Technical Connection

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INCOME WITHDRAWAL RATE FOR SEPTEMBER 2010

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CAPITAL GAINS TAX

The annual CGT exemption – future increases

We wrote to HMRC to enquire about the way in which the annual CGT exemption would be increased in the future. HMRC's answer was as follows:-

"You enquired whether in future the capital gains tax Annual Exempt Amount (AEA) will be indexed by reference to the CPI rather than the RPI. No announcement of change of the basis of indexation of the AEA has been made". This means that RPI will still be used as the measure for increasing the exemption.

In contrast, in the June 2010 Budget it was announced that the Government will use the CPI for the price indexation of benefits and tax credits from April 2011.

GOVERNMENT LAUNCHES RESTRICTED PENSIONS TAX RELIEF CONSULTATION

The Coalition government announced in the June 2010 Emergency Budget that it intended to consult on a new means of restricting pension tax reliefs by adjusting the main pension allowances (annual allowance and lifetime allowance). This would principally be achieved by 'significantly reducing the annual allowance'. If the proposals meet their objective the Government will implement the changes from 6 April 2011 and will include the necessary legislation in the Finance Bill 2011. The

Government will also then utilise the provisions included in the Finance (No.2) Act 2010 to introduce regulations to abolish the 'high income excess relief charge' that was introduced by the previous Labour government in the Finance Act 2010 and which is otherwise due to take effect from 6 April 2011.

The Government has now issued its consultation paper "Restriction of pensions tax relief: a discussion document on the alternative approach".

Timeline

Responses to the consultation were required by 27 August 2010.

The Government will confirm its intended approach by the end of September 2010 and will provide draft legislation in Autumn 2010. The legislation will become effective from 6 April 2011, with the necessary legislation included in the Finance Bill 2011.

Given the extent and complexity of the changes, it is arguable whether there will be sufficient time for providers to implement the necessary changes by April 2011, even if the draft legislation is known by Autumn 2010.

Overview of the key proposed changes

- Reduce the annual allowance from £255,000 to £40,000.

- Use a flat rate factor in the range of 15 to 20 when valuing increased DB benefits for annual allowance purposes.

- Remove the current exemptions to the annual allowance rules where a member has:
  - enhanced protection; and
  - pension input to an arrangement in a tax year during which he draws all his benefits from that arrangement.

- Any pension accrual/contributions in excess of the annual allowance to be treated as the top slice of an individual's income for tax purposes, effectively removing *all* tax relief on the excess.

- Reduce the lifetime allowance from £1.8 million to £1.5 million. There would be consideration of transitional protection for those individuals with existing pension savings above the reduced lifetime allowance.

- Consideration of freezing the value of rights covered by primary and enhanced protection.

- Consideration of whether tax relief on pension contributions should be capped at 40% for additional rate (50%) taxpayers.

FURNISHED HOLIDAY LETTINGS

Consultation document issued

On 27 July the Treasury published a consultation document dealing with furnished holiday lettings (FHL).

In the June 2010 Emergency Budget it was confirmed that FHL will continue to be treated as a trade for tax purposes – the previous Labour government had announced in its April 2009 Budget that the FHL rules were to be repealed in their entirety from tax year 2010/11 and the financial year beginning 1 April 2010 for companies. However, at the same time the Government announced that it would consult over the Summer and the consultation is now with us and ends on 22 October 2010.

Under the current rules, FHL which satisfy certain conditions (eg the property must be available for letting as holiday accommodation on a commercial basis for a total of 140 days or more in the tax year and must be so let for at least 70 of those days) are treated as a trade for tax purposes.

In the consultation paper it is proposed to

(i) increase the number of days for which a property is available for letting from 140 to 210 days – a 50% increase

(ii) increase the period for which it is actually let from 70 to 105 days – a 50% increase

(iii) to restrict the use of loss relief. Whereas currently losses can be set against other income of any nature and capital gains, it is proposed that losses made in a qualifying UK or EEA FHL may only be set against income from the same FHL business.

It is anticipated that the changes will be effective from tax year 2011/12 for individuals and for accounting periods beginning on or after 1 April 2011 for companies.

DOTAS AND INHERITANCE TAX

The disclosure of trust-based inheritance tax avoidance schemes

We knew it was coming! 27th July saw the publication of the consultation document on the extension of the so-called DOTAS (Disclosure of Tax Avoidance Schemes) regime to trust-based IHT avoidance arrangements. The closing date for comment is 20 October 2010 and the aim is to introduce regulations on the subject later in 2010/11 to come into effect from April 2011.

The DOTAS regime is contained in Part 7 of Finance Act 2004 and associated regulations. This “core” legislation is then applied to appropriate taxes by regulation. The so-called “main regime” was initially applied to income tax, corporation tax and capital gains tax. It was extended to cover SDLT in 2005 and NICs in 2007. In the June 2010 Budget the Government announced that it would consult with a view to extending DOTAS to trust-based IHT schemes. This followed specific legislation attacking two such schemes which, at the time, HMRC confirmed would not apply to regular discounted gift schemes - which was welcome.

The intention of this extension is that the DOTAS regime would apply to arrangements where property becomes relevant property (ie. becomes subject to the IHT discretionary trust regime) and the main benefit of the arrangement is the avoidance, reduction or deferral of the entry charge.

The financial planning sector (advisers and providers) will undoubtedly be a little concerned over the potential additional burden that the proposed extension of DOTAS may put on well-used IHT arrangements such as loan trusts and discounted gift trusts.

Fortunately, some comfort is at hand - at the consultation stage at least. A key driver behind DOTAS is HMRC/Treasury concern that they are unaware of the full extent of IHT mitigation and avoidance that is going on in connection with trust-based schemes. In their words, there is an "information gap". The objective, as is the case for the whole of DOTAS, is for HMRC to be in a position to identify schemes and users at an early stage.

With this in mind the referred to "comfort" at the consultation stage comes in two parts.

1. Confirmation that it is not intended to apply DOTAS to transfers into trust where business property relief, agricultural property relief, conditional exemption or exemption on a transfer into a heritage maintenance fund is available to remove or reduce the charge to tax.

2. HMRC reassurance that it wants to learn about schemes that are "new and innovative" not schemes of which it is already aware.

In order to restrict disclosures to "new and innovative" schemes the draft amending regulations contain a "grandfathering" rule that would exempt from disclosure "any scheme of the same, or substantially the same, description as the scheme that was first made available for implementation before a given date (which has yet to be determined)".

The apparent lack of need to disclose "existing" schemes will cause a collective sigh of relief from providers and advisers. The interesting part for designers of new schemes will be the extent to which the description of a scheme being "substantially the same" as one HMRC knew about can be stretched.

SETTLOR-INTERESTED TRUSTS – A NEW TAX FORM

Recently HMRC finally issued a new form which trustees may use to advise the settlor of the amount of income arising to a trust in cases where the settlor retains an interest.

Trust income is chargeable on the settlor where the settlor retains an interest under the trust. The settlor is treated as retaining an interest under a trust if the settlor or settlor's spouse may benefit from the trust or if the settlor has made a loan to the trustees and all or part of it remains outstanding. Such trusts are called "settlor-interested trusts".

A settlor-interested trust may be a discretionary trust or an interest in possession trust. If the trust is an interest in possession trust under which another beneficiary is entitled to income, that beneficiary is not assessed on the income but the settlor is.

If the trust is a discretionary trust, the trustees of the trust are primarily taxed at the trust rates (currently 42.5% on dividends and 50% on all other income) but, in effect, they pay tax on behalf of the settlor. All the trust income is still chargeable on the settlor and the settlor receives credit for the tax paid by the trustees.

In fact, this last rule was only introduced in 2006. Prior to that, where the trust was settlor-interested, the trustees would not be assessed to tax at all, only the settlor. Because of this there was initially no form that the trustees could give to the settlor specifying the amount of trust income on which he was to be assessed and which he could use, in appropriate cases, in order to make a tax reclaim where the tax taxed deducted at source exceeded his actual tax liability. Indeed, following the introduction of the need for trustees to pay income tax on behalf of the settlor, because of the uncertain wording of the legislation, it wasn't even entirely clear that the settlor could make such a reclaim. In fact, it was only in Finance Act 2010 that legislation has been put in place dealing with this matter. And whilst HMRC admitted a long time ago the need for the special form, this form has only just been published.

The form in question is a version of the form R185 (Trust Income). This has now been made into two separate forms:-

- Form R185(Settlor) – Statement of trust income chargeable on settlor, and
- Form R185 (Trust Income) – Statement of income from trusts

The first form is the form the trustees should give to the settlor and it specifies the amount of trust income the settlor is assessed on. The settlor will also need this form when making a tax reclaim which would be the case where the trust is a discretionary trust and the settlor is not a 50% (ie. additional rate) taxpayer. Since 6 April 2010, even if the settlor is a 40% taxpayer, he will be entitled to a 10% reclaim of tax given that the trustees' income tax rate is equivalent to the additional tax rate paid by individuals whose taxable income exceeds £150,000. The tax reclaim is made using the standard Form R40.

The second form, R185 (Trust Income) – Statement of income from trusts - has two parts, one dealing with discretionary income payments from a trust and the other with vested (ie. non-discretionary) income entitlement from a trust, ie. the form can be used for both interest in possession and discretionary trust income. The new version now shows more clearly which figures have to be transferred to the self assessment form completed by the beneficiary.

The third version of Form R185 (Estate Income) – Statement of income from estates - has also been published. This includes minor changes from the last version, made to make the form easier to understand, although the boxes themselves have not changed.

The publication of the forms is a timely reminder for all settlors who are assessed on trust income. The current form, of course, needs to be used for tax year 2009/10 during which the trust rate was 32.5% (dividends) and 40% (all other income), ie. equal to the higher rates of income tax. This means that for that tax year only basic rate, 10% or non-taxpaying settlors could claim a tax refund. However, as mentioned above, from tax year 2010/11 the number of reclaims in respect of discretionary trusts is clearly going to increase.

For individuals contemplating creating trusts, it should be remembered that it is possible to create a settlor-interested trust which will nevertheless be effective for inheritance tax purposes. By including a spouse of the settlor as a potential beneficiary under a discretionary trust, the trust will be a settlor-interested trust. However, the inclusion of the spouse (assuming he or she is not also a settlor) does not affect the inheritance tax efficiency of a trust, ie. the gift with reservation rules will not apply.

Subject to other practical and tax considerations, as well as the fact that trust accounts and reclaims need to be made, if the settlor is not an additional or higher rate taxpayer but a basic rate taxpayer, creating a settlor-interested trust in this way will mean that, in effect, the 50%/42.5% rates on trust income can be reduced to the settlor's basic rate of tax. Of course, any tax reclaimed by the settlor in the circumstances described above must be paid back to the trustees.

CONTRACTING OUT

An end to transfers from COSRS to money purchase schemes?

The DWP has been consulting on the necessary consequential legislation as a result of the abolition of contracting out on a money purchase basis.

One of the proposed changes, due to take effect from 6 April 2012, relates to the Contracting-Out (Transfers and Transfer Payments) Regulations 1996 – SI 1996/1462, and refers to the schemes to which a transfer may be made by a member of a contracted out DB occupational scheme. The change removes contracted out money purchase occupational schemes and appropriate personal pension schemes from the list of eligible receiving schemes and does not replace them with any other reference to money purchase occupational schemes or personal pension schemes. This would seem to prohibit members of contracted out DB occupational schemes transferring their benefits to any money purchase pension arrangement on or after 6 April 2012.

We telephoned the DWP to ascertain whether the above interpretation of the change to the legislation is correct and they confirmed that it is. If the regulations are implemented as drafted, this will effectively mean that transfers from nearly all DB schemes to any money purchase schemes will be prohibited. In 2008, 94% of active private sector DB scheme members were contracted out according to National Statistics. It would mean, for example, that it would generally not be possible for a DB member to transfer to a personal pension scheme to take advantage of drawdown. Perhaps the only way to access unsecured pension options would be to transfer the benefits to a section 32 arrangement, which offered drawdown.

The logic in amending this regulation is clear, but is the end result what the DWP intended? Members who transfer their contracted DB rights to a contracted out money purchase scheme (or personal pension scheme) prior to 6 April 2012 will receive protected rights benefits in respect of their GMP/section 9(2B) rights. However, from 6 April 2012 these protected rights benefits will be treated as normal non-contracted out benefits. If this is acceptable to the DWP then a transfer of a member's contracted out DB benefits to a money purchase scheme on or after 6 April 2012 should be similarly acceptable.

Cynics might suggest that the DWP move is another Treasury money-saving measure. Fixed revaluation rates for GMPs (which did not fall below 7% until April 1997) mean that GMPs are generally higher and growing faster than the SERPS accrual they replaced. Thus the government payments of GMP inflationary top ups (for all inflation for GMP accrued from 1978-1988 and above 3% from 1988) from State Pension Age (SPA) are effectively delayed and may never arise. However, on transfer to a money purchase arrangement, from SPA the DWP applies inflationary top ups to a (much lower) notional additional pension based on SERPS.

COMMENT

If no amendment is made to the proposed changes this could result in considerably less flexibility for members of DB schemes wishing to transfer their benefits to a money purchase scheme.

HMRC GUIDANCE ON TAX MATTERS

How far can a taxpayer go in relying on statements made in HMRC's Technical Manuals? The principle of legitimate expectation has recently been considered by the First-tier Tribunal.

The concept of "legitimate expectation" in relation to HMRC guidance given to taxpayers has developed over the last few years. This concept means that where a taxpayer has relied on HMRC guidance on following a course of action, he will not be liable for tax and tax penalties as a result of the action taken.

A recent case has considered

(i) the First-tier Tribunal's jurisdiction to consider a legitimate expectation case and,

(ii) if it did, whether the taxpayer did have legitimate expectation in that particular case.

This case considered whether the taxpaying company, Hanover Company Services Ltd (Hanover), was justified in not operating output tax on printed documentation that it provided as part of its company formation services. Hanover argued that it had not operated output tax on the advice of its VAT adviser. In giving this advice, the VAT adviser had relied on the HMRC view set out in their Manual that existed before November 2005.

In reply HMRC argued that they changed their treatment of these transactions in January 2006 and announced that change in the Business Brief 01/2006. Therefore, Hanover should have adopted that revised treatment (and applied VAT to the printed material). It was clear from a VAT compliance visit in May 2006 that this was not happening.

In defence of their action, Hanover argued that they had acted under the principle of legitimate expectation. HMRC argued that they had no right of redress under legitimate expectation and, indeed, the Tribunal had no jurisdiction to even consider their argument on this.

The decision

The Tribunal held:

(i) That following the decision in the case of Oxfam v HMRC in 2010, it did have jurisdiction to consider the case.

(ii) That Hanover had not relied on the HMRC guidance because it had relied on its VAT adviser – even though the VAT adviser had relied on the HMRC guidance. The

Tribunal went on to say that when relying on HMRC statements, it is necessary that the ruling or statement relied upon should be "clear, unambiguous and devoid of relevant qualification". As to the last point, the HMRC guidance in question had a general health warning and so did not satisfy this condition.

On this basis Hanover had no legitimate expectation to rely on HMRC guidance and the Tribunal upheld the penalty assessments that HMRC had imposed on Hanover.

Conclusions

The following conclusions may be drawn from this case:-

(i) A taxpayer may form an appeal on the basis of reasonable expectation that can be heard by a Tribunal (although because of the uncertainty in this area of the law, they should also lodge a judicial review claim in the Upper Tribunal within the appropriate time limits).

(ii) Taxpayers should be wary of general HMRC guidance, especially where health warnings are given. In light of this, it may be that only specific guidance to the taxpayer can be relied on.

(i) Reliance by an **adviser** on HMRC guidance may not be sufficient to give rise to a defence of legitimate expectation to the actual taxpayer. It may be more appropriate for an adviser to inform the taxpayer of the existence of the guidance so that the taxpayer directly relies on the guidance and not the advice of the adviser (which may be based on the guidance!).

BEREAVEMENT AND TAX – GUIDANCE FROM HMRC

HMRC has recently published a new on-line guide entitled "Bereavement and tax – guidance for advisers in third sector and voluntary organisations". This guide is designed to help individuals dealing with estates of recently deceased persons. It is aimed at personal representatives rather than professionals such as solicitors. It is to help personal representatives close the deceased's tax affairs and it covers income tax and capital gains tax practicalities and touches on inheritance tax. In addition to dealing with the tax affairs of the deceased and their estate, it also includes a section on the impact of a death on the tax position of widows/widowers, surviving partners and other family members.

It does not deal with the practical aspects of administering an estate. There are links to other useful publications and sites.

The guidance can be found here: http://www.hmrc.gov.uk/menus/guidance-bereavement.pdf.

INCOME WITHDRAWAL RATE FOR SEPTEMBER 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 September is 3.5%.