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HMRC ISSUES GUIDANCE ON THE TAXATION OF SMALL PENSIONS

HMRC has issued a note on its website aimed at pensioners indicating that all private pension benefits should now be taxed under PAYE. It refers to some pensions still being paid under the "old arrangement", which has resulted in a number of them being paid tax free, even when some tax should have been paid.

It indicates that if an individual is receiving a pension which started before 6 April 2007 and no tax is being taken off, nothing will normally change until after 5 April 2008 when the current tax year ends. HMRC will check to see whether the individual's pension can continue to be paid tax free or whether tax is due.

Where tax is due the individual will receive a PAYE coding notice. For most individuals this should mean that their pension will be taxed from 2008/09 onwards and any underpayment of tax for 2007/08 will normally be collected in 2009/10 through PAYE month by month.

HMRC will not normally ask anyone to pay any tax which should have been paid on a pension before April 2007. This would only happen if the individual's pension provider had given details of the individual's pension to HMRC for 2006/07, or in exceptional circumstances if HMRC found that the individual had deliberately tried to avoid paying the tax.

INHERITANCE TAX REPORTING REQUIREMENTS

Reporting requirements for discretionary trusts
HMRC proposes increases in the reporting limits

HMRC's proposals on the reporting of certain inheritance tax transactions, published on 13 July, will cut out a lot of complex paperwork for advisers and their clients, assuming they are implemented as proposed. To understand why, it is first necessary to look at the current rules:

CURRENT RULES

(a) Lifetime Chargeable Transfers: For a lifetime chargeable transfer, such as a gift into a discretionary trust, the donor must report the transfer on form IHT 100, normally within 12 months from the end of the month in which the transfer is made. A report is always required unless the transfer is an 'excepted transfer', which means:

- the value transferred together with the value of any previous chargeable transfers during the same tax year does not exceed £10,000, and

- the value transferred together with the values of all previous chargeable transfers during the 10 years preceding it does not exceed £40,000.

(b) Periodic and Exit Charges for Relevant Property Trusts: An IHT 100 (and supplementary event forms) must also be completed on the ten-year anniversary of a relevant property trust (ie. a trust subject to the IHT discretionary trust regime) and on any transfer out of such a trust. The same 12 month time limit described above normally applies. There are currently no minimum reporting thresholds but returns are not required for a trust whose sole asset is cash and whose value does not exceed £1,000.

The effect of these rules is that all but the smallest chargeable lifetime transfers need to be reported and that many relevant property trusts have to make returns reporting that no tax liability has arisen. This used to be a minor irritant because chargeable lifetime transfers were rare and the relevant property regime was confined to discretionary trusts. That state of affairs was changed by the Finance Act 2006 reforms, which mean most new trusts other than absolute/bare trusts are within the relevant property regime and lifetime transfers into them are chargeable.

HMRC does not want to be inundated with returns when no tax is due and equally its 'customers' do not want to fill out pages of seemingly pointless paperwork. The problem was acknowledged shortly after the 2006 Budget announcement, but it has taken HMRC over a year to put together its proposals, which it plans should take effect **from 6 April 2007 in respect of transactions occurring on or after that date.** Comments on the proposals are invited before the end of August.

PROPOSED NEW RULES

(a) Lifetime Chargeable Transfers: These would only need to be reported when:

1. The value of the asset (before the deduction of any liabilities, exemptions or reliefs) owned by the donor before the gift (or, if greater, the loss to the estate) is more than 70% of the nil rate band rounded to the next £5,000 (ie. £210,000 in 2007/08); *or*

2. The value of the lifetime chargeable transfer is more than 70% of the nil rate band rounded to the next £5,000 (ie. £210,000 in 2007/08); *or*

3. The cumulative total of all chargeable transfers made by the donor in the seven years preceding the current transfer, but including that transfer, exceeds 85% of the nil rate band rounded to the next £5,000 (ie. £255,000 in 2007/08).

Example 1

John intends to arrange a discounted gift plan based on a discretionary trust with an investment of £260,000. This represents a chargeable transfer of £200,000 after the discount. John has not made any chargeable transfers in the previous seven years.

Although the chargeable transfer is under £210,000 (condition 2) and the cumulative total is less than £255,000 (condition 3), a report from John would still be required because the initial sum involved in the gift is £260,000, ie. above the £210,000 threshold (condition 1).

It would appear that if John wants to avoid the reporting requirement, all he need do is arrange the plan in two separate tranches. However, the detailed regulations may close off such an obvious escape.

(b) Periodic and Exit Charges for Relevant Property Trusts: The rules here are slightly more complex but, broadly speaking, the basis is:

- *Periodic charge:* No report is required unless:

  - the value of the trust property (including non-relevant property and any property transferred out in the previous ten years) *plus*

  - the chargeable transfers made by the settlor in the seven years before the trust started

  exceeds 70% of the nil rate band rounded to the next £5,000 (ie. £210,000 in 2007/08).

Example 2

John decides to go ahead with a plan. At the tenth anniversary, the value of the plan (allowing for the discount) is £153,000. The then nil rate band is £440,000 and the threshold for reporting is therefore £310,000 (£440,000 x 70% rounded to the next £5,000). An IHT 100 is thus not required.

- *Exit charge:* If this arises within the first ten years, then the 70% threshold applies to:

- the value, at the date it became part of the settlement, of all the property in the settlement, *plus*

- the chargeable transfers made by the settlor in the seven years before the trust started.

If the exit charge occurs after the first ten-year anniversary, then no report is required if:

- none was needed at the previous ten-year anniversary, and

- there have been no additions to the trust since then, and

- there is and has been since the last ten-year anniversary, no non-relevant property in the trust.

Example 3

John dies 19 years after the plan is set up and the death benefit, distributed by the trustees on wind up of the trust at the end of year 19, is £700,000. As there was no periodic charge at the previous ten-year anniversary and no additions had been made to the trust, no inheritance tax arises and no report is required.

If the trustees had delayed distribution until year 21, then there would have been a periodic charge at the end of year 20 and an exit charge report subsequently required unless the nil rate band exceeded the value of the trust's assets at the 20th anniversary (which is unlikely).

COMMENT

The HMRC proposals will make life much easier, but there are still a few pitfalls to watch out for. Until the regulations are in place, the current reporting rules apply. However, for transactions taking place on or after 6 April 2007 the 12 month time limit means the reporting limits should be known before the reporting deadline.

INHERITANCE TAX – DEATH ON ACTIVE SERVICE

A recent newspaper article has highlighted a little known exemption from inheritance tax

The "Death on active service, etc" exemption, contained in section 154 Inheritance Tax Act 1984, provides an exemption from IHT for an estate passing on death. The exemption applies when a person is certified by the Defence Council or Secretary of State as dying from wound, accident or disease contracted while on active service against an enemy (or on service of a similar nature) or from aggravation during that period of service of a disease contracted at some previous time.

The exemption does not apply to lifetime gifts. In the case of a war wound, the wound does not have to be the only or direct cause of death, provided it is a cause ie. it need only contribute to death (Barty-King -v- Ministry of Defence [1979] STC 218, [1979] 2 All ER 80). In this case the fourth Duke of Westminster died in 1967 of cancer after sustaining a wound in 1944 while on active service. The judge in this case held that the proper question for the court to ask was "whether the wound was a cause of the deceased's death, and not whether the wound was the direct cause of death."

It has been reported recently that a firm of solicitors in the South West of England had saved a family £1 million in IHT by claiming the death on active service exemption in relation to the estate of an 83 year old veteran of World War II who sustained injuries in France in 1944 but did not die until 2005.

The exemption is available provided HMRC Inheritance Tax is furnished with a valid certificate issued by the Ministry of Defence. To obtain the standard certificate, information must be provided of the deceased's service number, a copy of the death certificate and any relevant supporting medical evidence such as a post-mortem report. When somebody dies in service and the Ministry of Defence is in no doubt that section 154 applies, a simplified certificate is issued to the next of kin in the form of a letter.

It is important to note that HMRC Inheritance Tax has no discretion in matters concerning section 154. The exemption will be given on production of one of the two types of certificate i.e. standard or simplified.

Due to the nature of the exemption it cannot be known for certain that the exemption will apply. A solicitor who specialises in representing the estates of deceased service personnel therefore advises that supporting paperwork must be watertight – for example medical evidence should be collated and updated as necessary – and put together now rather than left until death has occurred. Such evidence will, of course, be necessary to support the case for a reclaim of IHT paid as IHT must be paid before probate can be granted. In the absence of medical evidence, a statement as to the facts would need to be made by the individual concerned.

COMMENT

For those whose families could potentially benefit from this exemption, which is the oldest in the long history of death duties, they should carefully assemble evidence and it would be helpful for them to discuss the matter with their adviser and their GP. Rather like as for the normal expenditure exemption, the availability of the exemption can only be determined after death has occurred for which reason it is important that supporting evidence is assembled in advance so that it is available later should the need arise.

CONSULTATION PAPER ON EQUALITY ACT

The Government has issued a consultation paper proposing a single Equality Act

The Government has issued a consultation paper proposing a single Equality Act. It should be noted that the existing exemptions contained in the Age Regulations for pension schemes are to be retained. In addition, the draft Sex Discrimination Act 1975 (Amendment) Regulations 2007, which accompany the consultation paper, indicate that insurance companies can charge different premiums or offer different benefits to men and women.

The intention is to draw all the existing legislation on discrimination into a single Equality Act with clear practical guidance so as to simplify and improve the legislation. Responses to the consultation are required by 4 September 2007.

COMMENT

The consultation document itself runs to 190 pages which does not bode well for the length and complexity of the final legislation. Simplification is an elusive target as those in the pensions industry well know.

INDEPENDENT TAXATION PLANNING

Transfers between spouses
The tax implications
The scope for saving tax

It was reported on the front page of Saturday's Daily Telegraph dated 14 July that Gordon Brown gifted his £700,000 central London flat to his wife weeks before he moved into 10 Downing Street. It is interesting to see that Mr Brown is carrying out some independent taxation planning – he is very much a higher rate taxpayer with a Parliamentary salary well into six figures. Mrs Brown, by all accounts, has little or no income.

It is instructive to consider the consequences of this action:

(i) The transfer of the flat would give rise to no CGT or IHT implications because it is a transfer between spouses who are living together (CGT) and both are UK domiciled (IHT).

(ii) If the flat were let for a rental of, say, £2,500 per month (£30,000 per annum) and Mrs Brown has no or only a negligible amount of other income, this could save the couple up to £7,000 per annum in income tax. Mr Brown would pay £12,000 income tax at 40% but Mrs Brown perhaps only about £5,000 – taking account of her personal allowance, her 10% tax band and the 22% (falling to 20% from tax year 2008/09) basic rate tax payable on rental income.

(iii) Any rental income could, it is thought, be paid into a joint bank account with it all continuing to be taxed on Mrs Brown but this may perhaps be a risky route to take. Payment into an account in just Mrs Brown's name would be preferable.

(iv) Mrs Brown should make sure that if the flat is sold the proceeds are paid just to her and not, say, into a joint account – otherwise Gordon could still be treated as the owner of all or part and the settlement provisions would apply with some of the capital gain being taxed on him.

Similar principles will apply to gifts of financial products including investment bonds/unit trusts and OEICs. Also a gift of OEICs/unit trusts between spouses will not cause the taper relief built up by the original owner to be lost on disposal by the new owner.

DWP ISSUES WINDING UP AMENDMENT REGULATIONS

The DWP has now issued The Occupational Pension Schemes (Winding Up, Winding Up Notices And Reports Etc) (Amendment) Regulations 2007 – SI 2007/1930, which come into force on 1 October 2007.

These regulations enable the trustees and administrators of DB occupational schemes and hybrid schemes that are in the process of winding up to:

- discharge pension entitlements by the payment of a winding up lump sum, or trivial lump sum, even if the member did not have a right to the lump sum under the scheme's rules, and

- discharge their liability to pension credit members by way of a winding up lump sum.

Despite the above, in either of the above situations the trustees will still need a general power under their scheme to pay lump sums.

In addition, the regulations will also require schemes which commence winding up on or after 1 October 2007 to report to the Pensions Regulator 2 years after winding up started, instead of after the current 3 years.

During the consultation on these regulations it was suggested to the Government that the winding up lump sum rules should be extended to allow pensions in payment to be commuted, where the value of the member's current pension is less than 1% of the standard Lifetime Allowance. The Government has indicated that it intends to look further into this.

COMMENT

These are very sensible and welcome amendments.

PENSIONS TAX SIMPLIFICATION NEWSLETTER

HMRC has issued Pensions Tax Simplification Newsletter No.28. Its main topics included:

- QROPS and the new Australian pension provisions - SI 2007/160 has introduced the appropriate amendments to enable Australian pension schemes still to be able to obtain qualifying recognised overseas pension schemes (QROPS) status.

- QROPS listing - HMRC has confirmed that where a registered scheme makes a transfer to an overseas scheme that was shown on HMRC's QROPS list, that it should have just and reasonable grounds for asking HMRC not to apply a scheme sanction charge should it subsequently be found that the scheme was not a bona fide QROPS and was withdrawn from the list by HMRC. To ensure such protection the UK scheme administrator must have checked the HMRC QROPS list not more than one day before the transfer was made. The UK scheme administrator should also keep a note of the date on which the list was checked (and retain a copy of the overseas scheme's HMRC QROPS letter if this has also been obtained).

HMRC will in future be publishing an updated QROPS list twice each month (at the beginning and middle of each month). UK scheme administrators can check the status of unlisted QROPS (it should be remembered that HMRC can only provide a listing of those QROPS that have consented to the disclosure of their status) by sending HMRC PSS a form of authority obtained from an overseas scheme for HMRC to disclose its QROPS status even if it had not appeared on the published list.

- Bridging pensions - where schemes have paid bridging pensions in accordance with the pre A-Day rules then they can reduce those pensions when the member reaches SPA by the full amount of the bridging pension that has been paid without resulting in an unauthorised payments charge. Transitional protection will be introduced by regulations and apply to bridging pensions to which the member has become entitled on or before 2 July 2007. Where bridging pensions came into payment after 2 July 2007, to avoid any unauthorised payments charge any reduction in the pension must comply with the rules of the new regime as set out in Schedule 28 of the Finance Act 2004, as amended by the Registered Pension Schemes (Bridging Pensions) Regulations 2007 – SI 2007/826.

ARCTIC SYSTEMS APPEAL DECISION

On 25 July 2007 the House of Lords handed down their judgement in the case of Jones v Garnett (also known as the "Arctic Systems Ltd" case) in favour of the taxpayer, Mr Jones.

The judges agreed that the arrangement between Mr and Mrs Jones was not a commercial one and was one that had the requisite element of bounty crucial to determining whether or not the arrangement amounted to a settlement. Lord Hoffman stated in effect that two unrelated people would not have entered into such arrangement (which was to the benefit of one party and at the expense of the other) resulting in Mr and Mrs Jones having an equal shareholding when they knew that one party, Mr Jones, would be doing all of the work.

Given that there was the necessary element of bounty there was clearly a settlement for the purposes of section 660A ICTA 1988. However, section 660A(6) provides that if an outright gift is made from one spouse to another this will not be a settlement for the purposes of section 660(A)(1) unless the gift is one that "is wholly or substantially a right to income". Great emphasis in the judgement was placed on the fact that an ordinary share (unlike the preference share used in Young v Pearce) was much more than a mere right to income. The arrangement was therefore bounteous but was also outright and so section 660(A) did not apply.

COMMENT

Despite this victory for the taxpayer the Government has issued a Ministerial statement stating its intention to change the law so that HMRC's tax loss is stemmed in the future.