Technical CONNECTION

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LIFE POLICY TAXATION

In his recent Budget the Chancellor announced some provisions aimed at dealing with, in particular, two tax avoidance strategies based on single premium life assurance bonds.

One strategy was based on a bond established as a number of individual policy segments. Normally, in such a case each segment (whilst being a genuinely independent policy) will be purchased for an identical premium and offer identical benefits. In the structure targeted by these latest provisions, however, there would typically be some manipulation of premiums and benefits between segments designed to

- give the policyholder an entitlement to a stream of cash payments from the plan with no immediate tax charge by the encashment of policies for an amount equal to the premiums paid to those policies

- defer the possible tax charge until the latest possible time by ensuring that all of the investment growth on the plan accrued to just one (the last to be encashed) policy segment.

The Budget proposals prevent this planning from working in the future through new legislation that will remove the scope to defer income tax in this way. This is achieved by only recognising a segment as an individual policy if it stands up economically as part of the group of policies.

If the segment does not stand up economically it will be a connected policy of other interdependent policies are treated as a single policy for the purposes of the chargeable event legislation.

It is, however, important to note that these new provisions will in no way affect bonds which are properly structured as genuinely independent policy segments and have no artificial allocation of premiums and benefits between them. In this respect the Government has said

"Standard industry arrangements which divide a sum invested across a number of identical but genuinely distinct and economically self-contained policies will not be affected."

Plans effected before 21 March 2012 will also not be affected provided that they are not varied to increase the benefits secured, assigned or used as security for a debt on or after 21 March 2012.

It is reassuring that bonds that have genuine and commercial segmentation founded on genuine independent (albeit identical) policies will continue to operate as they always have without the new tax rules applying.

Such a structure gives a very "flexible" approach to using a bond in financial planning. For example if, say, a higher rate taxpaying husband owns a bond and at a later date he doesn't need full access to the proceeds of the bond, segments could be assigned to other adult family members when they have a need for cash.

The benefits of such action are that

- there will be no tax charge on the assignment (because it is not for consideration)
- any chargeable event gains will be taxed on the assignee and he/she is very likely to pay a lower rate of tax than the original policyholder. Indeed, the new owner would qualify for top-slicing relief over the whole term of the policy in order to determine any higher rate tax liability
- not all of the policy segments would need to be dealt with in the same way.

Perhaps of even more importance is that by the issuance of a plan as a number of small but identical and independent policy segments gives the investor another option as to how money can be taken from a plan when the whole plan is not to be encashed.

As recent cases ("Shanthiratnam" and "Captain Cleghorn" for example) have proved, taking a large amount of money from a bond by an "across the board" part surrender where the amount taken vastly exceeds the available "5% allowances" under the bond, can give rise to a (sometimes) substantial amount of tax being due on the "excess" which is totally out of line with the actual investment growth on the bond. In some cases the amount of "real" gain can be dwarfed by the taxable "excess".

Having the ability to cash in whole segments as opposed to taking a large part encashment "across the board" can be tremendously valuable in these circumstances.

COMMUTATION OF SMALL PERSONAL PENSION POTS

Although HMRC will be issuing detailed guidance on the new commutation of small personal pension pots provisions, it has clarified a number of points in discussions with the ABI. These include:

1. Providers will be able to re-shape a policy/fund which has more than one arrangement into one (or two) arrangement (s) of up to £2,000 before the commutation takes place, as long as the arrangement to be commuted does not exceed £2,000. A maximum of two arrangements of up to £2,000 may be commuted in an individual's lifetime.

   The re-shaping of such a policy/fund into one arrangement of £2,000 would not have any retrospective effect and this re-shaping would not be regarded as the creation of a new arrangement. So, for example, effectively creating one arrangement would not be seen by HMRC as an action that would result in a loss of fixed or enhanced protection.

2. A signed declaration by a member that he has received no more than one such payment previously, will be adequate for a scheme provider to proceed with the commutation of his small personal pension pot.

The ability to reshape an individual's arrangement under one policy into one arrangement, which can then be trivially commuted, is very helpful. This will be of particular use where an individual is a member of a pre A-Day personal pension, which commonly was set up with 100 arrangements or more but where the aggregate policy value is £2,000 or less.

CAPPED INCOME TAX RELIEF

One of the most mysterious announcements in the recent Budget (which was also referred to in the Chancellor's speech) was the imposition of a limit on certain income tax reliefs. Details of how this would work were sparse to non existent. For the record, it was reported as follows:

The Government will, from 6 April 2013, introduce a new cap on income tax reliefs to ensure that those on higher incomes cannot use income tax reliefs excessively. For anyone seeking to claim more than £50,000 of relief, a cap will be set at 25 per cent of income (or £50,000, whichever is greater).

At the time there was general concern as to the type of "tax-efficient investments" the Government had in mind. For example, would payments into registered pension plans, VCTs or EISs be affected? Reassurance that this would not be the case existed in the shape of the existence of a cap on the amount that could be placed in these investments. Further, various statements made in the Treasury Red Book indicated that the measures were not intended to apply to investments that already incorporated a "tax relief cap". For example:

"*This (ie the new limitation) will not be extended to those reliefs that are already capped, as to do so would reduce the amount of support the tax system gives to, for example, enterprise and pension contributions*".

The targeted reliefs

Thoughts on what the Government intends in relation to this provision are now slowly emerging. Whilst it is still difficult to be certain, it would seem that the new rules could, for example, apply to loan interest relief and capital losses made in connection with an investment by individuals into new non-quoted qualifying trading companies (ie those that would qualify for EIS relief).

Capital losses on the disposal of shares currently qualify for income tax relief under section 132 ITA 2007. Let's look at this in more detail.

Subject to existing anti-avoidance provisions, an investor is able to offset realised qualifying losses on such share disposals against income in the tax year in which the loss is incurred or in the tax year preceding that in which the loss is incurred.

For example, if a person invests £200,000 into a qualifying business that subsequently fails, they will be entitled to loss relief on the amount invested. In effect, this means they can offset £200,000 of (capital) losses against £200,000 of income. On the assumption that they have £400,000 of income in that year, this would result in a tax saving of £100,000 (£200,000 @ 50%) in the current tax year.

If the proposed new rules are to be applied to this type of loss relief then, from 6 April 2013, the amount of loss relief available will be capped at the greater of £50,000 and 25% of the investor's income which, in the example above, would be £100,000. This would mean someone with £400,000 income would pay tax on £300,000 of their income in the 2013/14 tax year, a saving of around £45,000 (i.e. £100,000 @ 45%).

Since the Budget announcement, HMRC and the Treasury have issued a joint clarification note giving further detail on how this restriction on uncapped tax reliefs will operate. The new provisions propose that certain currently uncapped reliefs will be subject to a cap, per individual, of the greater of £50,000 and 25% of income.

The main points are that

(i) the cap will apply to charitable donations
(ii) the cap will apply to loss reliefs that can be claimed against total income, qualifying loan interest relief and a number of other smaller reliefs
(iii) the cap will not apply to:

- the ordinary carrying back or forward of losses against profits of the same trade
- notional tax on life insurance gains. This would seem to be aimed at the basic rate tax credit for UK life policies. Clarification will be needed before we can be certain whether and, if so, how, deficiency relief will be affected
- reliefs that are already capped eg pensions tax relief, EIS and VCT investments
- computational reliefs which should, it is hoped, exclude "top-slicing " relief in relation to chargeable event gains under life policies

The guidance indicates that there will be a need for a new definition of "income" for the purposes of applying the cap. In this connection the clarification note states that: "To ensure that there is a level playing field regardless of how, for example, pension contributions are made, there will be a new definition of income for the purposes of calculating the reliefs individuals are able to claim." This would seem to mean that an individual's income for the purposes of the new rule will be income before the deduction of pensions contributions.

"Also as some reliefs (such as Gift Aid) reduce tax liability in a different way, the self assessment return will calculate the amount of relief to make it equivalent to those reliefs that offset income."

The clarification also gives a simple example of how the cap would work:

"An individual has a total income of £250,000 under the new definition. He claims qualifying loan interest relief of £40,000; relief for a donation of shares, valued at £25,000, to charity; and has invested £50,000 under the Enterprise Investment Scheme (EIS)

As the total uncapped relief claim (of £65,000) exceeds £50,000, a cap of 25% of income will apply. This means the total allowable uncapped relief will be £62,500. The investment of £50,000 under the EIS will be unaffected but if the EIS shares are later disposed of at a loss, any loss relief claimed may potentially be subject to restriction if the total reliefs claimed in the same year exceed £50,000".

COMMENT

While the Treasury document delivers some valuable additional understanding, more clarification is needed on particular issues and this will no doubt emerge through the consultation. It is reassuring that already capped reliefs will be unaffected but many will find it surprising that it is intended that the cap will apply to charitable donations.

There has been a certain amount of criticism of this proposed change – particularly as regards its affect on gifts to charity. It may well be the case that the Government will need to dilute the impact of these provisions in the future.

The clarification document quotes the USA and other countries as restricting tax relief (including relief on charitable donations) and so makes the point that the proposed cap on tax relief should not be seen as being particularly unusual.

PENSIONS, BANKRUPTCY AND DEBTS

Two recent High Court judgements have seen the courts indicate that where an undischarged bankrupt or debtor is eligible to draw his retirement benefits, but has chosen not to do so, that the trustee in bankruptcy or the debtor's creditors will be able to able to obtain an order to bring those benefits into payment. This will enable the retirement benefits to be used to repay/help repay the individual's creditors.

Raithatha v. Williamson

Prior to the coming into force of the Welfare Reform And Pensions Act 1999 (WRPA 1999) a bankrupt's pension arrangements in general fell into the bankrupt's estate and, as such, the relevant rights vested outright in the bankrupt's trustee in bankruptcy, who could deal with them as he saw fit. However, following the changes in the WRPA 1999, where an individual was made bankrupt on or after 29 May 2000, his pension benefits under an 'approved pension arrangement' (which now includes registered pension schemes) are excluded from his estate.

It should, however, be remembered that section 310 of the Insolvency Act 1986 generally allows trustees in bankruptcy to recover (for a maximum period of 3 years) income of the bankrupt over and above that needed to meet his and his family's reasonable domestic needs. This includes any income derived from a pension which has been drawn on. Accordingly, lawyers, insolvency practitioners and pension trustees had taken the view that pensions, which had not been crystallised, even if they could have been crystallised, were protected from the trustee in bankruptcy. The decision in the Williamson case indicates that this view is no longer appropriate.

The High Court ruling in the case of Raithatha v. Williamson is likely to mean that there will now be new circumstances where a trustee in bankruptcy can make a claim against a bankrupt individual's 'approved' pension benefits.

Mr Williamson was aged 58 at the time he was adjudged bankrupt on 9 November 2010. His single most valuable asset was his pension scheme, which had a value of almost £1 million, and which he had chosen not to crystallise. It initially appeared that as Mr Williamson had not drawn his pension benefits these could not be made subject to an income payments order under section 310. However, before Mr Williamson was discharged from his bankruptcy, the trustee in bankruptcy was advised to consider issuing an income payments order against Mr Williamson's pension rights under section 310(7) of the Insolvency Act 1986.

Section 310(7) provides "that for the purposes of this section the income of the bankrupt comprises every payment in the nature of income which is from time to time made to him or to which he from time to time becomes entitled, including any payment in respect of the carrying on of any business or in respect of any office or employment and (despite anything in section 11 or 12 of the Welfare Reform and Pensions Act 1999) any payment under a pension scheme but excluding any payment to which subsection (8) applies".

Mr Raithatha, the trustee in bankruptcy, then raised the question with the High Court as to whether the bankrupt's rights and interests or entitlements, whether to the payment of a lump sum and/or an income arising under any pension scheme of which he was a member and whether drawn or activated or not, constituted income by reference or in relation to which the Court was entitled to make an order pursuant to section 310(7). The trustee in bankruptcy argued that Mr Williamson's fund could provide a PCLS of £248,708 and an annuity of between £23,000 and £43,000 if his benefits were drawn. He went on to argue that pension entitlements (whether to draw a lump sum and/or an annuity) which a bankrupt was entitled to receive, but had not yet elected to receive, constituted a '… payment in the nature of income which is from time to time made to him or to which he from time to time becomes entitled …' within the meaning of section 310(7), and therefore constituted income by reference to which the Court was entitled to make an income payments order.

On behalf of the bankrupt, it was submitted that whilst case law had established that pension income was to be treated as income for the purposes of section 310 this did not extend to include the rights to elect to draw on that income under the terms of his pension scheme when the bankrupt did not himself choose to do so. To do so would fly in the face of what Parliament intended by reason of the WRPA 1999.

The Deputy High Court Judge concluded that there was no logical reason why Parliament would have intended there to be a distinction between a bankrupt who had drawn down his pension and was caught under the income payments legislation and one who could draw but had not done so. This means that the trustee in bankruptcy may now make an appropriate order against Mr Williamson's pension scheme in respect of both the available PCLS and the annuity income. The right to appeal has been given, and this decision seems likely to be challenged.

This case should be a warning to all bankrupts who have substantial (and accessible) pension pots which they believe would be safe from the clutches of a trustee in bankruptcy.

Blight and Others v. Brewster

The recent ruling in the High Court in the case of Blight and Others v. Brewster has confirmed that an order can be made to recover a debt owed by an individual from that individual's pension

benefits, even where these have not been drawn by that individual. Mr Brewster had a judgement debt due to be paid to the claimants (Mr Blight and others). Mr Brewster was aged over 55, and had a pension arrangement from which he had not crystallised any benefits. Mr Brewster had not sought bankruptcy protection.

The High Court Judge ruled that in order to repay the balance of the judgement debt due to the claimants Mr Brewster will be required to "sign such letter as may be presented to him by the Claimants' solicitors to delegate to the Claimants' solicitor the power to make in the Defendant's name the election to receive his tax free 25% payment, up to the amount needed to repay the balance of the judgment debt. I also propose to order that if the Defendant does not comply with this order, the Claimants be authorised by the Court to write in the Defendant's name to Canada Life making the election on his behalf and in his name. There is no question here of assigning the right to make the election: there is simply a question of authorising another party to act on the Defendant's behalf. A copy the order of the court together with the Claimants' solicitor's letter should be sufficient authority for Canada Life to act on the election."

This case highlights that where an individual has a debt, and would have been able to repay all or part of that debt by crystallising his pension benefits, the Court will issue an order requiring the drawing of such benefits to enable the debt to be repaid, if the individual had failed to exercise his option to draw those benefits.

NEW TVAS RULES

In late February the FSA issued Consultation Paper CP12/4 entitled 'Pension Transfer Value Analysis Assumptions', which proposed changes to the TVAS assumptions, currently set out in COBS 19.1. The FSA has now issued a final statement, with its new rules, which came into effect on 1 May 2012. The new regime broadly follows the February proposals, which were subject to considerable pre-publication consultation with 'industry stakeholders'. However, there are several important changes and gaps in the revised COBS19.1:

- *Mortality* The mortality basis is to be updated to make it consistent with the approach in the new TM1 (v2.0), including immediate provision for unisex annuities. The FSA has clarified that male and female rates should include adjustment factors for improving mortality before being blended on a 50/50 basis.
- *CPI and deferred benefits* At present there is no FSA-given assumption for revaluation of DB pensions in deferment where the revaluation increase is based on the Consumer Prices Index (CPI). The regulator is not introducing one now, but says it will be consulting on a suitable rate as part of its consultations on the PwC review of projection rates which was published in April. In the interim the 2.5% rate stipulated in COBS 19.1.4R (1)(d) should be used.
- *CPI-linked annuities* At present such annuities are valued using the same interest rate assumption as RPI-linked annuities The FSA suggested in February that the RPI assumption should be used, even though it overstated the true cost of the benefits. This produced some critical feedback and the FSA now says 'we accept that the approach we proposed was inconsistent with that proposed for CPI in deferment and, after consideration, have decided that CPI pension increases should be valued using a CPI-linked annuity rate'. However, as no such annuities exist in retail space, the FSA had added consultation on CPI-

linked annuities to the projection rates discussions. Until a decision is made, the FSA warns that 'firms should not anticipate the introduction of such a rate'.

- *Limited price indexation* LPI annuities are currently meant to be valued using the same assumptions as RPI annuities, a basis the FSA proposed to leave unchanged in its February paper. This produced a similar kick-back to the CPI-linked annuity proposals, with respondents pointing to the different caps and collars that can apply to LPI annuities. The arguments prompted the FSA to again move ground. The new rules now say:
  - for caps of 3.5% and below, fixed rate escalation based on the cap should be used;
  - for collars of 3.5% or above, fixed rate escalation based on the cap (if there is one) should be used; and
  - in all other cases, the RPI annuity rate should be used.

  The FSA say 'Essentially, this means that where pension increases are generally expected to fall at or below the approximate rate of inflation, they are being treated as fixed-rate increases at the level of the cap, which will place a lower value on them compared to our original proposals. Where pension increases are expected to be at or above the approximate level of inflation and capped, these will be treated as fixed-rate increases at the level of the cap which will place a higher value on them than expected in our original proposals. Otherwise, the increases will be valued as if they were RPI-linked, in line with our original proposals'. The FSA will consult on CPI-based LPI annuities alongside its consultation on unconstrained CPI-linked annuities.
- *Annuity interest rate* In February the FSA proposed to keep its current basis of annuity interest rate (AIR), with yearly changes. This met with some criticism because of the potential risk of the rate becoming unrealistic. In response the FSA says that for TVAS calculations only the AIR will be calculated as a 12 month moving average, with 0.2% rounding, as now. This should produce smoother revisions than the annual quantum jump or drop – this year's produced a decline of 0.8%.
- *Illustrations* The FSA has stepped back from requiring illustrative rates of return to take account of the loss of fixed benefits and the transfer of risk from the DB scheme to the member. Instead it has added extra guidance in the Suitability section of COBS 19.1, specifically addressing these issues. The regulator has also included guidance on the need to inform DB scheme members that – due to the current lack of CPI-based annuities – it may not be possible for scheme benefits to be replicated if they were to transfer. In addition, there is new guidance to underline that the break-even rate of return should not in itself be viewed as sufficient justification for recommending a transfer.

INCOME WITHDRAWAL RATE FOR MAY 2012

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 2012 is 2.5%.