Technical Connection

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PENSIONS BILL 2007

The Government has issued the Pensions Bill 2007. This sets out a number of the criteria for the new Personal Accounts to be introduced in 2012 as well as implementing a number of the changes arising from the Deregulatory Review. (see below).

RESIDENCE AND DOMICILE

The Government has issued a consultation paper on residence and domicile
A summary of the proposals

In his Pre-Budget Report on 9 October 2007, the Chancellor announced proposals to change the tax rules that apply to UK resident non-domiciliaries with effect from 6 April 2008. On 6 December HM Treasury published a consultation paper entitled "Paying a fairer share: a consultation on residence and domicile". In it they point out that people who move to the UK from abroad make a significant contribution to GDP (£12 billion) and to income tax (£4 billion). They comment that, whilst it is important that the UK remains an attractive place for workers with key skills, it is also important that those who choose to live here make a reasonable tax contribution to society.

The proposed measures

The measures announced, which apply only to income tax and capital gains tax and not inheritance tax, are designed to strike the right balance between competitiveness and fairness.

- Currently, non-UK domiciled but UK resident individuals are subject to income tax and CGT on the remittance basis. This means that, in general, they will only pay UK tax when they bring that income or gains back to the UK. With effect from 6 April 2008 non-domiciliaries who have been tax resident in the UK for longer than 7 out of the past 10 years will move onto the arising basis and pay income tax and CGT on worldwide income and gains as they arise. This does not apply if their unremitted foreign income or gains are less than £1,000 in a tax year. However, it will be possible to remain on the remittance basis of taxation on payment of an annual charge of £30,000.

  People in this group will be able to choose, on a year-by-year basis, whether to pay the £30,000 charge (and keep the remittance basis), or move to the 'normal' basis of UK taxation (i.e. pay tax on income and gains as they arise).

- People who use the remittance basis of taxation (other than those with foreign income and gains of less than £1,000 in a tax year) will not be entitled to personal tax allowances, certain reliefs and the annual CGT exemption. Again, they can choose (on a year-by-year basis) between keeping the remittance basis or keeping their allowances, reliefs and annual CGT exemption.

- Currently, only whole days spent in the UK count towards establishing residence. So it is possible for someone to work 5 days in the UK, with only 3 days counting towards residence i.e. the part-day of arrival and part-day of departure would be ignored. Changes will be made to the residence rules such that days of arrival into and departure from the UK will count towards establishing residence. This will bring UK practice into line with international practice.

- Current 'flaws and anomalies' that allow individuals using the remittance basis to bring back profits yet sidestep UK tax on foreign income and gains will be removed. For example:

  - The 'ceased source' loophole that stops tax applying if the source of the income or gain no longer exists in the tax year when funds are remitted.

  - The 'cash only' loophole that means HMRC can only tax foreign savings and investment income if remitted as cash. If such income is turned into an asset and that asset is imported into the UK, tax can only be charged on the income if the asset is sold or turned into cash in the UK.

  - The problems with taxing remittances from 'mixed funds' i.e. a mixture of foreign income, employment income, capital gains and capital.

  - Alienation of income and gains through offshore vehicles and structures (such as a trust) or closely connected persons (such as a close relative), where anti-avoidance legislation does not work effectively.

Other possibilities

HMT has also suggested that other options might be considered. For example:

- Apply the flat rate charge without the 7 year 'grace period' but at a perhaps lower rate.
- Impose an additional, higher charge for those who remain here for a longer period and wish to stay on the remittance basis e.g. rising to £50,000 after 10 years out of 12.
- Setting an upper time limit on the length of time a UK resident non-domiciliary could retain access to the remittance basis.

COMMENT

There has been speculation about a reform to the rules on residence, domicile and the remittance basis for a number of years now. The fact that the deadline for responses is 28 February 2008, that draft legislation will be published 'soon' and that the measures will be in the 2008 Finance Bill and take effect from 6 April 2008 suggest that the Government has pretty well made up its mind as to the outcome.

PROTECTED RIGHTS AND SIPPs

The DWP are consulting on draft amending regulations which will permit protected rights to be held under all SIPPs from October 2008

Following the changes to the FSA regulatory regime applicable to all types of personal pensions, including SIPPs, the DWP has decided that there should no longer be a prohibition on the holding of protected rights benefits under SIPPs. Accordingly it has introduced draft amending regulations, which will enable protected rights to be held under all types of SIPP (and not just those schemes using individual insurance funds as at present) provided the scheme is a registered scheme. It is proposed that this change will be introduced from October 2008.

These draft regulations also include a change to the contracting out legislation which will abolish the ability for any survivor's annuity in respect of protected rights benefits to continue to be paid to any other person if the survivor dies during a five year guaranteed period. Where a member dies while a member of a contracted out money purchase scheme and leaves a surviving spouse or civil partner, the member's residual fund must be used to provide a dependant's annuity (or additionally in the case of an appropriate personal pension scheme a dependant's unsecured or alternatively secured pension). Currently, where the survivor dies regulations in SI 1996/1537 provide for the annuity to continue to be paid to or for the benefit of a person or persons other than the survivor. The regulations go on to indicate that the survivor can elect that where he or she dies, or remarries before pensionable age, the annuity can be paid to his or her children and continue to be paid until the youngest reaches age 18. If, however, the children die or attain age 18 within 5 years of the date on which the annuity commenced, then it can continue to be paid to 'any one person' for the remainder of the 5 year period.

From 6 April 2006 this provision has conflicted with the new tax rules which prevent a dependant's pension being guaranteed to be paid for a minimum period and which do not permit survivor's benefits to be paid to someone other than a dependant. These amending regulations will bring the provisions of SI 1996/1537 into line with the tax rules under the new regime.

COMMENT

The ability for protected rights to be held in all SIPPs is a long overdue change and will provide additional welcome flexibility for the holders of such benefits.

THE PENSIONS DEREGULATORY REVIEW

The Government has issued its final response to the further consultation on the Deregulatory Review

The two main changes announced, and included in the Pensions Bill 2007, as a result of this Review are:-

1. A reduction in the revaluation rate for deferred members

The Government has included appropriate provisions in the Pensions Bill 2007 to reduce the maximum increase for deferred benefits for members of final salary schemes from 5% pa to 2.5% pa. Any benefits that accrue after the implementation date (ie January 2009) will then be increased in deferment by the lesser of 2.5% pa and the RPI. Deferred benefits accrued prior to January 2009 (and benefits accrued in respect of active members prior to January 2009) will continue to be revalued in deferment by the lesser of 5% pa and the RPI.

2. The abolition of safeguarded rights

Safeguarded rights are to be abolished, and provision for this is included in the Pensions Bill 2007. The DWP will also begin looking at other aspects of the pension sharing legislation, in consultation with stakeholders, in the first half of 2008.

THE DWP SETS OUT NEW IMPROVED FAS TERMS

The Government has announced that it will substantially improve the benefits package for individuals subject to the Financial Assistance Scheme (FAS)

The Government has announced the following extension of benefits:

- all scheme members will be guaranteed 90% of their accrued pension at the date their scheme began wind up. This will be subject to a cap of £26,000. The value of the cap will be protected although it is not indicated whether such protection will be in line with a set index (eg the RPI) or at the discretion of the DWP.

- payments made to individuals from the FAS, which derive from pension accrued post April 1997, will be increased each year in line with the lesser of 2.5% pa and the RPI.

- assistance will be paid from each failed scheme's normal retirement age, subject to this being no lower than age 60.

- individuals unable to work due to ill-health will be able to apply for benefits to commence from age 60.

- members will be able to draw a tax-free lump sum, up to their full lump sum entitlement, if their share of the scheme fund allows.

- help will be extended to members of schemes wound up by solvent qualifying employers. This will benefit around a further 11,000 employees.

The inclusion of solvent qualifying employers, and the other changes, will mean that the FAS can now make provision for up to 140,000 affected employees.

COMMENT

At long last the benefits under the FAS have been brought in line with those under the PPF. It is a shame that the Government could not have made these changes earlier and without the need for the interventions of the High Court, the Parliamentary Ombudsman and the European Court.

It is not exactly clear how these changes will affect the final draft of the Financial Assistance Scheme (Miscellaneous Amendments) Regulations 2007 which are designed to implement the changes announced in the 2007 Budget and come into effect early in 2008.

INCOME SHIFTING LEGISLATION

The Government has issued a consultation paper on income shifting, with draft legislation and draft guidance
A summary of the proposals

Introduction

The Government believes that an individual should pay tax on income that is attributable to them. According to the Government, income shifting occurs when one individual redirects part of their income to a second individual who is subject to a lower rate of tax. As a result the shifted income suffers less tax.

The Jones v Garnett case (see page 1 of our November bulletin for a resumé) has, in the view of the Government, highlighted the need for new legislation to "provide clarity for business" regarding the Government's position. With this in mind a consultation paper on income shifting, with draft legislation and draft guidance, was issued by the Government on 6 December. This follows on from an announcement in the Pre-Budget Report 2007 that the Government would be taking action to counteract the tax advantage gained from income shifting through partnerships and companies, by the use of non-commercial arrangements.

The consultation period runs to 28 February 2008 with legislation taking effect from 6 April 2008.

The legislation

The draft legislation takes the form of the addition of sections 681A-681F to the settlements legislation in Part 13 of the Income Tax Act 2007 (tax avoidance).

As mentioned earlier, the legislation is to be effective from 6 April 2008 and applies to income that would be subject to tax in tax year 2008/09 and later. It will apply when income is shifted from one individual (Individual 1) to another (Individual 2) provided four conditions are satisfied as follows:

1. Individual 1 is party to or has power over the relevant arrangements. A relevant arrangement is one which is not a genuine commercial arrangement and, in all the circumstances, it is reasonable to conclude that the purpose, or one of the main purposes of the arrangement, is the avoidance or reduction of income tax.

   As would be expected "arrangement" is widely defined to include "any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)".

   A genuine commercial arrangement is defined, broadly, as one that would have been made by individuals acting on an arm's length basis.

2. Individual 1 forgoes income and any of that income would be income of individual 2. This income is defined as "shifted income" and income is foregone if individual 1 does not receive the income he or she is entitled to or, with regard to work done by individual 1, he or she might reasonably expect to receive income but does not.

3. Individual 1 has the power to control or influence the amount of income shifted.

4. The shifted income must consist of distributions from a company (most likely to be dividends) or profits of a partnership (this will include a limited liability partnership).

If the above four conditions are satisfied then the shifted income is treated as the income of individual 1 for the tax year in question and will not form part of the income of individual 2. However, this rule will not apply in a situation where the total amount of tax due from individuals 1 and 2 is equal to or less than it would be were it treated as not being shifted – in other words, for the legislation to apply a tax advantage must be secured. The income is not recategorised so if dividend income is foregone, dividend income is assessed on individual 1.

It is intended that the liability for Class 4 NICs, payable by the self-employed currently at the rate of 8% on profits between £5,225 p.a. and £34,840 pa, will follow the shifted income so the liability for NICs on shifted income will fall on individual 1 as well as the income tax liability.

The guidance

As well as explaining the legislation the guidance has an examples section within which there are 17 examples. Examples are based on partnerships, companies and changes in arrangements over different periods (for example where the division of income between partners fails to keep up with the changing level of labour contributed by each that would be reflected in a normal commercial remuneration arrangement).

By way of illustration, in one partnership example, individual 1 and individual 2 each put £100 into the business and both work full-time, with one providing graphic design services and the other managing and promoting the business. They split profits 50/50. The income shifting legislation would not apply here as the share of profits received by each individual reflects the balance of labour and capital put into the business.

In contrast, consider two spouses who have a similar business and each put in £100. One spouse does all the work of the partnership. Profits are split 50/50. In this case the income shifting legislation will apply as the share of profits does not reflect the balance of labour and capital put into the business. The arrangement appears to be uncommercial and enables one spouse to forgo income he or she should otherwise have received.

General

The new legislation is in addition to the existing settlements legislation. The income shifting legislation will only apply if a tax advantage were still obtained from income shifting after taking into account the rules in the existing settlements legislation.

The new legislation will not generally apply to gifts. However, it may apply where gifts form part of an arrangement which results in income being received by individual 2 in the form of a distribution from a company or a share of partnership profits.

COMMENT

It is good news that there is draft legislation and draft guidance to comment on. If the Government estimates of a reduction in the tax lost through income shifting of £200 million, and the protection of a further tax loss of £350 million by 2010/11 prove accurate, the introduction of the legislation will have been worthwhile.

The new legislation should prevent individuals gaining a tax advantage from income shifting through company and partnership distributions. Individuals need to be aware that these rules can bite when a tax advantage is being derived from a non-commercial structure and with this in mind a review of the remuneration structure of the business would seem worthwhile. The important point though is that genuinely commercial arrangements should be unaffected.

FSA PROVIDE "ADVICE" ON PERSONAL ACCOUNTS

The FSA has provided a note which sets out the extent to which advisers will need to take into account, and make their clients aware, of the proposed introduction of Personal Accounts in 2012 when advising their clients.

The FSA accepts that there are still many aspects concerning Personal Accounts that need to be resolved and indicates "where an individual has a need and a desire to save (be that generally or specifically for retirement) there should be no question of delaying saving until 2012. Putting off saving would not be in the best interests of the individual".

The FSA goes on to indicate

"It is for advisers to assess the extent to which the future pension reforms are a factor in the advice given to each of their clients. The extent to which they are a factor will increase as the legislation is passed, the design of Personal Accounts becomes clearer and we get closer to this implementation date. Advisers will need to be aware of the developments as they happen to enable them to make reasonable assumptions when giving advice."

"Whether or not the future legislation and Personal Accounts have an impact on the advice given to a particular client at a particular point in time, it may have some effect on that client's circumstances in the future. Therefore, when advisers are talking to clients about the need to review their financial arrangements regularly, they may feel it is relevant to refer to the proposed pension reforms as a specific example of a potential reason for reviewing plans in the future."

HMRC ADVISES PITFALLS OF SURPLUS AVOIDANCE SCHEME

HMRC has indicated that it has received details of a tax avoidance scheme which is being promoted and which is designed to enable a member of a registered pension scheme to extract funds from the scheme tax free. HMRC has indicated that it will not achieve the desired effect and only result in unauthorised payment charges etc.

While HMRC understandably is not prepared to set out full details of the proposed device it has indicated that it purports to create a tax-free payment by artificially creating a surplus within a registered scheme by a scheme member surrendering their pension rights. It was then suggested that this would create a tax-free payment by making the surplus payment in a specified way.

HMRC wishes to make clear that a payment to a sponsoring employer arising out of a surplus generated by a pension scheme member surrendering their pension benefits is not an authorised surplus payment within section 177 Finance Act 2004 as prescribed in the Registered Pension Schemes (Authorised Surplus Payments) Regulations SI 2006/574 (the Surplus Regulations).

A payment made in these circumstances is therefore an unauthorised employer payment and as such is subject to income tax charges of up to 70 %. The scheme will, in addition, still be liable for the provision of the benefits 'surrendered'.

COMMENT

As set out by HMRC this particular device seems particularly unattractive as not only will it result in unauthorised payment charges but also a liability for the scheme to provide the benefits surrendered by the member.

WE WISH ALL OUR READERS A PROSPEROUS AND HAPPY NEW YEAR