Technical Connection

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THE 10% TAX BAND

The Government does a U-turn
Age allowance limits change
PAYE codings

In the 2008 Budget, the application of the 10% tax band (£2,320 for 2008/09) was restricted to savings income. However, non-savings income (which includes earnings and pensions) takes priority in a tax calculation and is taxed **before** savings income. For people with both types of income, this means that non-savings income will absorb the 10% tax band before savings income and savings income will benefit from the 10% rate only to the extent it has not been exhausted by non-savings income. Any non-savings income which uses the 10% band will, nonetheless, suffer tax at the 20% basic rate.

It was reported that this change would disadvantage some 5.3m poorer households. In a U-turn, the Government indicated that those who had lost out would be compensated. Compensation will be made by way of an increase in the standard personal allowance by £600 from £5,435 to £6,035. To ensure that higher rate taxpayers do not benefit from this change the higher rate threshold reduces from £36,000 to £34,800. The changes are effective from 6 April 2008. It has since been reported that the Treasury has confirmed that "for future years its aim is to continue the same level of support".

One consequence of this change is that each of the levels of total income above which the age-related allowance is completely reduced to the standard allowance is reduced by £1,200. The new limits are set out below. The corresponding figures are also shown for 2007/08.

	2007/08	2008/09
	£	£
Taxpayer aged 65 - 74 [personal allowance]	25,550	27,790
Taxpayer aged 65 - 74 [married couple's allowance]	33,240	35,780
Taxpayer aged 75 and over [personal allowance]	25,830	28,090
Taxpayer aged 75 and over [married couple's allowance]	33,680	36,260

Following the Chancellor's announcement of the increase in the personal allowance, HMRC issued a press release to explain that employers do not need to make any adjustments to employee PAYE code numbers at the present time. Furthermore employers should continue to use the allowances and guidance published in May 2008.

HMRC will be issuing details in the next few weeks of how and when the change to coding should be made and what it will mean to payroll.

FSA CONFIRMS ONGOING ANALYSIS OF PENSION TRANSFER ADVICE

The FSA has now issued its Retail Thematic Work for 2008/09 which includes an analysis of pension transfer advice (including SIPPs). This indicates: "Customers who seek advice on pension transfers should expect to receive advice that is suitable and meets their individual requirements. Since A-Day simplification in April 2006, when new pension tax simplification rules came into effect, we have identified significant growth in single premium transfers into self-invested personal pensions (SIPPs).

Transfers into SIPPs may be appropriate for some consumers, but they may not be suitable for everyone. Switching to a SIPP from some pension products – particularly those with high exit fees or lower investment risk - could result in potential financial detriment to some consumers. We began exploratory work in 2007, during which we also identified a significant growth of single premium transfers into personal pension plans (PPPs) more generally. As a result of this work, the next stage of the project will be to assess the quality of advice firms give consumers transferring into PPPs, including SIPPs. The intended outcomes of the project are that consumers are given suitable advice when considering such transfers and firms have regard to TCF outcomes when designing and marketing PPPs and SIPPs. We will do this through questionnaires to firms, desk-based research, file reviews and supervisory visits."

The findings are expected to be published in the fourth quarter of 2008.

COMMENT

This is a reminder from the FSA that SIPPs/deferred SIPPs are not right for everyone. This is especially so where the self selection of investment assets is not used, or unlikely to be used, by the member.

THE BURDEN SISTERS CASE

The Burden sisters lose their appeal in the European Court of Human Rights

The Burden sisters have lost their appeal in the European Court of Human Rights. The two sisters have resided together in the family home throughout their lives. On the death of the first sister the survivor will need to sell the property to pay inheritance tax. The sisters argued that they should be treated in the same way as a couple who are spouses/civil partners so that property passing to the survivor on first death would be exempt from inheritance tax and the payment of tax would be deferred until the second death.

By a 15-2 majority the Court ruled that the position of siblings is not inequitable. This supported the UK Government's argument that there was a difference between married couples/registered civil partners and siblings because couples choose those who they are in a relationship with whereas the relationship between siblings is one of consanguinity. No further appeal is possible.

FSA CONSULTS ON CONTRACTING OUT COMPARISONS FOR SIPPs

In preparation for the ability of SIPPs to hold protected rights from October 2008, the FSA has launched a consultation on the requirement for SIPPs to provide comparison quotes with S2P where a member is using the SIPP to contract out. The comparison required will be the same as that currently applicable where a member contracts out under an appropriate personal pension scheme. The FSA has indicated "we do not propose to change the current assumptions firms must make when producing Contracting-Out Comparisons for the new application of these disclosures to SIPPs. Nor do we, at this stage, propose to require SIPPs to produce projections of potential benefits for non-Protected Rights or transfers of existing Protected Rights." It does, however, go on to indicate that in Policy Statement 07/18 – Conduct of Business Regime, published in October 2007 - it said it would conduct further work to gauge the effectiveness of the projections rules in the light of developments in the SIPP market, and that it will provide an update on its views on this wider matter later this year.

The FSA also warn that "we wish to remind firms that any increase in transfers of funds to SIPPs to secure Protected Rights must reflect our advice and suitability rules."

NEW IR 20 BOOKLET PRODUCED

HMRC has produced an update of the IR20 booklet on residence and domicile which was last updated in December 1999. Amendments have been made to reflect developments since then, changes to cross-referenced material and changes to contact points arising from the merger of the Inland Revenue with HM Customs & Excise. Some of the guidance originally included has been removed from this updated version as it is no longer relevant. Where a section of guidance has been removed, its deletion is highlighted.

HMRC is expected to publish full replacement guidance to cover any changes to the residence and domicile rules included in the 2008 Finance Act.

NEW TAX RULES FOR OWNERS OF SECOND HOMES

A brighter tax outlook for owners of second properties

Changes in the tax legislation in the Finance Bill 2008 will remove the possible threat of tax for persons who buy second homes via a limited company.

The background to these changes is that over the last 10 years or so there has been a dramatic increase in the number of UK residents purchasing property, particularly overseas, for either holiday or retirement use. Many of those people would have been advised to acquire the offshore property by means of purchasing shares in a company which, in turn, owned the property.

There were several reasons why property owners used companies as the ownership vehicle, none of which had anything to do with UK tax. In France, Spain and Portugal, for example, this would have been done to avoid the "forced heirship" rules in those countries. Other countries restrict foreigners from owning land or property personally.

Until 1999, few people – including tax advisers – realised that there was a potential UK tax charge when UK residents bought properties intended for their own use via a company. However, the decisions in two legal cases highlighted the fact that in such cases a potential tax charge arose where the individual concerned was a director of the company that owned the property or acted as a "shadow director".

Under the appropriate tax legislation, where a director of a company is accustomed to act in accordance with the directions or instructions of another individual, then that "directing" person will be deemed to be a "shadow director" and will fall within the benefit-in-kind rules. These impose income tax liabilities on the cash value of services and benefits received. Here the service received from the company would be the accommodation the director occupies, free of charge.

Even if the company that owned the overseas property had its own appointed directors, it was likely that those directors would act on the instructions of the investor who had provided the funds to buy the property. Consequently, such investors would be deemed to be shadow directors and would be facing what would be substantial benefit-in-kind charges in the UK for what were essentially domestic arrangements.

It was announced in the 2007 Budget that an exemption would be introduced with retrospective effect, designed to avoid this problem for most of the people affected.

The draft legislation indicated that the benefit-in-kind charge would not apply where the offshore property was owned by a company that did nothing other than hold the property, where the share capital was owned by the individual – alone or with other individuals – and no funding had been given from a connected company.

A number of gaps in the original draft legislation have now been dealt with in the Finance Bill 2008.

The exemption has been extended to include cases where the property-owning company is, in turn, owned by a holding company which does nothing other than own the shares in the property company. The definition of a property-owning company has been expanded to cover companies in France and America. It will also enable the property to be rented out to third parties when not being used by the family.

COMMENT

Once the new legislation comes into force on the enactment of the Finance Bill 2008, it will be retrospective. This means that it will be possible for anyone who has paid tax to claim repayment for the previous 20 years, provided the new tests would have been met in those years.

The new legislation will not, however, provide an exemption where the shares in the property-holding company are owned by a family trust.

PADA FRAMEWORK DOCUMENT ISSUED

The Personal Accounts Delivery Authority (PADA) Framework Document has been issued. This has been drawn up by the DWP in consultation with PADA, and sets out the framework within which PADA will operate in its advisory phase. It will be updated for the executive phase of PADA following Royal Assent to the Pensions Bill 2008.

The document includes:

- the Authority's overall aims, and sets out how its objectives and key targets shall be agreed, and how these support the DWP's wider strategic aims, Public Service Agreements and DWP Strategic Objectives;
- the rules and guidelines relevant to the exercise of the Authority's functions, duties and powers;
- the relationship between the DWP and the Authority;
- the conditions under which any public funds are paid to the Authority; and
- how the Authority is to be held to account for its performance.

FOREIGN DIVIDENDS AND TAX CREDITS

The 10% tax credit for foreign dividends
The treatment of foreign withholding tax
The exclusion of certain offshore funds

It was announced in the Budget 2008 that from 6 April 2008 a 10% tax credit would be available on dividend income from non-UK resident companies where the recipient shareholder has a shareholding of less than 10% in the non-UK resident company(ies).

(a) Foreign withholding tax

What was not clear at the time of the Budget announcement was how the new system would operate on dividends from foreign companies, where there is usually an element of foreign withholding tax to be considered. The answer is to be found in Schedule 12 of the Finance Bill 2008. It makes slightly surprising reading, as it is clear that the Government has decided to give the new 10% non-payable tax credit on top of any credit for foreign withholding tax.

The best way to understand what is happening is to consider an example. Take a higher rate taxpayer who received last December a dividend payment from a Spanish company as follows:

Gross dividend	£1000.00
Spanish tax @ 18%	(£180.00)
Net dividend received	£820.00

As a higher rate taxpayer the additional UK tax due on the dividend was:

UK liability £1000@ 32.5%	£325.00
Credit for Spanish tax	(£180.00)
Additional tax payable	£145.00

Were the same dividend to be paid now, the calculation would be:

Gross Spanish dividend	£1000.00
UK tax credit (1/9th Spanish dividend)	£111.11
Gross dividend for UK tax	£1111.11

The additional UK tax liability now becomes:

UK liability £1111.11 @ 32.5%	£361.11
UK tax credit	(£111.11)
Credit for Spanish tax	(£180.00)
Additional tax payable	£70.00

Thus the additional liability is more than halved as a result of the change. How much of a saving stems from the new system depends on the rate of foreign withholding tax. The higher the withholding tax, the greater the proportionate drop in additional UK tax. Once the withholding tax reaches 25% or more, under the new system there is no additional UK tax for the higher rate taxpayer. This new system is therefore good news for many holders of foreign shares.

(b) Offshore funds

As mentioned in the opening paragraph, the 10% tax credit is available in respect of dividends received from non-UK resident companies. Non-resident companies include offshore funds structured as companies such as an OEIC.

An offshore fund invested in, say, fixed interest stocks or cash could therefore pay a dividend to a UK resident taxpayer accompanied by a 10% tax credit. A UK resident investor who invested in an identical UK-based fund would receive instead an interest distribution which does not carry a 10% tax credit. By switching to the offshore equivalent, the UK investor could therefore increase his net income by 25% as a result.

To rectify this loophole, an amendment to the Finance Bill has excluded offshore funds from the benefits of the 10% tax credit. However, the amendment, as tabled, does not affect all offshore funds.

It specifically refers to 'an offshore fund (within the meaning of section 756A of ICTA)', which basically means a collective fund for the purposes of section 235 Financial Services and Markets Act 2000. This will catch open-ended offshore funds, including exchange traded funds, but not closed-end investment companies (ie. companies with a fixed share capital like a UK investment trust). As a result:

- Distributions from offshore collective funds will be taxable as dividends in the same way as previously, ie. dividends are paid gross and the basic rate taxpayer has a 10% liability, while the higher rate taxpayer has a 32.5% liability. These rates apply even if the fund is purely invested in fixed interest securities or cash.

- For offshore closed-end investment companies, the 2008/09 tax treatment introduced in the Budget will apply, ie. distributions will benefit from a 10% tax credit. This makes offshore income-oriented investment companies (including some property investment companies) very attractive from an income tax viewpoint.

NEW PENSION TRANSFER VALUE CALCULATION RULES OUTLINED

The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008 – SI 2008/1050, set out the new transfer value calculation rules to apply with effect from 1 October 2008.

The main changes introduced by these Regulations are:

- Trustees (scheme managers, where appropriate) will be responsible for calculating cash equivalents.
- The method of calculation in the Regulations sets the minimum amount for the cash equivalent, although trustees can pay higher amounts if they wish.
- Trustees will be required to determine the assumptions to be used in the calculation on a 'best estimate' basis.
- Trustees will, as currently, be able to reduce the cash equivalent where a scheme is underfunded.
- Trustees will be able to reduce the cash equivalent to recover any 'reasonable administration costs' in carrying out the transfer.
- Members considering whether to transfer will be told where more information is available to help them make their decision.

THE GAP BETWEEN LEVEL AND INFLATION-LINKED ANNUITIES HAS RISEN

What is the difference between the starting rate for a level annuity and an RPI-linked annuity for a 65 year old male?

If your reply is that the index-linked annuity is about a third lower, you would have been right – well at least until recently. However, as at 27 May 2008 the answer is not far short of 40%. The top level annuity rate is 7.77%, while the best index-linked rate (from a different provider) is 4.75%.

The widening difference comes at a time when a jump in inflation may make more people think about RPI-linked annuities. The gap between index-linked and conventional annuities depends upon two factors:

1. Life expectancy. The greater the life expectancy, the bigger the initial difference in income. For example, the gap for a man age 55 is 47%. Thus one effect of improving longevity is that, all other things being equal, over time the gap will widen.

2. The other crucial factor is the difference between the nominal yield on fixed rate corporate bonds and the real (ie. inflation-adjusted) yield available from index-linked securities (which are almost entirely government bonds).

The credit crunch-driven rise in corporate bond yields has pushed up level annuity rates over the past year. However, index-linked gilt real yields have moved in the opposite direction. The average real return on 15 year + gilts is now around 0.85% against 1.45% at the start of June 2007.

Whether an index-linked annuity is worth buying depends on two imponderables:

- How long the investor lives, and

- The inflation over their lifetime.

One way to judge the market's long-term inflation assumption is to look at the difference between conventional and index-linked long gilt yields. This throws up a theoretical long-term inflation figure of 3.8% pa, more than enough to give Mervyn King a few sleepless nights.

However, even at 3.8% pa inflation, a 65 year old male will have to wait until his 79th birthday before his index-linked annuity overhauls its level counterpart. For total payments to be equal he will have to wait until he is 90.

If inflation matches the government's implicit target of 2.5% pa for the RPI, then the crossover point moves out to age 85 and the break-even total payment point is 102.

COMMENT

Rising inflation may tempt some people to consider index-linked annuities, but on current rates a would-be purchaser needs to be very long-living or very optimistic that inflation will increase to justify giving up the much higher starting amount from a level annuity.