Technical Connection

IN THIS ISSUE

Published by Technical Connection Ltd,
7 Staple Inn, London, WC1V 7QH.
Tel: 020 7405 1600 Fax: 020 7405 1601
E-mail: enquiries@technicalconnection.co.uk
www.techlink.co.uk

TAX AVOIDANCE SCHEMES – RETROSPECTIVE CLAIM FOR INCOME TAX

Offshore tax avoidance scheme
Retrospective claim for income tax
No breach of human rights

HMRC has won a Court ruling allowing them to claw back millions in backdated tax from people who used an offshore tax avoidance scheme.

In Huitson v HMRC, Robert Huitson, a UK resident self-employed IT contractor, started using a scheme set up by Montpelier Tax Consultants in 2001. Under the scheme Mr Huitson no longer supplied his services directly to his end user clients based in the UK, but instead an intermediary partnership contracted directly or indirectly with end users to provide his services. The partnership received full payment for the services, with Mr Huitson then receiving a fixed annual fee of £15,000 (or such lesser sum as might be generated by his work for the partnership). The rest of the payment (less management expenses) he received in his capacity as the owner of a life interest in an offshore trust in the Isle of Man into which the rest of the payment was paid.

Whilst the annual fee of £15,000 was subject to UK tax, until the relevant legislation was amended with retrospective effect in 2008, Mr Huitson contended that, as a result of the double tax agreement with the Isle of Man, at the time the income channelled through the trust was not subject to UK income tax. By using the scheme, over a 7 year period Mr Huitson had avoided £84,980 of income tax.

In the 2008 Finance Act the Government cracked down on this type of scheme, allowing HMRC to take retrospective action.

Mr Huitson made a claim for judicial review on the basis that the backdating of the tax demand breached human rights law, as the retrospective effect of the Finance Act 2008 amendment did not strike a fair balance as required by Article 1 of the First Protocol (A1P1) to the European Convention on Human Rights.

Mr Justice Parker dismissed the application that the Finance Act amendment breached human rights, stating that it was "immediately plain that the tax avoidance scheme, if it worked, would be singularly attractive to any person in the position of the claimant, that is any resident of the UK who, as a self-employed person, carried on a trade or profession here". He further explained that such a tax avoidance scheme "could be expected to have a very significant "bandwagon" effect".

The retrospective clawback of tax introduced in the 2008 Finance Act was unprecedented in the history of tax legislation - a precedent that may well be followed in the future.

COMMENT

Although Mr Justice Parker said that HMRC intended to take into account financial hardship to taxpayers before seeking to enforce tax demands and the payment of interest, this decision is expected to give substantial weight "to the need to ensure fairness", including to "the great body of UK resident taxpayers who steered clear of such arrangements".

With this decision falling in favour of HMRC it is likely many more taxpayers who used similar schemes will be hit for millions in unpaid tax.

ANTI-FORESTALLING: PROTECTED PENSION INPUT EXTENDED

The Special Annual Allowance Charge (Protected Pension Input Amounts) Order 2010 Introduction of a number of extensions to the circumstances where protected pension input applies

When the anti-forestalling provisions were introduced, a number of circumstances were set out where an individual's pension input would be protected from a special annual allowance tax charge. While these provisions were welcomed, questions were raised with HMRC concerning the extent of the protected input. There was particular concern in two areas:-

- the loss of protected pension input when an individual with protected contributions transferred his benefits from one individual money purchase arrangement to another and continued his same pattern of contributions under the new arrangement

- the exclusion from protected pension input of a lump sum contribution made on or after 22 April 2009 (or 9 December 2009) even where there had been a contractual agreement in place prior to 22 April 2009 (or 9 December 2009) that the contribution would be made

The Government agreed to look further at these issues and this has resulted in The Special Annual Allowance Charge (Protected Pension Input Amounts) Order 2010 which extends protected pension input in these and a number of other areas. These new regulations have retrospective effect to the beginning of tax year 2009/10, although they will not come into force until 19 March 2010.

The regulations create amendments to the Finance Act 2009 and therefore make no reference to the changed relevant income threshold announced on 9 December 2009. Draft Finance Bill 2010 clauses that legislate for the £130,000 ceiling were published on 23 February 2010. To ease understanding, we refer here to both the £150,000 and £130,000 limits, on the assumption that further corresponding amendments will be made to the Finance Bill 2010.

The main changes introduced by the regulations are as follows:

1. Member of a money purchase scheme (other than an occupational scheme, statutory scheme or part of a GPP)

An individual who has protected pension input

- based on regular contributions paid at a frequency of quarterly or more regularly in place prior to 22 April 2009 (for those with relevant income of £150,000 or more) or prior to 9 December 2009 (for those with relevant income of at least £130,000 but less than £150,000);

- whose protected contributions are being paid under a money purchase arrangement other than an occupational scheme, statutory scheme or part of a GPP; and

- who continues his contributions to a new money purchase arrangement which is not an occupational scheme, statutory scheme or part of a GPP

can retain his protected pension input in respect of continuing regular contributions under the new arrangement provided the following conditions are met:

a. the contributions continue on a regular basis (ie. quarterly or more frequently) and at a level not greater than that applicable under the original arrangement);

b. the new arrangement is set up within three months of the individual having ceased to be an active member of the original arrangement;

c. the new arrangement is the first arrangement set up after the original arrangement. (Any transfer to a further arrangement with contributions being paid to that new arrangement would result in the loss of protected pension input under that further arrangement); and

d. the original arrangement in respect of the member is not re-activated on or after the date the member joins the new arrangement.

2. Member of a money purchase scheme with benefits under an occupational scheme, statutory scheme or GPP)

The requirements are broadly the same as those set out in 1. above with the following significant differences:

- The new arrangement will be part of a new occupational, statutory or GPP scheme.

- The individual did not make more than one such new arrangement within one month beginning with the date he ceased to be a member of the original scheme.

- The new arrangement must have been set up for one of the following reasons:
  - The individual's employer had entered into a re-organisation of its pension provisions and the establishment of the new arrangement was a consequence of that re-organisation.
  - The making of the transfer was due to a 'relevant business transfer' (ie. a transfer of all or part of a business or undertaking which involves the transfer of at least 20 employees and in a case where the transferor and transferee are bodies corporate, they would not be treated as members of the same group for the purposes of Chapter 4 of Part 10 of the Income and Corporation Taxes Act 1988).

This change would seem to give protection to those members of an employer's money purchase scheme with protected pension input where the regular contributions are continued under a new arrangement selected by the employer. Prior to this change, for such protection to be available the member would have needed to be in a group of at least 20 members with the same contribution basis under the new scheme.

It is presumed that if an EPP is wound up at the instigation of the employer and replaced by a personal pension where contributions continue at the same level as under the EPP any protected pension input could be retained but we are awaiting clarification on this.

3. Cash balance schemes and added years accrual under DB schemes

The regulations also include extensions to the protected pension input provisions similar to those described in 1. and 2. above for members of cash balance schemes and for members of DB schemes making additional voluntary contributions to secure added years of pensionable service under the DB scheme.

4. Pre 22 April 2009 protected pension input

A contribution, not otherwise protected, will nevertheless be regarded as protected pension input if paid prior to 22 April 2009 (for those individuals with relevant income of £150,000 or more) and prior to 9 December 2009 (for those with relevant income of at least £130,000 but less than £150,000).

The regulations extend this relief so that where an individual, or that individual's employer, as at 22 April 2009/9 December 2009 was contractually committed to making a pension contribution for him, but it had not actually been paid by that date, the pension contribution will be regarded as protected pension input provided it is paid by no later than the date specified in the contractual agreement.

COMMENT

These extensions to the protected input provisions are to be welcomed. However, the increased complexity of the provisions is yet another nail in the coffin of pension simplification.

PERSONAL ALLOWANCES AND RELIEFS FOR COMMONWEALTH CITIZENS

The withdrawal of personal allowances and reliefs for non-resident Commonwealth citizens

By way of background, personal allowances and reliefs are normally only available to UK resident individuals. However, in a few exceptional cases they are available to non-UK residents. The exceptions include EEA nationals, residents of the Channel Islands and the Isle of Man, Crown servants and Commonwealth citizens.

Schedule 1 of Finance Act 2009, entitled "Income tax: abolition of non-residents' personal reliefs", is operative from **6 April 2010.** The change introduced by Schedule 1 means that the availability of personal allowances and reliefs will be withdrawn for non-UK resident individuals who can claim these by virtue of being Commonwealth citizens. Commonwealth citizens, though, may still be able to benefit, for example if they are EEA nationals or the allowances/reliefs are available to them under a double tax agreement.

Individuals likely to be affected are those living on islands in the Caribbean, Pacific or Indian oceans.

PENSIONS - HMRC DEVELOPMENTS

- ### Income withdrawal rate – March 2010

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date) in February 2010, is 4.5%.

- ### Draft anti-forestalling legislation

HMRC has published a draft http://www.hmrc.gov.uk/news/2065.pdf of the clauses, to be included in the Finance Bill 2010, amending the anti-forestalling provisions with regard to the lowering of the 'relevant income' threshold to £130,000.

- ### Anti-forestalling and unallocated contributions

HMRC has confirmed that where previously unallocated contributions held under a registered scheme (e.g under a SSAS) are allocated to a member during tax year 2009/10 (on or after 22 April 2009) or 2010/11 they will be set against the member's special annual allowance. This will apply irrespective of whether or not the unallocated contributions had been paid to the scheme prior to 22 April 2009.

- ### Notional earnings cap

HMRC has confirmed that the notional earnings cap for 2010/11 is £123,600.

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 "transitional period". This "transitional period" ends on the earlier of

- the first date after 5 April 2006 on which rule amendments in relation to such an existing scheme take effect that state that the modification regulations no longer apply to the scheme, or

- the end of the tax year 2010/11 (or such later time as is prescribed by HM Revenue and Customs)

Before 6 April 2006, section 590C of the Income and Corporation Taxes Act 1988 applied the permitted maximum (the "earnings cap") to pension schemes.

One of the features of the modification regulations is the preservation of the effect of the permitted maximum on existing pension schemes to which the modification regulations apply during the transitional period, despite the repeal of section 590C on 6 April 2006. The regulations continue to apply the permitted maximum during the transitional period as if section 590C had remained in force and the Treasury had made the required orders to set the permitted maximum figure for a particular tax year.

If section 590C had not been repealed on 6 April 2006, a Treasury order would have stated the permitted maximum figure for the 2010/11 tax year as £123,600.

- **Relief at source forms updated**

HMRC has revised the following three forms relating to the claiming of relief under the relief at source provisions:

APSS105	The Relief at Source: Interim claim by Scheme Administrator for recovery of tax deducted by individuals.
APSS106	The Relief at Source: Annual claim by Scheme Administrator for recovery of tax deducted by individuals.
APSS107	The Relief at Source: Statistical Return.

These changes have been made to deal with the new refund of member contributions that can arise in conjunction with the special annual allowance provisions. In particular, the revised forms highlight that the scheme administrator is liable for the tax charge on the refund and must remit the tax to HMRC along with the relevant quarterly Accounting for Tax Return (AFT) by the 45th day after the end of the quarter in which the refund was made.

As the first refunds cannot be paid until 6 April 2010 the first AFT which could potentially be affected is the 30 June 2010 return, which is due by 14 August 2010.

THE OFFICIAL RATE OF INTEREST

Reduction in the official rate of interest

"The official rate of interest" that applies to employment related loans will reduce from 4.75% to 4.0% from 6 April 2010.

If an employer makes a cheap loan to a higher paid employee (one earning £8,500 a year or more) or a director then the official rate is used to measure the benefit to the employee which is subject to tax as a benefit in kind. The benefit is the difference between the interest (if any) paid by the employee and interest at the official rate. An employer will pay Class 1A National Insurance contributions on any taxable benefit.

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.

COMMENT

This change will be important for proprietors of private limited companies who decide (perhaps because of increased tax rates) to remove money from their company by way of interest-free loan with salary/dividends being paid at a later date (when tax rates have reduced) to enable loan repayment. Following this announcement, the benefit in kind charge on the interest-free loan will reduce.

DISCOUNTED GIFT TRUSTS

HMRC's view on the application of the new section 81A IHT Act 1984 to discounted gift trusts

Many insurance companies offer discounted gift trusts. These trusts frequently operate on the basis that the settlor of the trust is entitled to a contingent reversionary interest in stated cash sums (which may equal annual 5% withdrawals from an investment bond) or to the maturity proceeds of a series of life assurance policies.

HM Revenue and Customs has previously confirmed, both to the ABI and in the POAT guidance notes, that these plans are not subject to the gift with reservation rules or the pre-owned assets tax rules on the basis that the settlor's rights are held on bare trust for him and are separate from the rest of the property held in the settlement.

The Pre-Budget Report 2009 introduced a new section 81A IHT Act 1984 to combat IHT avoidance schemes. The new section 81A is intended (to quote from the HM Treasury notes) to close down two "artificial schemes designed to avoid inheritance tax charges on relevant property trusts".

Because section 81A applies to reversionary interests under relevant property trusts, we have written to HMRC to determine whether section 81A could apply to currently marketed "retail" discounted gift trusts and they have confirmed that in cases where the settlor becomes entitled to an absolute interest the anti-avoidance legislation announced in the Pre-Budget Report – new section 81A - will not apply.

COMMENT

This is good news because it might have been possible that the settlor's interest under a discounted gift trust could be viewed as a contingent reversionary interest and so the new section 81A may have been a problem.

It is important to note HM Revenue and Customs have only given this confirmation on the basis that the settlor becomes entitled to an absolute interest and, presumably, this means that it is important that their interest cannot in any way be defeated under the terms of the trust.

UNFAIRNESS IN THE TRANSFERABLE NIL RATE BAND PROVISIONS

The Low Incomes Tax Reform Group (LITRG) is campaigning for amendments to the transferable nil rate band provisions to help widowed elderly people where the first spouse died before March 1972.

Under the transferable nil rate band provisions, which were introduced in 2008, where one spouse or civil partner dies without using their nil rate band (for example because all the assets passed to the surviving spouse) the unused proportion of the nil rate band can be transferred to the survivor. If none of the nil rate band is used by the first of the couple to die, the survivor has in effect two nil rate bands, currently £650,000, to offset against their estate. The rules apply to all second deaths occurring on or after 9 October 2007 regardless of when the first spouse died. However, because of the different rules that applied to tax transfers to spouses and nil rate bands under the estate duty and capital transfer tax provisions, unintentionally the result is that some individuals, according to the campaigners, are treated unfairly.

The issue is that under the estate duty rules there was no unlimited exemption for transfers between spouses. For deaths after 21 March 1972 but before 13 November 1974 the relief was capped at £15,000. For deaths before 21 March 1972 there was no relief at all. The unlimited spouse exemption only applied to deaths occurring between 13 November 1974 and 12 March 1975 under the estate duty regime.

With a very small or no spouse IHT exemption, even very small transfers of assets on death would have used up a large proportion or all of the nil rate band at that time. For example, if the first spouse died in 1970 when the nil rate band (then called the "small estates exemption") was £10,000 and there was no spouse exemption. If all of the estate of £10,000 was left to the surviving spouse, because there was no spouse exemption the entire transfer would have used up the full nil rate band and therefore the surviving spouse would have no transferable nil rate band at all.

According to the LITRG, they took up the question of reform at the time of the Finance Bill 2008 and drafted amendments to rectify the situation. Although sympathetically received by the opposition, the Government rejected the change claiming difficulties in sorting out the situation after so many years. The LITRG continues to campaign for change in the run up to the forthcoming Budget and General Election.

COMMENT

Given the relatively small number of estates likely to be affected by any changes to the legislation, as well as the generally downward trend in IHT revenues, it is probably unsurprising that the Government is not particularly inclined to look to further amend the legislation. However, given the forthcoming General Election and potential adverse publicity that this type of issue can bring, changes can't be ruled out.