning that can be carried out in connection with a deed of variation where the assets to be redirected have increased in value since death. In those circumstances, any redirection of the asset will give rise to a disposal for CGT purposes with the capital gain since the date of death being taxed on the beneficiary(ies) making the transfer (where the estate has been fully administered) and being assessed on the legal personal representatives (if the estate is still in the process of being administered). In these cases the disposal may be a useful way for the beneficiary or legal personal representatives (as appropriate) to utilise their annual CGT exemption. However, if the size of the gains would cause a liability it may be worth the parties making a statement in the deed of variation to the effect that the asset passes to the new beneficiary (i.e. the discretionary trust) on a no gain/no loss basis.

Finally, the issues involved in deed of variation planning may vary depending upon the type of assets involved. For example, if it is an interest in a private residence that is being transferred into a Will trust different considerations will apply. In particular, it is important to avoid the surviving spouse being treated as retaining an interest in possession in the part of the house gifted to the trust.

COMMENT

Deeds of variation continue to offer a whole host of planning opportunities for the tax adviser and financial adviser – not least the need for investment advice for any trusts that are created.

TAX AVOIDANCE

The Jones v Garnett (Arctic Systems) appeal to the House of Lords heard

Jones v Garnett (or the Arctic Systems case) was heard in the Court of Appeal nearly eighteen months ago. Almost 3 years since its original Special Commissioners hearing, HMRC's appeal to the House of Lords was heard from the 5th to the 7th of June. It has been strongly rumoured that the judgement will be handed down within the 6 to 8 week period following the hearing.

INHERITANCE TAX

Deemed domicile
The favourable position of domiciliaries of Italy, France, India and Pakistan
Favourable position only applies on death

It is generally well known that under section 267(1) IHT Act 1984 an individual is treated as domiciled in the UK if he was domiciled in the UK at any time within the previous three years or was resident in the United Kingdom for seventeen out of the previous twenty tax years - the so-called "deemed domicile" rule. A deemed UK domiciled person is liable for UK inheritance tax on his or her worldwide assets.

However, section 267(2) IHT Act 1984 provides that the deeming provisions in section 267(1) IHT Act 1984 shall not affect the interpretation of any subsisting double tax treaty referred to in section 158(6) IHT Act 1984 (that is a double tax treaty concluded before 1975 in the days of estate duty). The reason for this provision is that "foreign IHT/estate taxes" will often itself be based on the deceased's domicile, and were it not for the exclusion of section 267(1) by section 267(2) a person could be domiciled for tax purposes in two places: the foreign territory under general law, and the United Kingdom under the deemed domicile rules, with the result that both territories would tax that person on his worldwide assets passing on death.

For Italy, France, India and Pakistan, the existing estate duty (pre 1975) double taxation treaties remain in force. This means that people who are domiciled in those countries under the general law, will not be subject to the UK deemed domicile rule.

The effect of section 267(2) is that a person in such a position would only be subject to UK IHT on his UK situated assets.

To take advantage of this "treaty protection" it is important that any Will governed by British law deals only with UK situated assets. Somebody in such a situation should therefore take specialist advice.