Technical Connection

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THE IHT NORMAL EXPENDITURE OUT OF INCOME EXEMPTION

Withdrawals from a single premium bond HMRC confirms the position as regards the IHT normal expenditure out of income exemption

There has been some recent discussion on the STEP Trust Discussion Forum and at tax conferences on the ability of somebody to take account of withdrawals from single premium bonds as part of their income in determining whether they qualify for the normal expenditure out of income exemption.

The background to this was following a presentation made by a senior Inland Revenue official at a tax conference in 2005, he apparently then, in connection with single premium bonds, stated in writing:-

"regular withdrawals of 5% per annum then, so long as the capital of the bond is maintained, the presumption must be that the withdrawals are income".

At the time, it was our belief that this was a somewhat surprising statement from HMRC. At the very least, the "so long as…." proviso means that the facts of each case would need to be taken into account.

However, it did raise a number of issues. Firstly, it is accepted that the word "income" is not defined in section 21 or section 272 IHT Act 1984 but given that this is a taxing statute one would expect it to have a tax meaning.

Secondly, even if the capital value of the bond is maintained after the withdrawal, it is not necessarily the case that withdrawals, in effect, reflect only income arising on the investments underlying an individual's single premium bond. Indeed, the statutory hypothesis, underlying the well-known "5% withdrawal" rule, is that the withdrawals are capital not income.

Thirdly, from a tax and, indeed, a legal standpoint, a life assurance policy, such as a single premium bond, is treated as a non-income producing investment. The policyholder has rights in a contract of life assurance which he can exercise from time to time by, for example, making a part surrender but he has no entitlement to the underlying income of the investment fund that belongs to the life office.

The income tax legislation recognises this by use of the chargeable event legislation which **treats** chargeable event gains as income.

Our view at the time was that in light of the points made above, we believed that it may be overoptimistic to rely on this earlier HMRC statement in all cases where a claim is being made for the normal expenditure exemption if part of the donor's "income" arises from withdrawals from a single premium bond and it is those withdrawals which cause the policyholder to maintain his standard of living and/or are used to make the gift.

However, this issue has recently surfaced again with a number of commentators continuing to suggest that a 5% withdrawal from a single premium bond could count as income for the purposes of the normal expenditure out of income exemption. Therefore, in order to obtain clarity, we wrote to HM Revenue and Customs to ask for an authorative statement on the issue and they have replied as follows:-

"It is our view that the regular withdrawals of 5% of the premium from a single premium insurance bond are payments of capital and, as such, they do not fall within the description of income for the purpose of the section 21 IHTA 1984 exemption.

We are aware that contrary opinions have been expressed in the insurance industry and we intend to make our position clearer in an update to the guidance in the Inheritance Tax Manual in due course".

COMMENT

HMRC's view on this subject looks clear and hopefully this will now bring clarity to this issue. Persons who are seeking to make regular gifts out of income with a view to using their normal expenditure out of income exemption cannot take account of withdrawals from single premium bonds in determining their level of income.

JUNIOR ISAs

Final regulations laid effective from 1 November 2011

On 27 July 2011 the Government laid detailed final regulations (The Individual Savings Account (Amendment No.2) Regulations 2011 – SI 2011/1780) to facilitate the establishment of Junior ISAs

(JISAs) from 1 November 2011. The Guidance notes for ISA Managers have been updated so that they now include guidance on the JISA. The regulations also update some of the ISA regulations.

Most of the "adult" ISA rules apply to JISAs, and of course there are rules that are specific to the JISA. The main change between the draft and the final regulations is that the annual subscription limit is £3,600 for tax years 2011/12 and 2012/13, not £3,000 as originally proposed. From 6 April 2013 the annual limit will be increased in line with the Consumer Prices Index.

TREASURY PUBLISHES CONSULTATION ON EIS AND VCT INVESTMENT START-UPS

In the March 2011 Budget the Chancellor made a commitment to consult on the simplification of the EIS and VCT schemes and support for seed investment and start-ups.

The Treasury has now released a consultative document. The aim is to consult on:

- additional support for seed investment via the creation of a new scheme;
- simplification of the current schemes; and
- refocusing the current schemes to ensure they remain appropriately targeted

Additional support for seed investment via the creation of a new scheme

The consultation document explains that existing EIS and VCT schemes are aimed at smaller companies which find it hard to raise equity investment. The smallest companies, especially start-ups, face particular difficulties attracting investors to make early-stage investments ('seed investment').

To make investment more attractive, the Government has considered a number of alternatives to meet the policy objectives of enhancing seed investment by Business Angels. Following assessment of the advantages and disadvantages of different strategies, the Government is proposing to develop a new stand-alone scheme, targeted at the seed level, named the Business Angel Seed Investment Scheme (BASIS).

The BASIS would be modelled on the current EIS scheme but targeted more directly at Business Angels to incentivise their investing at the seed-stage of a company's development, with the possibility of introducing more flexibility around the use of debt instruments. Access to the scheme would be restricted to a narrower category of investor and a narrower category of company than the current EIS.

Simplification of the current schemes

The consultation document proposes allowing EIS investors to qualify for relief where investment is made via preference shares, including using the same definition of 'eligible shares' for the EIS as is given to the VCT, and changing the current 'connected individuals' definitions.

The consultation also touches on possible future simplifications centred around:

- The barriers to price-setting mechanisms
- The merger of EIS companies

- Periods of grace for payment for shares
- Excluded activities

Refocusing of the current schemes to ensure they remain appropriately targeted

Finally, given the additional incentives offered by the recently increased EIS rate of tax relief and proposed changes to EISs and VCTs from April 2012, the Government feels that the schemes must continue to be targeted as genuine high risk capital investments. The consultation document aims to tackle this perceived problem by introducing legislation to address:

- Companies that are established solely for the purposes of accessing relief
- Acquisition companies
- The exclusion of some feed-in tariff businesses

Responses to the consultation document should be submitted no later than 28 September 2011.

PENSIONS - FINANCE ACT 2011 AND ASSOCIATED REGULATIONS

The Finance Act 2011 received Royal Assent on 19 July 2011. The pension provisions are set out in sections 65 to 72, and Schedules 16 to 18. The changes principally relate to the annual allowance, the lifetime allowance and the abolition of compulsory annuitisation at age 75.

Our May 2011 Bulletin reviewed the draft regulations issued regarding the changes to the annual allowance, standard lifetime allowance and 'age 75' provisions included in the Finance (No.3) Bill 2011. Our June 2011 Bulletin provided details of three further draft regulations in respect of the 'age 75' changes.

Ten sets of regulations have now been issued following the passing of the Finance Act 2011. These largely follow the draft regulations, although a number of the earlier draft regulations have been consolidated into one document and there are several changes from the original drafts. The most important of these are:

- An inflation linked annuity will count as secure pension income when assessing the £20,000 Minimum Income Requirement for flexible drawdown, even if it allows for a drop in income during times of deflation.

- No change has been made to the maximum allowable income from a variable lifetime annuity. This will remain as 120% of the annuity on which it is based, rather than being reduced to 100% as proposed in the draft regulations

AGRICULTURAL PROPERTY RELIEF

Farmhouses and "character appropriate" for APR purposes

In Golding v HMRC (2011) the First-tier Tribunal (Tax) has given an important decision on the eligibility of farmhouses for IHT Agricultural Property Relief (APR).

The case concerned the estate of the late Mr Golding who had farmed a 16-acre smallholding in Staffordshire since 1965. When Mr Golding died, APR was claimed on the smallholding to reduce the liability of his estate to Inheritance Tax (IHT). While HMRC accepted the claim in respect of the land and buildings of the smallholding, they did not accept the claim that the three-bedroom farmhouse, which was in a poor state of repair, was eligible for any relief because it was not of a 'character appropriate' for APR purposes.

A part of HMRC's argument was based on the limited financial viability of the smallholding. The level of activity on the smallholding had diminished over the years and, in the period leading up to his death, Mr Golding had grown vegetables mainly for his own consumption and sold a few eggs to some 15-20 customers.

The Tribunal found in favour of the executors of Mr Golding concluding that, although the level of profits was below the National Minimum Wage, the deceased was still working his holding, as a farm, when he died. The judge stated that it would be unreasonable to expect the activities of an 80-year old to be extensive in nature. It was also clear from the taxpayer's actions that he intended to carry on farming. This was illustrated by the purchase of new equipment by Mr Golding shortly before his death.

This decision has been welcomed by practitioners as one based on a common-sense approach.

COMMENT

APR is available on the transfer of agricultural property in the UK, Channel Islands, Isle of Man or the EEA provided various conditions are satisfied. The property must be agricultural property, which includes woodland and buildings used for rearing livestock, agricultural land and cottages, farmland and farmhouses occupied with the agricultural land.

There has been a considerable amount of case law on what qualifies as a farmhouse for the purposes of APR.

Earlier cases, in particular Antrobus (2002 and 2005), confirmed the broad basis of a claim for relief on a farmhouse. This established that a wide range of factors need to be considered, including the size of the holding in relation to the house, the cropping and stocking history of the agricultural holding and what has been termed the 'elephant test' of knowing a farmhouse when you see it.

In a more recent decision in McKenna (executors) v IRC [2006], the house failed to qualify as a farmhouse because the owners had a contract farming arrangement and the day-to-day management of the farming was the sole responsibility of the contractor and an agent on behalf of the owners.

In the Golding case, the Tax Tribunal seems to have accepted, once again, that cases should be looked at "in the round". This is good news for the taxpayer as, had HMRC been successful, this could have had serious implications as the definition of "character appropriate" would have been narrowed.

The case reminds us of the importance of APR as one of two (with business property relief) extremely valuable reliefs available in IHT planning.

PUBLIC SECTOR PENSIONS UPDATE

In a written ministerial statement dated 19 July 2011, Danny Alexander, Chief Secretary to the Treasury, indicated how the Government is progressing with the proposed public sector pension changes in light of the Hutton Report, following discussions with the TUC. The key points are as follows:

- Initial discussions on reform should be opened on a scheme by scheme basis. The central process will continue alongside this. These discussions are necessary to ensure a fuller understanding of the implications of reforms, before final conclusions are reached. Scheme level discussions will deliver initial proposals for reformed schemes by the end of October this year.

- To meet the target of £1.2 billion savings set out in the Spending Review for 2012-13, consultation on schemes' proposals for member contribution increases from April 2012 will need to be completed by the end of October, in order to ensure implementation from April 2012.

- The Government remains committed to securing the full Spending Review savings of £2.3 billion in 2013-14 and £2.8 billion in 2014-15.

- The Government has made it clear that lower earners should be protected from the impact of any contribution increases and has proposed that there should be no increase in member contributions for those earning under £15,000 and no more than a 1.5% increase in total (before tax relief) contributions by 2014-15 for those earning between £15,000 and £21,000. This amounts to a 0.6 percentage point increase in 2012-13 on the 40% pro-rata basis. This is a further concession by Government for lower earners. However, as the Government still intends to meet its target savings this means that the contribution increase for higher earners will be greater. The total increase will be capped at 6% (before tax relief) by 2014-15 for the highest earners. Members of the Armed Forces scheme will be exempt from any contribution increases.

- Lord Hutton's recommendations will form the basis of scheme level discussions and the Government will provide scheme specific cost ceilings (a total cap on the cost of a scheme). These will be established by the Treasury, with advice from the Government Actuary's Department, and after discussion with the schemes, by October 2011.

- The Government feels that cost caps alone cannot manage the risks of maintaining defined benefit schemes, and that the longevity risk should be addressed by increasing the normal pension age of such schemes in line with the increase in State Pension Age.

- For local government, the Government recognises that the funded nature of the scheme puts it in a different position and will discuss whether there are alternative ways to deliver some or all of the savings in respect of contribution increases.

There will be a further meeting between the Government and the TUC to discuss progress at the end of September.

UCITS IV

The European Parliament approved the European Commission's UCITS IV proposals towards the end of 2008. They were designed to counter some of the inefficiencies and difficulties in the cross-border sales of investment funds that had emerged under the UCITS III regime.

The actual final implementation of UCITS IV into the national law of the EU Member States was meant to be 1 July 2011. Luxembourg, which is a major centre for pan-European funds, passed its laws last December, while German legislation took effect from June. Ireland, another major base for pan-European funds, just squeezed within the deadline.

In the UK, the Treasury and FSA published a joint paper 'Transposition of UCITS IV: consultation document' at the end of 2010. The necessary UK statutory instrument was made on 30 June. Other countries have been less successful in producing the necessary legislation. France, Italy, Spain and Belgium are among those EU members that failed to meet the 1 July start date.

The changes to the FSA handbook prompted by UCITS IV are not yet finalised, although in mid-June the regulator did issue a 'near-final draft' of the revised rules and guidance. At the time the FSA promised definitive rules once the statutory instrument came into force, as this gives the regulator the power to make the required amendments.

UCITS IV introduces six important changes:

- **Removal of administrative barriers to the cross-border marketing of UCITS** Once the regulator of a fund has notified the regulator in the EEA Member State where the management company wants to sell its product, the fund can then be marketed without delay. There is no need to wait for the prior approval of the host State regulator, a process which has been agonisingly slow in some countries.

- **Introduction of a management company passport** UCITS IV allows a management company authorised in one Member State to operate a fund in a different Member State without needing to be established in the fund's Member State.

- **Improved investor disclosure** UCITS IV replaces the simplified prospectus requirements with key investor information (KII). This takes the form of the KIID (Key Investor Information Document), which is supposed to be 'a simple document giving key facts to investors in a clear and understandable manner'.

- **Mergers between UCITS funds** UCITS IV introduces a single harmonised EU regime on the authorisation requirements for a cross-border fund merger and on the information that will have to be given to investors when funds are combined. While in theory this reform, combined with the easier cross-border marketing and the management company passport, should mean mergers become more common, in practice individual Member State's tax rules will remain an obstacle.

- **Provision for master-feeder structures** The old UCITS Directive placed strict limits on the amount of a UCITS' assets that could be invested in another fund. UCITS IV relaxes these restrictions and enables a UCITS 'feeder' fund to be created which invests at least 85% of its assets into another UCITS called a 'master' fund. The master/feeder approach itself is nothing new – Bernie Madoff used it to gain access to European investors. The EU hopes – probably optimistically – that the relaxation of master/feeder structure rules will allow funds to benefit from economies of scale which will be passed onto investors.

- **Improved supervisory co-operation** UCITS IV establishes a detailed framework to improve the co-operation between UCITS regulators, particularly in relation to the supervision of a UCITS management company and fund when they are established in different Member States.

AUTOMATIC ENROLMENT REGULATIONS FOR CONSULTATION

The DWP has issued a consultation document, designed to complete the legislative framework, on draft automatic enrolment regulations. Any comments on the consultation are required by 11 October 2011, with the finalised regulations due to be issued in early 2012.

There are two main draft regulations:

- The Automatic Enrolment (Miscellaneous Amendments) Regulations 2011, and

- The Automatic Enrolment (Miscellaneous Amendments) (No.2) Regulations 2011.

These draft regulations include:

- amendments to existing legislation to reflect policy changes arising from the Making Automatic Employment Work Review, including measures to manage the burdens on business, such as allowing employers to apply waiting periods in respect of eligible jobholders; and

- a series of minor amendments intended to clarify the policy and remove legislative obstacles.

Draft guidance for persons certifying money purchase, personal pension and certain hybrid schemes has also been issued as part of the consultation together with two draft Orders in Council, relating to offshore workers and compromise agreements.

INCOME WITHDRAWAL RATE FOR AUGUST 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 August 2011 is 3.5%.