CONTENTS

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THE ABOLITION OF THE SETTLOR-INTERESTED TRUST PROVISIONS FOR CAPITAL GAINS TAX

New thinking required post 5 April 2008 when considering trust planning for children

(i) The current position:

Section 77 Taxation of Chargeable Gains Act 1992 (TCGA) provides that in the case of a settlor-interested trust, all capital gains will be taxed on the settlor.

A settlor-interested trust is one under which the settlor, settlor's spouse or minor child, who is not married or in a civil partnership, can benefit.

In such cases, all capital gains will be taxed on the settlor which means:-

(a) the trustees cannot use their annual capital gains tax (CGT) exemption
(b) gains will be taxed at the settlor's rates of CGT – not the trust rate.

(ii) The proposed change:

With the proposed reduction of the rate of CGT to 18% for all trustees and individuals, the Government has felt that the need for section 77 no longer exists and is proposing to revoke it with effect from 6 April 2008. This will mean that the gains of all trusts (other than bare trusts), after deduction of the annual exemption, will be taxed at 18%. It also would appear to mean that trustees of settlements (not bare trusts) will be entitled to the annual CGT exemption even in cases where the settlor/settlor's spouse or minor unmarried children can benefit.

This change, if it passes into legislation, could have an effect on using trusts as a means of planning for the future benefit of children.

Currently, where there is a desire to optimise the CGT position on investments for children, a bare (or absolute) trust may be used. The advantage for this type of trust is that all capital gains are taxed as the child's and so it is CGT effective but the downside is that the child can force the trust fund to be paid to him once he attains age 18. Therefore no control exists to the trustees to retain property in the trust even if it may not be appropriate for the child to receive the trust benefits.

If this change in legislation goes ahead it may no longer be so tax attractive for parents to have to give up this control or flexibility when making an investment for the benefit of a child. While the benefit of a bare trust would still be that the child's annual CGT exemption can be used the alternative, a discretionary trust, may not be so detrimental. It will all depend on the facts.

The abolition of the settlor-interested trust rules will mean that the trustees will have a maximum of one-half of the ordinary annual exemption available – which would halve the "CGT cost" of using other than a bare trust where, under the current rules, the parental settlor had less than one-half of their annual exemption available (ie because the same settlor has created more than one settlement). If the settlor would have had more than one-half of the unused annual exemption available then the abolition of the settlor - interested trust rules could actually be detrimental to discretionary trusts.

So, there is likely to be some new factors to take into account in determining the extent of the CGT price that a settlor has to pay for retaining legal control over investments for children.

Currently we only have draft legislation so absolute certainty over this issue is not yet available.

REGISTRATION DEADLINE FOR INDEPENDENT TRUSTEES

Independent trustees of pension schemes will need to register with HMRC by 1 April 2008 under the new money laundering regulations

HMRC is the supervisor for Trust or Company Service Providers where the business is not supervised by the FSA or a designated professional body. Unless independent trustees of pension schemes are so supervised they will need to register with HMRC by 1 April 2008. Registration will mean that HMRC will check that the firms/individuals have the appropriate money laundering procedures and controls in place. Failure to comply with the registration requirements may result in fines or, in extreme cases, imprisonment.

Pension schemes which have professional trustees should check that they have been registered appropriately.

GUIDANCE ON VOLUNTARY EMPLOYER ENGAGEMENT IN GPPs

The Pensions Regulator has published guidance on voluntary employer engagement in GPPs.

The guidance, produced in consultation with the Financial Services Authority, provides support to employers who offer a contract-based defined contribution (DC) pension scheme by:

- identifying ways in which they might choose to be involved in the governance of the scheme - referred to as 'employer engagement';
- considering employer engagement options, for instance by involving advisers, employer representatives, employees, management committees and trustees in reviewing the operation of the scheme;
- describing the specific functions an employer may like to consider for review; and
- providing case studies which give employers practical examples of effective engagement.

The guidance is voluntary and there is no statutory requirement for employers to follow what is set-out. However, all employers must ensure that they comply with their legal obligations (for example, payment of contributions on time).

Alongside the guidance the Pensions Regulator has also published a Defined Contribution Update. The Update details the progress towards meeting the Regulator's commitments in relation to work-based DC schemes, forthcoming guidance and also includes extensive independent qualitative research findings.

The Defined Contribution Update relates to work-place DC schemes, which includes trust-based schemes, contract-based group personal pensions with a direct payment arrangement and stakeholder pension schemes.

INCOME PAID TO MINOR BENEFICIARIES UNDER A DISCRETIONARY TRUST

Parental settlement
Minor unmarried child a beneficiary
Assessment of income to tax
Accumulation and capitalisation of income

We had occasion recently to review the tax treatment of income arising to a discretionary trust which is accumulated by the trustees and distributed to a beneficiary at a later date. The trust had been established for the benefit of a minor unmarried child of the settlor not in a civil partnership.

In these circumstances, provided neither the settlor nor the settlor’s spouse can benefit under the trust, income paid to or for the benefit of the child will be taxed on the parental settlor if it exceeds £100 gross in a particular tax year – section 629 ITTOIA 2005. Under section 646 ITTOIA 2005 the parental settlor can reclaim any tax he or she has paid from the trustees – section 646 ITTOIA 2005.

Where instead the trustees accumulate the income then it is assessed to tax on the trustees at 40% (32½% for dividends). If the trustees make an irrevocable decision to retain or accumulate the income as capital of the trust then it is capitalised and when it is later paid to a beneficiary it is not subject to tax.

If the trustees do not make such a decision and later make a payment to a beneficiary then, to the extent the payment can be matched to undistributed income of the trust, it is treated as paid to or for the benefit of the child and assessed to tax on the settlor, again under section 629 ITTOIA 2005, if it exceeds £100 gross in the tax year – section 631 ITTOIA 2005. The right to reclaim any tax paid from the trustees would also be available.

HMRC "CONCESSIONS" ON TAX PROPOSALS FOR NON-DOMICILIARIES

HMRC makes four minor "concessions"

On 12 February, HMRC clarified four aspects of the proposed rules on the tax treatment of non-domiciliaries that are due to come into force on 6 April 2008. HMRC stated:

- those using the remittance basis will not be required to make any additional disclosures about their income and gains arising abroad. So long as they declare their remittances to the UK and pay UK tax on them, they will not be required to disclose information on the source of the remittances;

- there will be no retrospection in the treatment of trusts and the tax changes will not apply to gains accrued or realised prior to the changes coming into effect;

- money brought into the UK to pay the £30,000 charge will not itself be taxable;

and

- it will continue to be possible to bring works of art into the UK for public display without incurring a charge to tax.

In addition, HMRC is also in discussions with the US authorities as to how the £30,000 charge could be treated as a credit against US tax. This is on the basis that although the £30,000 charge is not technically a payment of income tax it is to be collected and administered as though it were. HMRC has stated elsewhere that it is down to other countries to decide whether it is income tax in terms of a double tax treaty and so eligible for treaty relief to prevent double taxation.

PRE 22 MARCH 2006 TRUSTS – LAST CHANCE TO CHANGE BENEFICIARIES WITHOUT TAX COMPLICATIONS

For trusts in existence on 21 March 2006, (where no property has since been added), the changes made to the IHT trust regime on 22 March 2006 mean that 5 April 2008 is the last day that

- Qualifying interest in possession trusts can take advantage of the transitional serial interest provisions. This means, broadly, that if the person with the interest in possession [default (or named) beneficiaries under "flexible trusts"] are to be changed, one such change can be made before 6 April 2008 without the trust being subject to the IHT discretionary trust regime.

- Qualifying A&M trusts can alter their terms (if the trust permits) so that they do not fall into the IHT discretionary trust regime from 6 April 2008. This can be done by giving beneficiaries an absolute entitlement to benefits at age 18. Alternatively, if absolute entitlement vests between ages 18 to 25, a modified discretionary regime will then apply.

NOTIONAL EARNINGS CAP FOR 2008/09

The Registered Pension Schemes (Modification of the Rules of Existing Schemes) Regulations 2006 [SI 2006/No 364] modify the rules of existing pension schemes that automatically became registered pension schemes on 6 April 2006 for a certain period, called the "transitional period".

One of the features of the modification regulations is the preservation of the effect of the permitted maximum (earnings cap) on existing pension schemes to which the modification regulations apply during the transitional period. For tax year 2008/09 the permitted maximum figure has been fixed at £117,600.

PENSIONS MISCELLANY

- Section 177(2) of the Pensions Act 2004 provides that the amount of the pension protection levies raised for a financial year must not exceed the levy ceiling for that financial year and section 178(3)(a) of the Pensions Act 2004 provides that the levy ceiling must increase each year in line with any increase in the general level of earnings in Great Britain. The general level of earnings increased by 3.6% for the period of 12 months ending 31 July 2007 and therefore the levy ceiling for the financial year beginning 1 April 2008 is £833,410,200.

- An annuity interest rate of 0.6% is to be used for SMPI illustrations issued on or after 5 April 2008. This represents a decrease of 0.2% in the annuity interest rate over that used currently and should mean the pensions quoted should be lower in next year's illustrations.

- The Personal Accounts Delivery Authority (PADA) has launched its first consultation paper "Building personal accounts: choosing a charging structure". This relates to the shape of the charges rather than the actual level of charges.

  According to the accompanying press release the consultation will close on 22 April 2008 and PADA will publish its response by 15 July 2008. There are two further consultations planned – one looking at fund structures and investment choices; and the other looking at the scheme's rules.

NATIONAL SAVINGS

Guaranteed Growth Bonds and Guaranteed Income Bonds have been available from National Savings & Investments since 23 February and replace Capital Bonds, Pensioners Guaranteed Income Bonds and Fixed Rate Savings Bonds which were withdrawn from sale from that date.

Guaranteed Growth Bond (GGB)

The GGB is a lump sum investment with an interest earning period of 1 year, 3 years or 5 years. The compound rate of interest payable is fixed for the term, and gross rates are currently 3.95% for 1 year, 4.0% for 3 years and 4.05% for 5 years. Interest is credited to the Bond at the end of each year to build up the value of the investment. Interest is credited net of 20% tax and is assessable to tax in the tax year in which the interest is credited. Early encashment is possible – see below.

Guaranteed Income Bond (GIB)

The GIB is also available for terms of 1, 3 or 5 years. Guaranteed interest is paid to a bank or building society account, monthly in arrears, net of 20% tax. The interest is assessable to tax in the tax year of payment. Gross rates of interest are currently 3.85% for 1 year, 3.90% for 3 years and 3.95% for 5 years.

Main features common to both

- The maximum investment is £1 million. The £1 million figure represents the total of all holdings, both individual and joint, in GIBs, GGBs and Fixed Rate Savings Bonds. For example if an individual has £400,000 of GIBs he could only have £600,000 of GGBs.

- The minimum investment is £500 per Bond.

- Both are available to any individual aged 16 or over, and two such individuals jointly.

- In certain circumstances trustees can invest.

- Early encashment is possible with no minimum encashment amount, but at least £500 must remain in the Bond after encashment. There is a penalty charge of 90 days interest, whether or not the Bond has run for 90 days, unless the payment is made on death.

REPORTING REQUIREMENTS FOR CHARGEABLE LIFETIME TRANSFERS

Draft regulations published

Draft regulations, effective from 6 April 2007, were published on 5 February and HMRC intends to publish the final regulations in early March following a short consultation period. For this reason what follows is a summary of the proposed changes– a more detailed analysis will follow when the final regulations are available.

Background

Currently no account has to be sent to HMRC where the value transferred by chargeable lifetime transfers (CLTs) made by an individual in any tax year does not exceed £10,000, and the aggregate cumulative value transferred by all CLTs in the past 10 years does not exceed £40,000. Special limits apply on the termination of an interest in possession.

As regards periodic and exit charges arising under a relevant property trust (i.e. a trust subject to the IHT discretionary trust regime), an account has to be completed when such an event occurs regardless of the amount involved and whether any tax is due. The only exception to this rule is where, broadly, a trust's sole asset is cash of less than £1,000 - see also under "chargeable events" below.

CLTs

No account has to be delivered when the CLT is an "excepted transfer". Whether a CLT will be an excepted transfer depends upon the nature of the assets being gifted:-

Cash and quoted stocks and shares

For a transfer of cash and quoted stocks and shares to be an excepted transfer, the cumulative total of all CLTs made by the transferor in the **seven** years preceding the current transfer, but including the current transfer, must not exceed the nil rate band for the year of transfer (currently £300,000).

Assets other than cash and quoted stocks and shares

For a transfer of assets other than cash and quoted stocks and shares to be an excepted transfer

- the value of the current transfer plus the cumulative total of all CLTs made by the transferor in the **seven** years preceding the current transfer, must not exceed 80% of the nil rate band (currently £240,000) **and**

- "the value transferred by the transfer of value giving rise to the chargeable transfer" must not exceed the nil rate band less any CLTs made by the transferor in the seven years preceding the current transfer. In this connection the value transferred by the transfer of value giving rise to the CLT is the loss to the transferor's estate.

For example, assume that Jack makes a gift of land which gives rise to a transfer of value of £76,000. If Jack has not otherwise used this year's and last year's annual exemption, the CLT is £70,000. CLTs made by Jack in the preceding seven years total £100,000. If one then applies the two tests, the current CLT of £70,000 does not need to be reported because:-

- the cumulative total is £170,000, which is less than £240,000; and

- £76,000 is less than £200,000 [ie. the nil rate band (£300,000) less the CLTs made in the preceding seven years (£100,000)].

The termination of a qualifying interest in possession

No account has to be delivered on the termination of a qualifying IIP under a "specified trust" in two main sets of circumstances. A specified trust is a trust under which a beneficiary was entitled to an IIP before 22 March 2006; a trust for a bereaved minor under section 71A IHT Act 1984; a trust under which there is an immediate post-death interest (IPD1); a trust for a disabled person under section 89 IHT Act 1984 or a self-settlement for such a person under section 89A; or a trust in which there is a transitional serial interest (TS1). The two sets of circumstances are:-

(i) the asset which supported the IIP is cash or quoted stocks and shares and the value of the asset in which the IIP has been lost, plus the cumulative total of all CLTs made by the transferor (ie. the beneficiary who loses his IIP or whose IIP is reduced) in the preceding seven years, does not exceed the nil rate band; or

(ii) for trust assets other than cash and quoted stocks and shares, the value of the asset in which the IIP has been lost plus the cumulative total of all CLTs made by the transferor (ie. the beneficiary who loses his IIP or whose IIP is reduced) in the preceding seven years does not exceed 80% of the nil rate band **and** the value transferred on termination of the IIP does not exceed the nil rate band less any CLTs made the transferor in the preceding seven years.

It would seem that these rules will apply where the termination of the IIP gives rise to a potentially exempt transfer or a CLT.

Chargeable events – relevant property trusts

No chargeable event (ie periodic or exit charge) has to be reported where, broadly, the trust's sole asset is cash of less than £1000.

When the "£1,000" rule does not apply, for periodic and exit charges not to have to be reported the following general rules apply:-

(i) the trust must be a UK trust, the settlor must be domiciled in the UK from inception of the trust and there must be no related settlements; and

(ii) in the calculation of IHT in respect of the chargeable event under consideration, the notional chargeable transfer by the assumed transferor does not exceed 80% of the nil rate band ignoring any liabilities, exemptions or reliefs from IHT.

As there is no reference in the regulations as to the time limits within which an account has to be returned, presumably the current rule of submitting an account within 12 months from the end of the month in which the transfer is made will continue to apply.

BUDGET 2008

The Budget 2008 speech has been scheduled for 12:30pm on Wednesday 12 March. If you would like to receive details of our Budget services, please give us a call on 020 7405 1600 or email us at host@technicalconnection.co.uk.