Technical Connection

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THE ISA SUBSCRIPTION LIMIT

The application of the increased subscription limit to the over 50's

As readers will be aware it was announced in the Budget that people aged 50 or over could, from 6 October 2009, invest up to an additional £3,000 in an ISA to enable them to contribute £10,200 in tax year 2009/10. From 6 April 2010 the annual subscription limit for all qualifying investors will rise to £10,200.

There had been some confusion as to how the "over 50's" rule was to be applied in practice for tax year 2009/10. The crux of the matter was whether an investor had to have attained age 50 when the contribution was paid or had merely to attain age 50 at any time in tax year 2009/10.

In its ISA Bulletin Number 12, issued on 27 May, HMRC confirmed that people aged 50 or over on 5 April 2010 will be able to subscribe up to the new limit from 6 October 2009. In other words, a qualifying investor who attains age 50 at any time in tax year 2009/10 can subscribe up to £10,200 from 6 October 2009.

ISA managers do not need to obtain fresh application forms from investors aged 50 or over before they subscribe the new higher limits.

PENSION SCHEMES NEWSLETTER 37

The main topics covered in this Newsletter are:

Investment easements

HMRC confirmed the investment easements agreed with the Association of Member-directed Pension Schemes. In its confirmation HMRC provided clarification on how it will treat outstanding interest payments on any pre A-Day loan that is refinanced.

HMRC has broadly agreed that it will not seek to impose the 50% maximum allowable borrowing requirement, as set out in section 182 of the Finance Act 2004, where borrowings set up pre A-Day are refinanced/re-mortgaged, so long as the amount of the borrowings had not increased beyond its original amount. However, it confirmed that where interest due on the original borrowings had not been repaid it would apply the section 182 test where such outstanding interest forms part of the new borrowings. This will apply even where the aggregate amount of borrowing, including the unpaid interest, is less than the original borrowings.

Protected pension age and transfer of crystallised rights

Where a member has a protected pre A-Day pension age i.e. a pension age below 50 (or 55 from 6 April 2010) the right to draw those benefits from that earlier pension age will only be retained where a member transfers his benefits to another registered scheme if the transfer is a "block transfer" (i.e. very broadly two or more members transferring at the same time, or in a case where the member's scheme is being wound up a transfer to a section 32 arrangement). This will apply irrespective of whether the benefits being transferred are crystallised or uncrystallised benefits.

If the benefits being transferred are crystallised benefits, and the transfer was not a "block transfer", the protected pension age will be lost at the point of transfer and any benefit payments made under the receiving scheme before the normal minimum pension age (50, 55 from 6 April 2010) will be unauthorised payments.

PROGRESS OF THE PERPETUITIES AND ACCUMULATIONS BILL

Consultation on the reform of the rules on perpetuities and accumulations under English law has been going on for a number of years.

One version of the Bill was drafted in 2006 and another published in July 2008 when the Law Commission nominated the Bill to be dealt with under a new fast track procedure as a Bill which is unopposed. There was a short further consultation during which a number of charities expressed certain objections to some of the provisions of the Bill. The Bill that was introduced in the House of Lords on 1 April 2009 includes the same provisions as in the previous version.

To recap, the Bill's intention is to modify the operation of two legal rules known as the rule against perpetuities and the rule against excessive accumulations. The current maximum perpetuity period (the period of time for which a trust can exist) under English law is 80 years. This is to be replaced by 125 years. The rule against accumulations (ie. effectively not allowing trustees to accumulate income for more than 21 years) will be abolished except for charitable trusts – indeed it is the proposed retention of the 21 year limit on accumulations for charitable trusts that resulted in objections from a number of charities. There are also special provisions which will exempt pension trusts from the two rules.

Apart from the exemption for pension trusts, the Bill includes a number of other exceptions to the rules. One of those appears to change an important long-standing principle under English law. At present a trust which is expressed to be "for charitable purposes" is exempt from the rule against perpetuities. However, under the new legislation (which will generally apply to new trusts coming into effect after the commencement of the Act – either by declaration or appointment out of existing trusts), the exemption will only apply where an estate or another interest is vested in a specific charity, not where the trustees can apply the trust fund for any "charitable purposes". Many trusts include charitable provisions in the so-called "ultimate default clause" ie. one ensuring that the trust funds are wholly dealt with by the end of the trust period. Having such a default clause is essential in order to avoid a resulting trust from arising which could have unwanted tax implications. All individuals concerned with trusts and, in particular, with drafting trust provisions, need to keep abreast of these developments.

In another important change, the Bill confirms that trusts that are created by cash paid out of a pension scheme (by-pass trusts) will in future benefit from a 125 year perpetuity period. Currently, these trusts do not get the full pension scheme exemption and so most trusts adopt a period of the life of the pension scheme member plus 21 years.

PENSIONS MISCELLANY

- Using powers set out in the Finance Act 2008, the Government has extended the range of small payments which do not attract unauthorised payment charges beyond those covered by the existing trivial commutation rules.

- The Government and the Personal Accounts Delivery Authority (PADA) have set out a joint consultation on their proposals for the legal framework, the scheme order and rules, for the personal accounts scheme. Comments are required by 20 July 2009.

- PADA has launched its discussion paper on investment: Building Personal Accounts: Designing an investment approach, which is designed to seek the most appropriate investment approach for the personal accounts scheme.

  Responses will inform PADA's recommendations to the trustee corporation regarding the design of the scheme. The personal accounts scheme will be run by a not-for-profit trustee corporation, solely in members' interests.

- The DWP has issued an adviser guide, ´State Pensions Reform – briefing pack for advisers', to the changes to State pension provision, which start to take effect from 6

April 2010. The guide can be obtained from http://www.dwp.gov.uk/pensionsreform/pdfs/third-party-briefing-pack.pdf

This is an extremely good summary of the changes to State pension benefits and also provides information on what steps the DWP is taking to notify likely affected individuals of the changes.

- The ABI Options initiative has reduced the time taken for annuity transfers between providers to an average of just eight calendar days. This reduced time scale is a significant improvement of over three weeks on the previous 31 day average transfer time. Whilst this must be seen as welcome news there are still a number of ABI members who have not joined the initiative and as yet it does not seem to extend to non-ABI members, which will of course include many SIPP providers.

THE EQUALITY BILL

The impact of the Equality Bill on life assurance and pensions

The Equality Bill has recently started its progress through Parliament. As the Bill is currently worded, under the age discrimination provisions it appears that there may be problems where age is used as a key factor in the determination of life assurance and annuity rates. However, section 190 of the Bill includes provisions for Ministers to issue regulations to give specific exceptions relating to treatment on the basis of age, one of the “protected characteristics” set out in the legislation.

In the explanatory notes to section 190, which accompany the Bill, it is indicated that “age differences in the calculation of annuities and insurance programmes which are reasonable and based on adequate evidence of the underlying difference in risk”, could be one of the areas which may be included as an exception in the regulations.

COMMENT

As the draft legislation stands, there would appear to be a potential problem relating to both annuities and life assurance although this has been flagged up in the notes. It is to be hoped that appropriate exemptions will be included in regulations to ensure that this problem does not arise.

INHERITANCE TAX

(1) Farmland let in conacre and business property relief
(2) Renunciation of a gift fails to save inheritance tax

(1) FARMLAND LET IN CONACRE

A recent Court of Appeal decision in Northern Ireland, in the case of McCall and Keenan (as Personal Representatives of Eileen McLean, deceased) -v- HMRC, has upheld a shock tax ruling that could damage the ability of farm owners in Northern Ireland to pass on family

farms to the next generation. The decision will affect farmland let in conacre. It is estimated that around 30 per cent of Northern Ireland's total farmland is let in conacre. This amounts to about 300,000 hectares.

Until early 2008, HM Revenue and Customs had accepted in practice that agricultural land let in conacre was part of the normal trading business of farming. However, in April 2008, a Special Commissioners' decision overturned this, saying that letting land in conacre must be reclassified as an investment activity. The taxpayer appealed but recently the Court of Appeal in Northern Ireland upheld that Special Commissioners' ruling.

Farmland attracts two tax reliefs that reduce its value to nil for inheritance tax purposes and, in general, ensures that family farms don't have to be sold to pay inheritance tax. The first is agricultural property relief. This relief – at a rate of 100% - applies to the ordinary value of farmland. Secondly, where farmland has development potential but is still farmed by letting in conacre, it attracts a second relief - business property relief - also at 100 per cent on that additional development value. It is this relief that has now been placed at risk by the Court of Appeal decision. This means that thousands of acres of land let in conacre, which would previously be inherited tax free on the death of the farmer, may now have to be sold to pay inheritance tax at up to 40 per cent. Clearly, this can seriously impact on the ability of people to pass family farms to the next generation.

The facts of the case

The ruling applies to agricultural land held "in conacre" (or more technically agistment in this case). This is a system, peculiar to Ireland, where agricultural land is let to farmers. In general the term conacre refers to using land to grow cops whereas agistment is the expression that applies when land is used for grazing.

This particular case concerned 33 acres of agricultural land at Ballyclare, County Antrim which was owned by Mrs Eileen McLean. Mrs McLean died on 8 January 1999. The land was let in conacre for £1,800 per annum. Mrs McLean's son-in-law spent about 100 hours a year "tending" the land (by which is meant looking after and maintaining it).

Mrs McLean had inherited the land from her husband on his death in 1983. It consisted of grazing land. When Mrs McLean died the land had an agricultural value of £165,000 and a development value of £5.8 million – arising out of the local council zoning the land for development use.

HMRC decided that none of the value transferred on her death related to the value of any relevant business property for IHT purposes and therefore business property relief (BPR) did not apply. This meant that although agricultural property relief of 100% was due on £165,000, an IHT liability of £2.4 million arose on the balance value of the land. On the other hand if BPR was available no IHT liability arose.

The Special Commissioner's conclusions and the Court of Appeal decision

Before a claim for business property relief can be made, it is necessary to show that the deceased had conducted a business for the requisite statutory period. The Commissioner concluded that the son-in-law's activities on the land, coupled with the annual letting of the land to graziers, was just enough to constitute a business. The work involved in tending the

land (deemed to be done by the deceased) tipped the scales in favour of the conclusion that a business was being carried on in respect of the lettings of the land. In the appeal no challenge was made to the Special Commissioner's finding of the existence of a business. However, the Special Commissioner concluded that the business was one which consisted wholly or mainly of the holding of investments and that, accordingly, there was no entitlement to business property relief.

For the above reasons, the Court of Appeal determined that the Special Commissioner had properly applied the law and that his ultimate conclusion was one that he was entitled to reach having regard to the evidence and to his findings of fact. In particular, having reviewed the authorities, the Court of Appeal agreed that the level of services provided by the landowner was insufficient to justify holding that the landowner was operating a trade. The taxpayer's appeal was therefore dismissed.

The implications

The Court of Appeal's ruling means that business property relief will not be available, so the potential development value (and not the agricultural value) of the land will, depending on the specific facts of each case, be subject to inheritance tax at 40%. The taxpayer has requested leave to appeal to the House of Lords so we may not have seen the last of this case.

On the basis that the Court of Appeal decision stands, this means that the value of some farms may increase dramatically for IHT purposes, with every acre of land let in conacre liable for inheritance tax at rates of up to 40 per cent which could mean the forced sale of land.

(2) RENUNCIATION OF A GIFT

An attempt by a widow and her children to avoid IHT on an inheritance of £2m failed because they did not understand the operation of UK law.

Mrs Lau was separated from her German husband in 2001. When he died in October 2004 he left an estate of about £7m. Of this £665,000 was to be paid, free of tax, to each of his two daughters and his stepson. The grossed-up value of each gift would have been £1,108,333.30. The residue passed to Mrs Lau and was exempt from IHT.

After Mr Lau's death the family sought ways of mitigating the tax (about £1.33m in total) that would fall on the total £1,995,000 given to the three children. The daughters lived in Germany while the mother and stepson lived in Scotland. Correspondence between the lawyers for the daughters and mother resulted in a decision to effect a deed of variation. By the variation all three children would give up their inheritance in favour of their mother in return for £1,000,000 each. The variation was effected on 19 July 2006.

Although the variation was within 2 years of the date of the father's death it appears that the parties failed to take heed of section 142(3) Inheritance Tax Act 1984. Under this section, where a variation is made for "consideration" it has no effect for IHT purposes.

The two daughters accepted that they had failed in their attempt to reduce the IHT payable. However, the stepson tried a different approach. He claimed that on 23 March 2005 he had formally renounced his inheritance in an undelivered letter held by the solicitors. The stepson was subsequently paid £1,000,000 by his mother in October 2005 following a promise she made to him in 2001. He stated that he only executed the later deed of variation simply

because his name had been included in the deed, but it had no effect from his point of view because of the prior renunciation.

The question arose as to whether the renunciation was for consideration. The stepson said he renounced the £665,000 because he was financially secure. This was because his mother had promised him £1,000,000 in 2001 to help him set up a business.

The Special Commissioners found against the taxpayer for the following reasons:

1. It was not true that the stepson was financially secure – the promise made by his mother in 2001 could not be legally enforced and he was actually in need of funds.

2. The stepson was party to the negotiations to reduce the IHT charge on his mother.

3. The £1,000,000 paid to each of the three children was effectively £665,000 plus the IHT saved.

4. The stepson had not made a renunciation. The undelivered letter did not meet the formal requirements of section 142(1) – it should have been delivered.

COMMENT

This is simply a case of not taking proper legal advice. First the family failed to execute a valid deed of variation because it was done for consideration. Second, the stepson failed (apart from anything else) because his renunciation was void as his letter had not been delivered within the two year time limit.

PENSION SCHEMES AND INHERITANCE TAX

Use of trusts to receive death benefits from pension schemes
Pension schemes constituted under a deed poll and the IHT ten-year anniversary charge

These days it is frequently the case that members of pension schemes consider establishing trusts during their lifetime to receive death benefits from their pension scheme on their death.

The objectives of such a trust, commonly known as a “spousal by-pass” trust, are twofold:-

(i) The death benefits can “skip” an individual’s taxable estate for IHT purposes. So, for example, rather than death benefits being paid to a surviving spouse they can be paid into a trust under which the surviving spouse is a beneficiary and so not be added into his/her taxable estate.

(ii) The surviving spouse can be a beneficiary and so benefit from the trust, either by advancement of income/capital appointments or by way of interest-free loans.

Where this type of planning is undertaken, and the pension scheme member dies with death benefits being paid to the trust, the question arises as to how this by-pass trust should be taxed under the inheritance tax regime.

For these purposes, by virtue of section 81 IHT Act 1984, it will normally be the case that because assets will be passing from one discretionary trust to another, (ie. from pension scheme trust to the by-pass trust), the trust will be treated as commencing when the member joined the pension scheme.

This will therefore establish the date of the ten-year anniversary charges and the 7 year cumulation period of the settlor to be used in calculating any periodic or exit charges.

However, an exception to this rule applies in a case where the pension scheme is constituted by deed poll. Then the discretionary trust will be treated as having been established when the by-pass trust is actually executed. Moreover, if a lifetime pilot by-pass trust is used, by establishing a trust for a nominal amount (say £10), HM Revenue and Customs has confirmed to us that the payment of the death benefits to that trust (perhaps following an expression of wishes by the member) will not be regarded as property added to that trust. This is because such a payment is not treated as a chargeable transfer.

Example

Jack's SIPP is established under a deed poll. Jack joined the SIPP on 10 June 2002. On 6 May 2009, he sets up a by-pass trust (on a discretionary basis) for £10. On his death in September 2010, the scheme administrator follows his expression of wishes and pays £250,000 of death benefits to the by-pass trust.

As far as ongoing IHT on the by-pass trust is concerned, the trust will be subject to a ten-yearly anniversary charge on 6 May 2019 with the charge based on the value of the trust at that time and Jack's cumulative total in the seven years before 6 May 2009.

Had Jack's SIPP been constituted by a discretionary trust, the first ten-yearly charge (after payment of death benefits) would have arisen on 10 June 2012. In theory, a further periodic charge could arise on 6 May 2019 linked to the property then representing the £10 initial nominal gift to the trust.

Care needs to be exercised where the benefits in the SIPP arose by way of a transfer from other pension schemes because a different outcome may result.