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NON-DOMICILIARIES

HMRC has recently issued another set of questions and answers relating to UK resident but non-UK domiciled individuals.

The subjects covered are

- capital losses
- personal allowances
- remittances
- non-resident trusts

These will be of considerable interest to advisers who have clients who are likely to be affected by the new tax rules on non-UK domiciliaries.

DISCOUNTED GIFT TRUSTS

HMRC announces a change to the valuation rate of interest

On New Year's Eve (!) HMRC announced a reduction in the valuation interest rate used for the retained benefits within discounted gift trusts. The new rate is 5.25%, effective from 1 February 2009. The present rate is 6.75%, a level which has been unchanged since 1 September 2007.

The size of the revision – 1.5% - is evidence that HMRC has been well behind the curve in reviewing the rate. When HMRC made the last change, it said that the basis for the revision was to restore "the differential over short-term gilts to 1%". In discussion with them at the time information was gleaned that:

- HMRC did not normally expect to change interest rates more than once every three months.

- It had no specific index or individual gilt to which it referred, but its benchmark was 4-5 year gilts generally.

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

- It aimed to give about six weeks' notice of any revision.

- Although the then measure was short gilts + 1%, HMRC reserved the right to change it if pricing altered in the market for sales of life interests and similar rights.

The current yield on 4-5 year gilts is in the region of 2.5%-2.8%, which would suggest a discount rate of perhaps 3.75% rather than 5.25%. This points to HMRC having changed its interest rate basis without making any formal announcement. HMRC has since confirmed that it had been awaiting the outcome of "the AXA case" (ie the Bower case) before making any changes to the discounted gift valuation basis. The written High Court judgement (in favour of HMRC) has yet to be published and there remains a possibility that the case might go to the Court of Appeal. Only the recent sharp fall in short-term interest rates prompted HMRC to make the New Year's Eve announcement of a rate change.

The 1.5% interest rate reduction is therefore unlikely to be the end of matters and a more detailed announcement about the overall valuation basis can be expected at some stage. This will reflect the Bower judgement.

Although the move from 6.75% to 5.25% was a substantial one, HMRC confirmed that the 6.75% rate (which took effect on 1 September 2007) would apply to all discounted gift schemes established before 1 February 2009. In theory the taxpayer can propose and use an alternative basis, but in practice this would almost certainly prompt a legal challenge from HMRC.

The drop to 5.25% shows that HMRC has moved away from its earlier short-dated gilt + 1% basis (which would give about 3.75%). HMRC's next statement should explain what the new interest rate basis is.

TRANSITIONAL PROTECTION

The deadline for making an election is approaching

Because the introduction of the Standard Lifetime Allowance was a major new departure from previous pension tax regimes it was accepted that the benefits already accrued by some individuals prior to 6 April 2006 (or likely to be accrued by such individuals based on their pre 6 April 2006 pension entitlement) would exceed this new limit. The new rules therefore introduced provisions whereby such people could elect for transitional protection to ensure they were not disadvantaged by the introduction of the new regime.

Two types of protection can be secured by making an appropriate election to HMRC – primary protection and/or enhanced protection. To qualify for primary protection the value of a person's pension rights as at 5 April 2006 had to exceed £1.5 million. A person is able to claim enhanced protection irrespective of the value of his/her pension rights as at 5 April 2006, although such protection will normally be lost where any contributions are paid to the pension scheme on or after 6 April 2006 (or normally where benefits have continued to accrue for the individual under a final salary scheme on or after 6 April 2006).

The freezing of the Standard Lifetime Allowance at its 2010/2011 tax year level will mean that more people are likely to have pension benefits that will be affected by the Lifetime Allowance charge in the future. By making an election a person may be able to take advantage of enhanced and/or primary protection and therefore remove or reduce this liability. However, the deadline for making such an election ends on **5 April 2009** and so if a person is likely to be affected urgent action is needed.

HMRC has recently issued a revised APSS200 (election for enhanced and/or primary protection) form. The changes to the form are only very slight and are designed to make it easier to complete. Along with the revised form, HMRC has also included some useful notes setting out guidance including the following:

- Details of the 5 April deadline and late submissions
- Common errors in completing the APSS200
- Amendments to the election post deadline

ISAs

The latest list of persons authorised by HMRC as managers of ISAs was published on 15 January. Inclusion on the list means that HMRC is satisfied that the manager is authorised but does not mean that the manager is able to manage ISAs satisfactorily. HMRC advises that independent advice be sought if there is any doubt about the suitability of an ISA manager in a particular situation.

QUALIFIED INVESTOR SCHEMES

HMRC has issued draft guidance on qualified investor schemes (QISs). These are a form of authorised investment fund (AIF) available only to institutional and sophisticated investors. The guidance explains the new "genuine diversity of ownership" (GDO) condition introduced by secondary legislation, SI 2008/3159, which was laid on the 11 December 2008 and took effect from 1 January 2009.

The new rule ensures that QISs are genuine pooled investment schemes rather than arrangements designed to take advantage of the special tax benefits of an AIF that may in reality be closely held investments for the benefit of a few individuals.

This draft guidance was open for consultation until 30 January 2009.

IHT BUSINESS PROPERTY RELIEF AND HOLIDAY LETS

Historically, HMRC has usually allowed IHT business property relief for holiday lets where

(a) the lettings are short-term, and

(b) the owner, either himself or via an agent, was substantially involved with the holidaymakers in terms of their activities on and off the premises and so can be said to be carrying on a business.

Following recent legal advice, HMRC has reconsidered its approach in this area. It seems HMRC has been too liberal in the past. Therefore, for the future it will be looking more closely at the level and type of services provided, rather than who provided them.

THE EU SAVINGS DIRECTIVE AND LIFE INSURANCE CONTRACTS

The potential extension of the EU Savings Directive to life insurance contracts

Background

The objective of the Savings Directive is to counter tax evasion on cross-border payments of savings income in the form of interest to EU resident individuals by providing for the automatic exchange of information between EU Member States.

On 13 November 2008 the Commission of the European Communities issued a proposal for a Council Directive amending Directive 2003/48/EC on the taxation of savings income in the form of interest (ie the EU Savings Directive). The proposal is a result of the first 3 yearly review of the operation of the Directive.

One aim of the proposal is to extend the scope of the Savings Directive to income equivalent to interest received through investments in some "innovative financial products" and certain life insurance products.

Life insurance contracts

Interest payment is defined in Article 6 of the EU Savings Directive. A new Article 6(e) provides for benefits from a life insurance contract to constitute interest payments if they are "benefits from a life insurance contract where the contract provides for a biometric risk coverage which, expressed as an average over the duration of the contract, is lower than 5% of the capital insured **and** its actual performance is fully linked to interest or income of the kinds referred to in points (a), (aa), (b), (c), and (d) of Article 6; for this purpose any difference between the amounts paid out pursuant to a life insurance contract and the sum of all the payments made to the life insurer under the same life insurance contract shall be considered benefits from life insurance contracts."

In view of these tests, all of which need to be satisfied for the Savings Directive provisions in respect of interest payments to apply, it would seem that the benefits payable under a life insurance contract will be treated as interest for the purposes of the EU Savings Directive if

(i) it provides cover against a risk linked to death, disability or longevity;

(ii) the risk assumed by the insurer on average over the term of the contract is less than 5% of the "capital insured". The words "capital insured" are not defined but would seem to refer to the benefit payable on death although the words "capital invested" are used in the Explanatory Memorandum. The Articles do, of course, take precedence; and

(iii) the investment performance of the contract is fully linked to “interest or income of the kind referred to in points (a),(aa),(b),(c) and (d)….. of Article 6”.

From this it would seem that the type of policy most likely to fall within Article (6)(e) will be a single premium bond with little (less than 5%) or no life cover. To avoid the application of the proposed new Article (6)(e) the policy would on average need to provide life cover of 5% or more of the bid value of units. If this were the case then regardless of the underlying investments being fully linked to interest or not the policy would not be caught by Article 6(e).

If the cover provided does not satisfy the 5% test (which would currently be the case for most single premium bonds without built in life cover for which a separate charge is made) then it would have to be shown that the performance of the contract is not “fully linked to interest or income of the kinds referred to in points (a),(aa),(b), (c) and (d)”. These points can be summarized as follows:-

(a) Interest earned on debts derived from the lending of money. This would include interest earned on bank and building society deposits, gilts and corporate bonds.

(aa) Income paid which is a return on capital fixed at issue, with a return of at least 95% of the capital on maturity. The nature of the underlying assets is in this case irrelevant.

(b) Accrued and capitalised interest arising in respect of debts which fall within category (a).

(c) Distributions made by certain unit trusts and other collective investment funds which have invested more than 15% of their assets in investments falling within (a),(aa) and (b). The 15% limit applies to funds established in the UK.

(d) Accumulated income paid out when units in certain collective investment funds that have invested more than 40% of their assets in investments falling within (a) and (aa) are redeemed or realised. This section covers funds of funds, and the figure of 40% will be reduced to 25% from 1 January 2011. Currently the 15% rule in (c) applies, but this optional threshold is no longer available under the revised Article. Instead a Member State will have the option to treat as interest only gains on income which has been derived from investments falling within (a), (aa) and (b).

Under Article 8 – information reporting by the paying agent – the benefit to be reported is that calculated in accordance with Article 6(e) which is basically the amount by which the amount paid out exceeds the premium paid. This would seem to mean that any gain derived from life cover would be included in the amount of interest to be reported.

It is important to note that only contracts entered into on or after 1 December 2008 will be subject to the proposed Article 6(e).

Conclusion
It would seem that most bonds providing little or no life cover and offering an underlying

cash fund(s) would currently be considered to be producing interest for the purposes of the Directive if the investment gain were **fully** linked to interest or income. The word "fully" is not defined as far as we can ascertain. When the UK regulations are laid in due course they will presumably need to reflect the "fully" aspect and it would seem that in its ordinary meaning it would mean 100%. Logically, if this were so then it would seem that a fund which was invested as to only, say, 1% in equities would fall outside of the reporting requirements even if life cover of less than 5% is provided.

Regardless of this, a product fulfilling the "5% or more life cover" test would fall outside of the provisions regardless of what the underlying fund is invested in.

PENSIONS MISCELLANY

- The Personal Accounts Delivery Authority has announced the commencement of its procurement process for the personal accounts scheme administration services.

- The DWP has issued four research papers outlining how employers and employees are likely to react to the introduction of auto enrolment and personal accounts in 2012.

- HMRC has issued Pension Schemes Newsletter 36 which deals with the tax implications of a transfer from a UK registered pension scheme to an Australian QROPS. Full details can be found on the HMRC website.

- In connection with the Levy, the PPF has issued revised commutation, compensation cap and early retirement factors for all calculations with an effective date of 1 January 2009 or later.

- The Pensions Regulator has issued its final guidance on record keeping as well as updated guidance on clearance and abandonment.

- The Association of Consulting Actuaries has published its "Pension Trends in Smaller Firms Survey in 2008". This sets out the results of a questionnaire completed in June/July 2008 by 394 smaller companies (ie companies with less than 250 employees).

- As its dedicated pensions helpline for women approaches its first anniversary (on 4 February 2009) the Pensions Advisory Service is claiming that many women are unaware of and/or confused about forthcoming changes to the state pension.

- In an interview with the Financial Times, Tim Jones, the chief executive of the Personal Accounts Delivery Authority, has indicated that the full launch of personal accounts to all employers may not be completed until 2013 or 2014.

- HMRC has issued draft regulations to ensure that lump sums paid by non-UK schemes out of UK tax-relieved funds are taxed in the same way as the equivalent payments by registered pension schemes. Full details can be found on the HMRC website.

- The Pensions Act 2008 (Commencement No.2) Order 2009 sets out the commencement dates for a number of sections of the Act. In particular it sets out the abolition date for safeguarded rights and the effective date of the change of the early leaver revaluation rate as 6 April 2009.

THE RIGHTS OF BENEFICIARIES TO SEEK DISCLOSURE OF DOCUMENTATION CONNECTED WITH A TRUST

Breakspear v Ackland [2008] 3 WLR 698

The general principle on the right of beneficiaries to the disclosure of information about a trust stems from the case of Re Londonderry settlement (1965). In accordance with this principle the right of disclosure extends to documents such as the trust deed, subsequent appointments of benefits and trust accounts but the trustees do not need to disclose documents relating to the exercise of their discretion such as agendas for trustees' meetings, correspondence between the trustees or indeed a letter of wishes from the settlor. This so called "Londonderry principle" was confirmed in a number of subsequent cases, in particular in Rosewood v Schmidt (2003).

The case of Breakspear v Ackland concerned the settlement created in connection with divorce proceedings between Basil and Reeva Dunning, Basil's second wife. Basil had for some time been living with the second defendant in the case, Patricia, whom he later married. It was apparently always Basil's intention that Patricia should become a beneficiary of the settlement and receive substantial benefit from it upon his death, but for obvious reasons she was not initially named in the settlement as either a beneficiary or trustee. Basil gave a letter of wishes to his trustees and supplemented it orally. Some years later (after Basil's death) three of his children, who were beneficiaries under the trust, asked to see the letter of wishes. The trustees refused.

As stated above, the principle has been that the trustees generally have the right to refuse to disclose a letter of wishes from the settlor and, in such a case, the beneficiaries have the right to apply to Court to order disclosure. The fundamental question for the judge to decide in this situation is whether disclosure would adversely affect the interests of the beneficiaries as a whole or the ability of the trustees to administer the trust.

What was unusual about this case was that the trustees had openly stated that they would be applying for the Court's sanction before they came to distribute the trust fund. It was clear therefore that they anticipated a potential challenge from some of the beneficiaries in such an event. The judge ordered disclosure as sought by the beneficiaries. However, the judge made it clear that he would have upheld the trustees' refusal to disclose the letter but for the fact that the trustees had openly stated that they would seek the Court's sanction for the distribution of the trust fund.

Once the trustees approached the Court for sanction of the proposed scheme of distribution, the letter of wishes would be relevant to the Court's appraisal of the scheme. The judge said "In this particular and special context, the risk of family division which might result because of the disclosure would be outweighed by the necessity to give all potential beneficiaries a proper opportunity to make submissions to the court on the question of the scheme of distribution. The beneficiaries would need full knowledge of all the material facts on which the trustees would have made their proposals."

Although the judge read the letter of wishes, its contents were not set out in the judgement (on the basis that if the judgement was appealed successfully, the beneficiaries would then have wrongly become aware of the settlor's wishes).

COMMENT

In the light of the judge's comments in this case, it clearly cannot be said with any certainty that beneficiaries of a discretionary trust would have the right to insist on seeing the settlor's letter of wishes. As is always the case, everything will turn on the facts of the case.

INVESTOR PROTECTION

Compensation under the FSCS on the collapse of a non-UK life insurance company

Readers might be interested in hearing of the answer to a question raised with us recently. The question posed was "Is there any protection under the Financial Services Compensation Scheme (FSCS) for a UK resident individual with a life policy with an insurer based outside the UK but within the EEA".

For the protection under the FSCS to apply the policy must have been issued by a "relevant person" doing business in the UK.

For an EEA firm to be a relevant person it must

(a) have the permission of the FSA to carry on regulated activities; or

(b) be an incoming EEA firm. Such a firm is one that has EEA Passport rights under Schedule 3 Financial Services and Markets Act (FSMA) 2000 to carry on a regulated activity in the UK; or

(c) be an incoming Treaty firm which has Treaty rights under Schedule 4 FSMA 2000 to carry on a regulated activity in the UK.

For a policyholder of such a "qualifying" EEA firm to be protected he or she must have been habitually resident in the UK at the time the policy commenced.

THE OFFICIAL RATE OF INTEREST

The "official rate" of interest will reduce from 6.25% to 4.75% from 1 March 2009 for tax year 2009/10.

If an employer makes a cheap loan to a higher paid employee or a director then the official rate is used to measure the benefit to the employee. The benefit is the difference between the interest (if any) paid by the employee and interest at the official rate.

There is a de minimis provision which operates so that if the loan or total loans for an individual at no time in the tax year exceeds £5,000 no tax charge is made.