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PENSION ANNUITIES AND THE OPEN MARKET OPTION

In last month's bulletin we reported the issue of two research papers on the subject of open market options published by the ABI and DWP.

The FSA has now issued the results of its work on open market options under maturing personal pension and stakeholder pension schemes. This review showed up shortcomings in the literature issued to scheme members approaching retirement as well as delays in the payment of annuity benefits where these were set up using the open market option or were transferred to a new provider.

DRUMMOND -v- HMRC

Second-hand life assurance policy capital gains tax avoidance scheme

Appeal against Special Commissioner's decision turned down

The decision was handed down in the Court of Appeal on 23 July 2008 in the case of Drummond -v- HMRC.

The appeal by the taxpayer against the decision of the Special Commissioner involved a second-hand life assurance policy capital gains tax avoidance scheme undertaken in 2001 designed to create an artificial capital loss that could be offset against capital gains made on the sale of a private business.

(Legislation was introduced to block such a scheme for disposals occurring after 8 April 2003 by restricting the allowable loss to the economic loss suffered i.e. surrender value less purchase price).

The bare facts of the case were that Mr Drummond purchased for £1.962 million a number of life assurance policies under which premiums of £1.751 million had been paid. The surrender value of the policies at the time was around £1.751 million. The next day Mr Drummond surrendered the policies. A chargeable event gain of only £1,351 arose which was subject to income tax.

The surrender was also a disposal for CGT purposes. In such a situation, section 37 TCGA 1992 provides relief to prevent double taxation by enabling an investor to make a deduction for assessable income in the CGT calculation. It was contended before the Special Commissioner that, for the purposes of section 37, the amount to be taken into account as a receipt in computing "income" for these purposes was not the chargeable event gain of £1,351 but the actual surrender proceeds of £1.751 million. This would have meant the consideration received by Mr Drummond in the CGT calculation would be nil. Compared with the acquisition cost of £1.962 million, a CGT loss of £1.962 million would have arisen.

The Special Commissioner held that only the chargeable event gain of £1,351 could be taken into account as an income receipt for CGT purposes so severely restricting the allowable loss.

The Special Commissioner's decision relied heavily on Barclays Mercantile Business Finance Ltd v Mawson [2005] STC 1 and on the principle that the approach to tax avoidance is: ´First to decide, on a purposive construction, exactly what transaction will answer to the statutory description and secondly, to decide whether the transaction in question does so.' Thus in the Drummond case the question that had to be asked was: what expenditure, if any, was incurred wholly and exclusively on acquiring the life policies in question?

The answer, in the view of the Special Commissioner, was that there was none: for acquiring the life policies was not the purpose of the expenditure at all, because:

- the life policies for which Mr Drummond paid £1.962 million had a value of only £1.751 million;
- the purchase of the policies made commercial sense only if they were surrendered the following day and a tax loss created; and
- although legally possible, it was ´unthinkable´ that the policies would not be surrendered.

There was in fact no evidence that Mr Drummond wanted to acquire and hold the policies. The entire weight of the evidence was to the contrary. Thus, since acquiring the policies was not in truth the relevant transaction, no part of the £1.962 million fell to be treated as paid for the acquisition of the policies.

In the High Court Mr Justice Norris held that Mr Drummond had properly acquired the policies. Furthermore, he stated that in his view in order to calculate the capital gain when he disposes of them, he is only allowed to deduct "the consideration in money …. given by him…. wholly and exclusively for the acquisition of the asset."

As far as the "wholly and exclusively" point was concerned he found that £1.751 million was incurred "wholly and exclusively", with other incidental costs he expended of £210,000 having to be left out of account. From this consideration he was only entitled to deduct the chargeable event gain of £1,351 arising on surrender because it was only this amount which could be excluded within the relief available under section 37 TCGA 1992. Therefore because, on a statutory interpretation of section 37 no artificial loss arose, there was no need to consider the transaction as a tax avoidance scheme. It was not stated by the Judge but it would seem that on this construction the tax loss that arose was equal to the chargeable event gain of £1,351.

TRUSTEES FOUND PERSONALLY LIABLE FOR UNLAWFUL LOAN TO COMPANY

The Pensions Ombudsman has ruled that all the trustees of the Greenup and Thompson Limited Pension Scheme, including member-nominated trustees, were in breach of trust regarding an unsecured loan made to the scheme's sponsoring employer in July 2000. The Ombudsman held that the whole trustee board are personally liable for the outstanding loan of £130,074.

In June 2000, the employer requested an unsecured loan of £150,000 from the scheme, to be repaid by 31 December 2000, in order to purchase another company. Although the employer was in arrears on contributions (during the period from 1 January 2000 to 31 October 2000 the employer had been unable to pay any of the £84,614 contribution due) and in poor financial health, the trustees agreed to the loan. In September 2001 the scheme entered winding-up and the employer went into voluntary liquidation.

The statutory independent trustee, who was appointed in February 2002, informed the Pensions Regulator when it became aware of the loan on 10 June 2002. The Pensions Regulator concluded that the trustees had committed a criminal offence by agreeing to the loan. The independent trustee then brought a complaint about the trustees' conduct to the Pensions Ombudsman. Although it did so outside the Ombudsman's usual three year time limit, the Ombudsman accepted jurisdiction on the grounds that the delay in bringing the complaint could be attributed to the Pensions Regulator's prior involvement.

The Ombudsman concluded that the trustees had committed a breach of trust in making the loan. Their decision had fallen below that of a prudent man. Since the making of the loan constituted an investment decision, the Pensions Act 1995 prevented the trustees from relying on any exoneration and indemnity provisions in the scheme rules.

The trustees claimed to have relied on advice, but there was no evidence that any advice had been received on whether the loan was prudent. The Ombudsman ordered the trustees to compensate the scheme for the loss resulting from their decision to make the loan.

COMMENT

Although there was no evidence of fraud or dishonesty, the trustees were held personally liable in this case for failing the "prudent man" test. This leaves a clear message that before making any investment decision trustees should seek professional advice.

INVESTMENT TAXATION – THREE CONSULTATION PAPERS ISSUED

At the end of July the Treasury issued three consultation papers on various aspects of investment taxation as follows.

1. Tax elected funds

One of the complaints of the UK investment industry is that it has lost out to Ireland and Luxembourg as a location for pan-European and international funds because of UK tax rules. It has been estimated that Ireland's collective investment funds are now almost equal in value to the UK's, while Luxembourg's are nearly two and a half times as great.

Somewhat belatedly the Treasury is proposing a partial remedy to the situation by the introduction of 'Tax Elected Funds' (TEFs). The main features of these would be:

- Authorised unit trusts and OEICs would be able to elect for TEF treatment, subject to satisfying certain conditions.
- Investment gains would be free of tax within the fund (as now).
- UK dividend income received by a TEF would pass through and be paid as a UK dividend, with the accompanying non-reclaimable 10% tax credit for UK investors.
- Foreign dividend income would not be taxed within the TEF.
- The document states that 'the Government is minded to stipulate that funds electing to be a TEF will not be permitted to invest in property'. However, it then qualifies this by suggesting that consideration will be given to allowing 'a small proportion' of property investment for mixed funds.
- Other investment income would not be taxed within the fund and would be distributed as an interest payment and taxed accordingly in investors' hands.

2. Investment trust companies

Within an HMRC authorised investment trust company all income, other than UK dividends, is currently subject to corporation tax (normally at 28%).

The Treasury proposal for investment trust companies is that they will be able to opt to separate out their interest income and have this taxed at 20%. All other income would be taxed as now. Investors would then be subject to tax on the separate dividend and interest elements of each distribution.

The AIC has welcomed the proposal, which would make UK-based fixed interest investment trusts a more tax-efficient proposition. However, going offshore would still be more beneficial:

- There is no internal tax on any income (although withholding tax could apply).

- Dividends paid to investors now come with a 10% notional tax credit thanks to the Finance Act 2008, so interest can pass direct to basic rate taxpayers with no tax charge. Higher rate taxpayers only face an effective 25% charge.

3. Qualified investor schemes

The qualified investor scheme (QIS) is an FSA authorised investment fund open primarily to institutional or sophisticated individual investors, i.e. not retail investors.

The QIS regime was perceived by HMRC as potentially offering tax advantages to certain investors in a similar way to 'personal' unit trusts. The result was an anti-avoidance rule in Finance Act 2005 which imposes a tax charge on certain non-institutional investors if their holdings (either alone or together with connected persons) represent 10% or more of the QIS. This rule has meant that very few QISs have been launched.

The Treasury's proposal is to replace the existing 10% rule with a version of the 'genuine diversity of ownership' rule introduced for Property Authorised Investment Funds. The aim is still to ensure the QIS tax advantages are only available where the fund is 'widely held'. Draft regulations are included in the consultation.

ENTREPRENEURS' RELIEF – CONDITIONS FOR ASSOCIATED DISPOSALS

Finance Act relaxation

Schedule 3 Finance Act 2008 includes a modification to section 169P(4)(d) TCGA 1992 as introduced in the Finance Bill. The modification made concerns entrepreneurs' relief and its application to associated disposals.

As was the case with retirement relief, entrepreneurs' relief is extended to apply to the gain on an associated disposal of an asset outside of a business, e.g. a company, as long as the disposal of that asset takes place at the same time as the disposal of the interest in the business, e.g. the shares in the company itself. The asset must have been used for the purposes of the business for at least the last year.

Perhaps even more important is that where the asset to be disposed of (e.g. a property) has been used by the business, if the property has been let for a commercial rent this will prevent entrepreneurs' relief applying.

In the Finance Bill the period to be taken into account to determine whether commercial letting had taken place was the entire period of ownership. An amendment in the Finance Act ensures that only periods since 6 April 2008 will have to be taken into account. Therefore if the rent paid is less than a commercial amount a proportionate amount of entrepreneurs' relief should be available, and full relief should be available if no rent has been paid.

HMRC ISSUES UPDATED GUIDANCE ON SALARY SACRIFICE

HMRC has issued updated guidance on what constitutes an effective salary sacrifice and how such a sacrifice may impact on pension benefits and contributions, statutory earnings-related payments and the National Minimum Wage.

The updated guidance confirms whether the salary sacrifice must be made for a set period or whether an employee can opt in or out of such an arrangement. It also confirms that HMRC accepts that certain “lifestyle changes” may justify changing a salary sacrifice arrangement before the intended period has elapsed. Although “lifestyle changes” are not specifically defined HMRC indicates that generally this term “is used to refer to unforeseen life events (e.g. redundancy of a partner, pregnancy of employee or partner, marriage or divorce of employee) where an employer might agree to revisit an existing contractual arrangement to take account of a change in circumstances.”

It confirms that it is open to an employer, when a salary sacrifice has been put in place, to ask their local HMRC office to confirm the correct tax treatment of the arrangement.

HMRC confirms that “statutory earnings-related payments such as SMP and SSP are calculated on cash earnings and so will be affected by reductions in cash pay in return for non-cash benefits-in-kind. Whilst SMP and the other statutory payments must be based on cash earnings, employers can, of course, make payments over and above any statutory entitlement and may choose to base those additional payments on the original salary (often referred to as the "notional" salary). The employer can only reclaim statutory amounts calculated on cash pay in accordance with the statutory payment rules.”

However, how other salary-related benefits are calculated is usually up to the employer to decide (e.g. occupational pension scheme contributions, overtime rate, pay rises etc). In such latter cases the employer can decide to base these on the new reduced salary or an unreduced notional salary based on the individual’s pre-sacrifice salary. In either case the way in which benefits are to be determined must be explained to employees.

MAKE THE MOST OF EXCLUDED PROPERTY TRUSTS – WHILE YOU CAN

Domicile is a very important concept for inheritance tax (IHT) purposes. In short, if a person is domiciled in the UK then he will potentially be subject to UK IHT on his worldwide assets. For those who are non-UK domiciled, they will only suffer IHT on their UK situs assets. Therefore, for those people who are non-UK domiciled and wish to make an investment that is IHT efficient, the solution is simple – invest outside the UK.

However, this may not be totally “plain sailing”. The IHT rules use the concept of deemed domicile. This means that, irrespective of legal domicile, a person will become deemed domiciled for IHT purposes once they have been tax resident in the UK for 17 out of the last 20 years. The satisfaction of this test will mean that all of an individual’s worldwide assets will suddenly become subject to IHT. And with the recent change in the remittance basis for income tax and capital gains tax linked to UK residence of 7 out of the last 9 tax years, we may even in the future see a reduction in the number of years of residency that will cause a person to become deemed UK domiciled for IHT purposes.

So for the non-UK domiciled person who has been resident in the UK for a number of years and is facing UK deemed domiciled status in the foreseeable future, what action can they take to protect their assets against UK inheritance tax? Well, for such a person, help is at hand in the shape of an excluded property trust.

An excluded property trust is basically a discretionary trust that satisfies two conditions:-

(i) it is established when the settlor is non-UK domiciled for IHT purposes
(ii) it only invests (and remains invested) in excluded property (see below)

The trust must therefore be established before the settlor has UK deemed domiciled status for IHT purposes (ie. currently before he/she has lived here for 17 tax years).

By "excluded property" we mean all overseas property, UK authorised unit trusts and OEICs and UK gilts. Many persons with overseas links will prefer the 'feel' of offshore investments and for those people offshore collective investments – such as offshore (life assurance) bonds and offshore funds – will appeal. Indeed, offshore bonds provide a very tax efficient wrapper for the non-UK domiciled investor in the new rigid remittance basis regime.

Another huge benefit of the excluded property trust is the fact that the settlor can be a potential beneficiary under the trust without there being a gift with reservation of benefit. This is because the excluded property rules override the gift with reservation provisions. HMRC has recently reconfirmed that this is their view of the legislation and this means that an individual can establish an excluded property trust as a means of saving IHT and yet still have access to the trust funds.

PENSIONS REGULATOR ISSUES DRAFT GUIDANCE ON THE CALCULATION OF TRANSFER VALUES

The Pensions Regulator has now published its draft guidance on the calculation of cash equivalent transfer values (CETVs). Comments are required on this by 19 September 2008.

From 1 October 2008, trustees will become solely responsible for the calculation of transfer values from a DB scheme. The legislation establishes a framework which provides for the calculation of an "initial cash equivalent" (ICE) which is then adjusted, if necessary, to arrive at the final CETV available to the member to transfer. The ICE must place a value on the member's accrued benefits together with any options and discretionary benefits that the trustees decide should be included.

A transfer value in respect of defined benefits is calculated on actuarial principles as the capital sum which, if invested appropriately, is expected to provide the relevant member's benefits as they fall due. The calculation requires assumptions to be made about many factors, including investment returns, mortality rates, inflation rates and the relative age of any dependant(s). These are necessarily somewhat subjective and require the trustees to take decisions.

The assumptions must be chosen with the overall aim of leading to a best estimate of the ICE. This is a best estimate of the amount of money needed at the effective date of the calculation which, if invested by the scheme, would be just sufficient to provide the benefits. However, trustees should recognise that 'best estimate' is not a precise concept and they will often need to be pragmatic and accept choices which seem to them reasonable in the light of the information and advice they have obtained. When deciding on the assumptions for this best estimate, and to put them in a position to make informed decisions, trustees must seek advice from their actuary. The DWP has made clear that some of the individual assumptions need not be on a best estimate basis, provided that a best estimate is the overall result.

This guidance is designed not only to clarify some of the issues relating to the new calculation rules but also to cover a number of areas that have not been addressed by the Regulations, including the calculation of transfer payments where there is not a statutory right to a CETV and where benefits are provided by a scheme in respect of a transfer in.

The Pensions Regulator is particularly seeking views on its proposed guidance in certain areas such as discretionary benefits, investment strategy, reductions for underfunding, cash transfer sums, transfers in, disclosure and administration expenses.

STATUTORY LEGACIES ON INTESTACY TO BE INCREASED

On 28 August the Government announced an increase in the statutory legacy on intestacy in England and Wales from £125,000 to £250,000 where the deceased leaves a spouse or civil partner and children; and from £200,000 to £450,000 in all other cases.

The Government is proposing to introduce these increased amounts from 1 February 2009.

OFFSET MORTGAGE INTEREST AND COUNCIL TAX

An opportunity for the self-employed to reduce their income tax bills – but at a possible CGT cost

This is not so much a change of approach but more a welcome confirmation of current practice. New guidance issued by HMRC in BIM 47825 states explicitly that self-employed workers can offset their mortgage interest and council tax against their income tax bill – on the basis that part was incurred wholly and exclusively for the purpose of their trade. These are expenses that some accountants have traditionally believed to be “off-limits”. A spokesman for HMRC said that the self-employed had always been able to offset interest, but conceded that this was the first time the matter had been formally clarified.

Of course, by claiming that a part of the private residence is used for business purposes, this will correspondingly restrict the amount of capital gains that qualify for the CGT principal private residence relief when the house is sold. Normally this will relate to the proportion used for private purposes.

And that’s not all. The HMRC guidance also gives useful examples about claiming other expenses such as heating, electricity and external redecoration. A proportion of various costs can be claimed provided certain criteria are met, for example an area of the home is used exclusively for business purposes for a prescribed amount of time.

COMMENT

Where a self-employed person works at home – either solely or in addition to a separate place of work – it is possible to claim business expenditure linked to an appropriate proportion of the expenses incurred on that area of the home. This means that if the individual is paying mortgage interest and, say, 25% of the home is used for business purposes, 25% of the total interest would be a deductible expense.

If the trader is planning to sell the property in the foreseeable future, they may wish to tread carefully before claiming the relief as if the part of the capital gain that relates to the business part of the property exceeds the annual CGT exemption, a CGT liability will arise at 18% on the excess. It may be possible to defer this by claiming CGT roll-over relief if business usage will continue in the new property.