Technical CONNECTION

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HMRC ISSUES PENSIONS CLARIFICATION

Pension input period default rules

Satisfying the MIR where an individual wishes to apply for flexible drawdown

Those in receipt of an unsecured pension on 5 April 2011

- ### Pension input periods

HMRC has provided clarification of how the new pension input period default rules set out in the Finance (No.3) Bill 2011 will work. It has now confirmed to us that where a new pension arrangement is set up on or after 6 April 2011 it will automatically have a default pension input period end date of the 5 April immediately following the commencement date unless a nomination is made for a different pension input period end date prior to that 5 April. Such nomination can be for any date from the date of nomination up until the day prior to the anniversary date of the commencement of the arrangement.

The above will mean that if John, for example, paid his first contribution to a SIPP on 1 June 2011 he could make a nomination prior to 5 April 2012 to change the pension input period end date to any date before 1 June 2012. Such date cannot predate the date of nomination. If no nomination had been made by 5 April 2012 the pension input period end date for John's SIPP would automatically default to 5 April 2012.

If John made a nomination on, say, 1 May 2012 to bring his pension input period end date forward to 31 May 2012, this would mean:

- The first pension input period in respect of his SIPP would run from 1 June 2011 to 5 April 2012

- The second input period would run from 6 April 2012 to 31 May 2012

- The third pension input period would run from 1 June 2012 to 31 May 2013

As it is the pension input by, for or on behalf of a member from each arrangement with a pension input period ending in the tax year concerned that is tested against the member's annual allowance in that tax year, it is essential to understand the rules regarding pension input periods.

It is very important to note that there has been no change in respect of the pension input period end dates for those arrangements set up prior to tax year 2011/12 and so the pre-Finance Bill rules apply.

• The minimum income requirement (MIR)

There have been a number of recent articles in the trade press on the way in which the £20,000 pa minimum income requirement (MIR) will be applied where a member is making a flexible drawdown declaration. Many have suggested that the individual must be in receipt of secure pension income of at least £20,000 that is actually paid or payable in the tax year in which the declaration is made. We have been in correspondence with HMRC on this subject and can confirm that this is indeed the case. The following example illustrates the point:

John, aged 63, has a drawdown fund of £1.75 million. He wishes to elect for flexible drawdown in 2011/12. On 1 September 2011 he used part of his drawdown fund to purchase a level single life lifetime annuity of £2,000 per month (payable monthly in advance), and on 15 September makes a flexible drawdown declaration. In tax year 2011/12 he will only receive pension annuity payments of £16,000 (i.e. 8 months [1/9/11 to 1/4/12 inclusive] of £2,000). We asked HMRC whether John would meet the MIR requirement in 2011/12 as his annualised income was £20,000 or more or whether he would have to delay his application for flexible drawdown to 2012/13 as he would only actually receive £16,000 secure pension income in 2011/12.

HMRC confirmed that if this annuity was his only secure pension income in 2011/12 he would not be able to meet the MIR test as he would only have received £16,000 income in that tax year. He would have to wait until tax year 2012/13 to make a valid declaration for flexible drawdown.

• Unsecured pension

HMRC has clarified the circumstances in which an individual taking an unsecured pension on 5 April 2011 can continue to take income for the balance of his current 5 year review period based on the old unsecured pension limits, rather than the new drawdown pension limits.

Transitional provisions apply to a member of a scheme in receipt of an unsecured pension as at 5 April 2011. These enable such a member to continue to be able to take maximum income determined at the last unsecured pension review date up until the end of that five year review period. There are some exceptions to this where a member reaches age 75 or transfers his benefits to another scheme before that five year review date.

A number of questions have been raised with HMRC following the publication of the Finance (No.3) Bill 2011 clauses. Some commentators had interpreted the draft legislation to result in a loss of the transitional provisions when uncrystallised monies are transferred into the scheme from which the member is taking his drawdown pension. It was felt that any transfer-in would mean that from the next anniversary of the unsecured pension review date, the member's maximum income would be calculated in accordance with the new drawdown limits. HMRC has now confirmed to the Association of Member-Directed Pension Schemes that this is not the case, and that any transfer-in of uncrystallised benefits will not affect the continuation of the transitional provisions.

It should, however, be remembered that where a member, who is subject to the transitional provisions, transfers his (now) drawdown pension benefits to a new scheme, these benefits will become subject to the new drawdown pension limits from the next anniversary of the unsecured pension review date.

OVERTURNING WILL PROVISIONS

It is well known that in England and Wales it is generally up to the individual to decide how to distribute his/her estate on death. The position is different in Scotland and in many European countries where certain beneficiaries (usually the children) cannot be wholly disinherited. However, even in England, this testamentary freedom is subject to challenge under the Inheritance (Provision for Family and Dependants) Act 1975.

In the case of Ilott v Mitson and Others [2011] EWCA Civ 345, the Court of Appeal had to adjudicate on proceedings brought under this Act by a daughter of the deceased, Mrs Melita Jackson, who died in 2004 aged 70 and who left the bulk of her estate worth £486,000 to three charities - the Blue Cross, the RSPB and the RSPCA.

Her daughter, Heather Ilott, had left home at the age of 17 and, despite a few attempts, had still not been reconciled with her mother by the age of 43, when her mother died. Since the age of 17 Heather had not received any financial support from her mother and she had no expectation of receiving anything under her Will. At the time of her mother's death she had 5 children and was living on benefits. She brought a claim against her mother's estate claiming that the Will failed to make reasonable financial provision for her.

At first instance the Court found that the Will did not make sufficient financial provision for Heather and awarded her a lump sum of £50,000. The charities appealed on the basis that, although the daughter was not well off, she was unable to show any moral or special obligation that meant she should receive maintenance from her mother's estate. Although the charities succeeded on appeal, the case was appealed again by Heather (with help of a pro bono barrister) to the Court of Appeal who reversed the decision and reinstated the award in her favour.

The Court of Appeal held that an adult child of the deceased does not have to go so far as to show a moral obligation or some other special circumstance to succeed; the fact that the Will does not make reasonable financial provision is sufficient. In addition, the Court of Appeal acceded to Heather's request that she be allowed to appeal further the award of £50,000 in an attempt to obtain a higher amount.

COMMENT

What was interesting in this case was the fact that the deceased had left a very clear explanatory letter to her executors giving reasons why she had made no provision in her Will for her only child and daughter and instructed her executors to defend any claim that the said daughter brought against her estate. Other than making lifetime gifts, it is difficult to see what else the testatrix could have done to ensure that her wishes were carried out.

This case, coupled with a number of other cases involving charities, indicates that those making Wills need to take great care when leaving legacies to charities, especially at the expense of family members. One possible course of action that could be considered is the inclusion of a discretionary trust in a Will under which the trustees could use funds to advance to both charitable and non-charitable beneficiaries. This could, in many cases, at least avoid costly legal proceedings, as no charity could sue where it was merely an object of the discretion, and a disgruntled family member might be satisfied with a small advancement by the trustees (which would usually be preferable to spending money on legal costs). Of course, if it is important to avoid inheritance tax, then any trust in excess of the available nil rate band should only include charities as beneficiaries.

PENSIONS MISCELLANY

- Pension Schemes Newsletter 46 covers the nomination of pension input periods, the payment of a member's annual allowance charge from his scheme benefits, disguised remuneration, employer asset-backed pension contributions and revisions to the penalty charges for failing to submit an Accounting for Tax return or a self assessment return.

- The Social Security (Reduced Rates of Class 1 Contributions, Rebates and Minimum Contributions) Order 2011 – SI 2011/1036 sets out the contracting out rebates to apply for the quinquennium commencing in 2012/13. This confirms the fall in the rebate for DB schemes from 5.3% to 4.8% (made up of 3.4% employer and 1.4% employee).

SELF ASSESSMENT

New penalty regime for the late filing of self assessment returns and late payment of tax

With effect from 6 April 2011 HMRC has introduced a new penalty regime for the late filing of self assessment income tax returns and late payment of tax. The new penalties for filing a tax return late are as follows:

1 day late	Initial penalty of £100 (regardless of whether there is any tax to pay)
3 months late	A further penalty of £10 a day up to a maximum of £900
6 months late	A further penalty of the greater of 5% of the tax due and £300
12 months late	A further penalty of the greater of 5% of the tax due and £300. A higher penalty of up to 100% of the tax due could be charged in more serious cases.

The new penalties for paying tax late are as follows:

30 days late	An initial penalty of 5% of the tax unpaid at that date
6 months late	A further penalty of 5% of the tax that is still unpaid
12 months late	A further penalty of 5% of the tax that is still unpaid

These penalties are on top of the interest HMRC will charge on outstanding amounts, including unpaid penalties, until payment is received.

THE EXTENSION OF THE DISCLOSURE RULES TO INHERITANCE TAX

In the Autumn of 2010 HMRC announced that the Disclosure Of Tax Regulations were to be extended to certain inheritance tax planning arrangements. The Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2011 (SI 2011/170) have now been brought into effect to deal with this situation. HMRC has also issued supplementary guidance notes.

Basically, the Regulations provide for arrangements that satisfy certain conditions to be declared to HMRC. HMRC will then allocate a scheme reference number which will enable HMRC to identify the scheme in the future and co-ordinate enquires into tax returns of people who have used the scheme. The reference number system only applies to inheritance tax schemes and arrangements that become notifiable on or after 6 April 2011.

It needs to be borne in mind that the purpose of disclosure is to enable HMRC to **become aware of the scheme**. It does not signify any form of acceptance or non-acceptance of the scheme. Likewise, if the scheme is exempt from disclosure under, say, the grandfathering provisions (see below) this does not indicate that HMRC either finds the scheme acceptable or that it accepts that it has the intended effect under current law. It merely signifies that HMRC is already aware of it or that it does not fall within the Disclosure Of Tax Regulations.

The need to notify

To be a notifiable inheritance tax scheme, the scheme must satisfy three tests. Even if it satisfies those three tests, there is a let-out in that it does not need to be notified if the grandfathering rules apply.

The three tests

For a scheme to be notifiable, three tests must be satisfied as follows:-

Test 1: Are there arrangements (including any scheme, transaction or series of transactions) or proposals for arrangements, which result in property becoming "relevant property"?

"Arrangement" includes any scheme, transaction or series of transactions and "relevant property" means property held on relevant property trusts ie. discretionary trusts or post 21 March 2006 interest in possession trusts that are not IPDIs (but not charitable trusts).

Test 2: Do the arrangements give rise to a "relevant property entry charge" advantage?

Relevant property entry charge refers to the IHT charge that arises when a person makes a transfer of value during lifetime to a discretionary trust.

"Advantage" has a wide definition and includes the avoidance, reduction, relief from or deferral of the charge. There generally needs to be a transfer of value for this test to be satisfied but if it is the arrangements that have resulted in there being no transfer of value, disclosure will be required.

Test 3: Is the tax advantage a main benefit of the arrangements or proposals?

Here HMRC says that it would expect it to be obvious to any potential client what the relationship is between the tax advantage and the other benefit of the product they are buying or arrangements they are making. It should therefore be relatively obvious whether the tax advantage is the main benefit or not. The test is objective.

Even if the three tests are satisfied, a taxpayer/scheme promoter will be saved from disclosure if the grandfathering rules apply. If they do not, disclosure will be necessary.

The grandfathering rules

One of the aims of the extension of the disclosure rules to inheritance tax is to restrict disclosure to those schemes which are new or innovative. This is achieved by exempting from disclosure those schemes which are the same or substantially the same as arrangements made available before 6th April 2011. This is known as 'grandfathering'. HMRC has provided some guidance on what is meant by "substantially the same" as follows:

"A promoter is required to disclose the same scheme only once. Minor changes, for example to suit the requirements of different clients, need not be separately disclosed providing the revised proposal remains substantially the same.

What constitutes a change in a scheme or arrangement so that it is no longer substantially the same is a matter which will need to be considered on each occasion.

In our view a scheme is no longer substantially the same if the effect of any change would be to make any previous disclosure misleading in relation to the second (or subsequent) client.

In general provided the tax analysis is substantially the same we will regard schemes as "substantially the same" where the only change is a different client including a different company in the same group.

We will not regard schemes as substantially the same where there are changes to deal with changes in the law or accounting treatment, changes in the tax attributes e.g. schemes creating income losses instead of capital losses or other legal and commercial issues.

However, special care must be taken where an existing tax product is used as part of an otherwise bespoke scheme. This has been described to us as "the use of existing toolkit".

Where a piece of "existing toolkit" is used as part of a separate scheme for the same or different client then it may be that the resulting scheme is so different from the earlier planning idea that the disclosure position needs to be considered afresh. In some situations this might involve the client being given two or more numbers, for example where the scheme involves a combination of ideas that were themselves disclosed and allocated a number."

Subject to what is said above, the Regulations exempt from disclosure arrangements which are the same or have substantially the same description as arrangements:

- which were first made available for implementation before 6th April 2011;
- in relation to which the date of any transaction forming part of the arrangements falls before 6th April 2011; or
- in relation to which a promoter first made a firm approach to another person before 6th April 2011.

It is a matter of fact whether an arrangement is grandfathered. Evidence of grandfathering would include:

- the existence and substance of the arrangement being clearly described in tax manuals or publications;
- the production of an affidavit where evidence that the grandfathering rule applies is subject to legal professional privilege; or
- a practitioner's own record as to when they made, or learnt that competitors were making, an arrangement available.

List of grandfathered schemes & schemes that are not within the regulations

Clearly, there could be a number of disputes as to whether a scheme/arrangement is grandfathered. In order to clarify this area, HMRC has made available a list of schemes which it regards as being 'grandfathered'. This list is purely illustrative and should not be regarded as being exhaustive. HMRC points out that if there is any doubt as to whether a scheme ought to be disclosed then a disclosure should be made. Schemes relevant to financial planning that can be treated as "grandfathered" include:

- **Discounted Gift Trusts/Schemes -** Discounted gift trusts/schemes where the residual trust is a bare trust would not require disclosure as there is no property becoming relevant property. Where, in relation to a discounted gift trust/scheme, property becomes relevant property then disclosure will not be required where the grandfathering provisions apply.

- **Loan into trust -** A transfer into a relevant property trust by way of loan where, other than the establishment of the trust, it is a single step transaction, will not be disclosable as the grandfathering provisions will apply.

- **Insurance policy trusts -** A transfer of the rights to the benefits payable on death into a relevant property trust will not be disclosable even where other benefits, for example critical illness benefits, are payable to the settlor as the grandfathering provisions will apply.

  The payment of premiums on a policy settled into a relevant property trust paid by the settlor or other person will not be disclosable as the grandfathering provisions will apply.

- **Pension death benefits -** The transfer of pension scheme death benefits into a relevant property trust where the scheme member retains the retirement benefits will not in itself require disclosure. However, where the transfer is part of arrangements which enable an advantage to be obtained in respect of the relevant property entry charge then disclosure may be required. This will depend on whether it can be shown that the arrangements are within the exceptions to disclosure outlined in Regulation 3 (the grandfathering rule).

HMRC CLOSES QROPS LOOPHOLE

The Government has announced a change in legislation to prevent tax avoidance by the use of certain QROPS. On 6 April 2011 David Gauke, the Exchequer Secretary to the Treasury, made a statement that new measures to achieve this objective will be included in the Finance (No.3) Bill 2011. The full text of the statement is:

"The Government will bring forward a new clause in the Finance (No. 3) Bill to prevent tax avoidance through the interaction of relief for pension savings and the provisions of certain double taxation arrangements. The new clause will provide that, notwithstanding the terms of a double taxation arrangement with another territory, a payment of a pension or other similar remuneration may be taxed in the United Kingdom where:

- *the payment arises in the other territory;*
- *it is received by an individual resident of the United Kingdom;*
- *the pension savings in respect of which the pension or other similar remuneration is paid have been transferred to a pension scheme in the other territory; and*
- *the main purpose or one of the main purposes of any person concerned with the transfer of pension savings in respect of which the payment is made was to take advantage of the double taxation arrangement in respect of that payment by means of that transfer.*

In the event that tax is paid in the other jurisdiction, appropriate credit will be available against the UK tax chargeable. This will have effect in relation to payments of pensions or other similar remuneration made on or after 6 April 2011."

It is understood that this amendment has been rushed in following concerns that UK resident individuals could transfer their UK pension benefits to a QROPS in Hong Kong and then take advantage of the pension article in the new UK/Hong Kong DTA that became effective for income and capital gains tax purposes on 6 April 2011.

INCOME WITHDRAWAL RATE FOR MAY 2011

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 May 2011 is 4.0%.