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DISCOUNTED GIFT TRUSTS

The size of the discounted gift will be larger from 1 September

HMRC recently issued a bulletin announcing an increase in the valuation interest rate used for calculating the value of the retained benefits within discounted gift schemes. The new rate is 6.75%, effective from 1 September, compared to the previous rate of 6%.

HMRC blames the change on rising short-dated gilt yields as the interest rate basis now being used is short-dated gilt yields +1%. The higher rate will mean a lower discount is applied to the gift because it reduces the present value of the retained benefits. The effect is exactly the same as rising yields reducing the cost of a fixed annuity.

A 0.75% yield adjustment may not sound much, but it could increase the discounted value of a gift by 10% to 15% - the younger the age, the greater the increase.

We asked HMRC Inheritance Tax about its new practice on interest rates and were told the following:

- It does not normally expect to change interest rates more than once every three months

- It has no specific index or individual gilt to which it refers, but its benchmark is 4-5 year gilts generally

- The minimum interest rate change would be 25 basis points (0.25%)

- It will aim to give about six weeks' notice of any revision

- Although the current measure is short-dated gilt yields + 1%, this could change if pricing altered in the market for sales of life interests and similar rights.

COMMENT

HMRC is now clearly paying more attention to discounted gift plans. In turn financial advisers might need to watch short-dated gilt yields more closely than in the past.

OVERSEAS PROPERTY AND A BENEFIT IN KIND TAX CHARGE

HMRC has published draft legislation to amend section 100 of ITEPA 2003 so that individuals who have bought homes abroad will generally not face a benefit in kind income tax charge if they use a company to hold the property. HMRC has invited comments by 5 October 2007.

Currently, when accommodation is provided by an employer, tax is due on the value of the benefit to employees and directors if the property is available for their personal use.

Some UK residents have bought holiday properties abroad but held them via companies to avoid legal problems in the jurisdiction/community in which the property is situated. Most have been unaware of the possible UK tax charge in respect of living accommodation where they have some influence over the company's affairs (whether through an agent or not).

The proposed legislation, which will be retrospective, will remove the tax charge where certain qualifying conditions are satisfied. The exemption will only apply to the benefit in kind charge. It will apply where the overseas property is owned by a company that is owned by individuals, who are directors of the company and for whom the property is available for use, where the company's sole activity, according to HMRC, is holding that property "for occupation and/or letting".

COMMENT

This is an overdue change to the law which was never designed to catch individuals who set up companies for such non-commercial purposes.

INDIVIDUAL SAVINGS ACCOUNTS

The much announced changes to ISAs from 6 April 2008 now have regulatory backing

Background

Before last year's Pre-Budget Report (PBR) several Government announcements about the future of ISAs and PEPs were made. These were confirmed in the PBR that followed and, for good measure, announced again in the Budget four months later. In the rush of finalised legislation issued as Parliament shut up shop for the summer, the necessary amending regulations for ISAs and PEPs emerged. These will have effect from 6 April 2008. The main changes are:

- **Indefinite ISAs**

The end date for ISAs, which was scheduled to be 5 April 2010, will be removed.

- **Abolition of the mini/maxi distinction**

The arcane rules for maxi-ISAs and mini-ISAs, which seemed designed as a trap for the unwary, will disappear. Instead in any tax year an investment may be made in one cash ISA and one stocks and shares ISA, subject to the contribution limits.

This is a sensible move that gives investors a little more flexibility. For example, it will be possible to invest £5,000 in a stocks and shares ISA with company A and £2,200 in a cash ISA with bank B. At present the maxi-ISA rules would not permit the investment to be split between different providers.

- **New investment limits**

From 2008/09 the overall investment limit will be £7,200 per tax year, of which up to £3,600 may be invested in a cash ISA.

- **Cash to stocks and shares transfers**

The cash component of an ISA will be transferable to the stocks and shares component, but not vice versa. Partial transfers will be permitted for previous years but, for a current year transfer, all of the contribution for that year and accrued interest must be transferred.

- **PEPs become stocks and shares ISAs**

The PEP regulations will fall away and all existing PEPs will become stocks and shares ISAs. This will mean that the investment opportunities increase marginally, eg insurance products will be permitted investments. Less favourably, it will introduce a flat 20% tax charge for interest earned on uninvested cash. At present such interest is tax-free provided no more than £180 a year is withdrawn.

There is no requirement on providers to merge portfolios where a client holds both an ISA and a stocks and shares PEP.

- **The end of TOISAs**

TESSA-Only ISAs (TOISAs) will officially become cash ISAs and the term will disappear.

COMMENT

There is more spin than substance to these changes, but when they take effect next April they could give another boost to the ISA transfer market. The proposal to allow Child Trust Funds to roll over into ISAs at age 18 is subject to future consultation.

THE TAXATION OF OFFSHORE FUNDS

How offshore funds are taxed
The change from next year in the tax treatment of foreign dividends

For tax purposes, there are two types of offshore collective investment fund – a "distributor" fund and a "roll-up" fund. A roll-up fund does not declare any income, for distribution or accumulation. Instead any income is internally accumulated within the fund. This means that there is no taxable income but the price the investor pays for this is that on subsequent disposal of shares/units in his fund, all the profit is subject to income tax as an offshore income gain. In particular, one cannot offset the annual CGT exemption against the offshore income gain and so, in effect, all capital growth has been converted into taxable income.

Distributor funds, on the other hand, distribute at least 85% of their income. Either this will be paid to the investor or accumulated by buying more shares/units. This income is subject to income tax but capital gains, on encashment of shares/units, are subject to CGT so taper relief and the annual CGT exemption are available. As regards these distributor funds it is important to note that the tax rules on income are changing.

Higher rate taxpayers are set to pay less UK tax on dividends from non-UK companies from 6 April 2008, when rules will be brought into line with those for dividends from UK companies (see below). Basic rate taxpayers will, in most cases, continue to have no further income tax to pay and be no better or worse off as a result of the change. The definition of offshore funds embraces collective investment schemes constituted:

(i) as a non-UK resident company ; or

(ii) a unit trust with non-resident trustees ; or

(iii) an overseas arrangement which involves rights of co-ownership but which does not fall within (i) or (ii).

HMRC has confirmed to us that the intention is to make available the 10% tax credit in circumstances where it would be available in the UK which would include entities within (i) and (ii) at least. The position should be clarified in Finance Bill 2008.

Foreign dividends usually come with some tax already deducted - so-called withholding tax - which UK resident investors can offset against their UK tax liability. This overseas tax is typically 15 per cent but can vary and it cannot be recovered.

From 6 April 2008, foreign dividends will also come with a 10 per cent UK tax credit - effectively meaning 10 per cent UK income tax is deemed to have already been paid. This will further reduce higher rate taxpayers' additional liability. On dividends where withholding tax is 15 per cent it would seem, subject to what will be in the legislation, that the remaining UK tax due will fall to 10 per cent of the net dividend received plus withholding tax from 17.5 per cent currently. This is quite generous because it means that effectively investors will be getting two tax credits.

The new credit is for foreign dividend income of up £5,000 per person in total a year. But to benefit, investors may well have to complete extra pages of the tax return.

THE REVIEW OF INSURANCE CONTRACT LAW

Consultation paper on insurance contract law issued
Paper covers pre-contract information from the insured
Insurable interest is to be covered in the next consultation paper

The Law Commission and the Scottish Law Commission are jointly carrying out an in-depth review of insurance contract law. The consultation paper issued on 17 July is the first of a number to be issued, dealing with particular areas of insurance contract law under review. One of the areas highlighted for review is that of insurable interest. This consultation paper does not deal with this matter. Instead, the Law Commissions have announced that they intend to consider insurable interest in their next consultation paper.

The 17 July consultation paper deals with the broad issues of pre-contract information from the insured – for example misrepresentation, non-disclosure and breach of warranty. These were identified as the areas presenting particular problems and being in "urgent need of reform."

Pre-contract information from the insured

Anyone applying for an insurance policy is obliged to disclose all material facts regardless of whether or not the insurer asks any specific questions. If there is non-disclosure of a material fact, the insurer may set the policy aside and refuse to meet any claim. Under current law this will be the case regardless of whether the non-disclosure was innocent, negligent or fraudulent.

The Commissions recognise that the current law, in effect, can operate "as a trap" and allows claims to be rejected even where policyholders have acted honestly and reasonably. Although individual policyholders have recourse to the Financial Ombudsman, this is not considered to be satisfactory. Furthermore, the services of the Ombudsman are not available to medium and large businesses ie. businesses with a turnover of at least £1 million.

The Commissions propose a different set of rules depending on whether the insured is a private individual, referred to as a consumer, or a business.

For consumers, the Commissions propose to replace the duty to volunteer information under the general duty to disclose with a requirement to answer questions carefully and honestly. If a consumer answers questions or gives other information honestly and takes reasonable care, he should be protected. If the consumer acts deliberately or recklessly in giving incorrect answers or provides incorrect information, the insurer will be entitled to avoid the policy and refuse all claims under it.

The consultation paper further proposes a different set of rules where the consumer acts negligently. In such cases, according to the Commissions, the law should aim to put the insurer in the position in which it would have been had it been aware of the full facts, for example, if the insurer would have charged more, the claim should be reduced proportionately to the underpayment of premiums.

For businesses the Commissions propose that businesses should continue to have a duty to volunteer information but the duty should be limited to facts that a reasonable insured in the circumstances would realise the insurer wanted to know.

Pre-contract information and intermediaries

It has long been the case that it is not always clear for whom the intermediary is acting and the insured often bears the consequences of any mistakes or wrongdoing by the intermediary. The Law Commissions propose to make it clear that "tied agents" who sell the products of a limited range of insurers should be treated as acting for the insurer while an intermediary who is clearly independent will be treated as acting for the insured.

Warranties

Another issue that the consultation document deals with is that of warranties as to the future. Under current law, where an insured gives a warranty about future actions, any breach will discharge the insurer from all further liability, even in respect of claims which have no connection with the breach. The Commissions propose that, firstly, any warranty should be set out in writing, and that a breach of warranty should not automatically discharge the insurer from liability. Instead, the insurer should pay a claim where the insured can prove that, on the balance of probabilities, the event constituting the breach did not contribute to the loss.

Life assurance -specific issues

As far as life assurance business is concerned, the consultation covers in more detail the issues of misrepresentations by the life assured in life of another policies and joint life policies.

With a life of another policy, the issue is whether the proposer should be bound by statements made by the life assured. Currently, in most cases where a life of another application is made, the proposer would sign the form to confirm that the answers given by the life assured "form the basis of the contract". This converts all the answers provided by the life assured into warranties. This will mean that even an innocent and reasonable mistake by the life assured would amount to a breach of warranty and as such could prevent the policyholder from recovering under the policy, whether it was material to the risk or not.

The Commissions think this goes too far. Accordingly, they provisionally propose to abolish the "basis of the contract" clauses in consumer contracts. Instead, any statements of past or current fact would be treated as representations, meaning that innocent or immaterial misstatements will not automatically lead to avoidance of claim by the insurance company. For example, if the life assured had acted deliberately or recklessly, the insurer could avoid the policy. If they acted negligently, the insurer would have a proportionate remedy. However, if the life assured acted innocently and made a mistake in giving a wrong answer to a question, this would amount to an innocent misrepresentation and the insurer would be required to pay the claim. It would be for the insurer to show that either the life assured or the policyholder, or both, behaved deliberately recklessly or negligently.

Somewhat different rules are intended to apply to business contracts.

COMMENT

As indicated above, the proposals are contained in a consultation paper and the closing date for responses is 16 November 2007.

It seems, without a doubt, that the Commissions are addressing the most pressing issues first. There have been numerous cases recently highlighted by various consumer bodies and TV programmes, such as the BBC Watchdog, where the strict application of the rule on warranties and disclosure by insurance companies appears to be grossly unfair to the individuals concerned. In particular, there seems to have been a number of claims under critical illness policies, where insurance companies declined to pay the claim because the life assured failed to disclose a fact, which seemed to be totally unrelated, or a minor piece of information, such as visit to a doctor a number of years before the application was made. If the new proposals are adopted into law, such situations will be less likely to arise. We now look forward to the next instalment in the consultation process, ie. the consultation paper including insurable interest.

LAW OF TRUSTS

The duty of care to tell a client the tax implications of a trust

In the recent case of Phelps v Stewart and Dinsmore (2007) the settlor of a trust had been the victim of a road accident and had successfully claimed damages from the negligent driver of over £1 million.

The solicitors acting for the settlor arranged for him to consult with a trust specialist. She (the trust specialist) advised the settlor that he should arrange for the damages to be paid into a discretionary trust under which he, the settlor, would be one of the potential beneficiaries.

At the time the IHT nil rate band was £234,000, so the effect of paying £1 million (in four separate tranches) into the discretionary trust was that the settlor (the road accident victim) had made substantial lifetime chargeable transfers over the nil rate band, taxable at the 20%

lifetime rate. As someone without knowledge of how trusts worked the settlor was unaware of these charges.

The settlor sued the trust specialist, and she settled that claim. The trust specialist then sought to recover this sum from the solicitors who had acted for the settlor in the personal injury claim, and who had introduced the settlor to her.

Her argument was that her retainer was limited to advising a trust to receive the initial tranche of the damages, £35,000, not any subsequent tranches. The Court rejected her argument noting that her retainer had not been recorded in any contractual document. The Court considered that the client (the settlor) was unsophisticated, and would not have known what conventions normally operated between a trust adviser and their clients, nor would he have been familiar with the course of dealings between the solicitor and the trust specialist.

In this case there was no written retainer, spelling out in detail what the trust specialist was going to do or, as in these circumstances, what she was not going to do, ie she was not advising on the tax consequences of the transaction being undertaken.

The trust specialist had sought to argue that there was a convention under which those with specialist expertise set up trusts on the basis that they were only good for the first payments made into them and that specialist advice should be taken before additional payments were made. The Court rejected this argument, accepting the solicitor's evidence that it had been explained that further sums, beyond the initial £35,000, were to be paid into the settlement.

COMMENT

It can be argued that in many cases the trust draftsman might assume that there will be no further sums added. It would therefore be wise to confirm with a client what assets are to be added to the settlement and when, with a stark warning that additional sums or assets should not be added without additional advice being taken at the time.

This case follows the 1997 case of Hurlingham Law Estates Ltd v Wild where a client instructed a solicitor in connection with the purchase of a house, to be bought in the name of a company. This turned out to be disadvantageous for tax reasons. The Court held that the solicitor should have advised on the tax consequences of the proposed arrangements, and were unsympathetic to the argument that the solicitor has merely been retained to undertake the conveyancing. The Court held that the duty owed to the client was rather wider, and covered the underlying business issues. Again, as in the Phelps case, the party giving advice had not limited the scope of his advice in writing.

As has been shown in this case, the duty of care that is required for an unsophisticated client means that the professional is expected to cover all aspects of the proposed investment or business venture. The only way to avoid such a burden is to make sure that the scope of advice is limited in the first instance.