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STATUTORY RESIDENCE TEST

HM Treasury (HMT) has now published a summary of responses to last year's consultation on a statutory residence test ("SRT") and reform of ordinary residence. These changes are due to come into effect from 6 April 2013 and will represent the most significant change to the UK's tax residence rules for over 100 years.

One of the key proposals was that the basic structure of the SRT should remain a three part test. It has been confirmed that HMRC will continue on this basis. The three parts will be as follows:-

- Part A contains factors that would be sufficient in themselves to make an individual **not resident** in the UK;
- Part B contains factors that would be sufficient in themselves to make an individual **resident** in the UK if they did not meet a Part A condition; and
- Part C contains **connection factors and day counting rules** which only need to be considered by those whose residence status is not determined by Part A or Part B.

Other important issues that arise from the HMRC response are as follows:-

- The new rules will apply from 6 April 2013 and cannot be applied to past years to gain a more advantageous tax position;

- The period needed to work full-time abroad to break UK tax residence will remain a complete UK tax year;
- No distinction will be made between substantive and incidental duties spent in the UK for the workday count 'full-time working abroad' test;
- There will be no specific carve-out for existing duties currently considered incidental, such as training or reporting back to line management;
- In recognition of concerns from employers, HMT will consult on proposals to increase the maximum number of workdays a UK non-resident person can spend in the UK from 20 to 25 days without losing non-resident status. There will also be consultation on whether 3 or 5 hours constitute a working day;
- Ordinary residence will be abolished;
- There will be transitional rules protecting existing reliefs claimed under not ordinarily resident status for a maximum of two years following the abolition of ordinary residence;
- Overseas workday relief will only be available to non-UK domiciliaries. This relief, which is available for earnings relating to work performed overseas, will be placed on a statutory basis;
- The look back period for overseas workday relief will be reduced from five to three years (i.e. only three tax years of non-residence will be needed between assignments to the UK, rather than the five proposed in the original consultation);
- Foreign service relief on qualifying termination payments will now only be available in respect of non-UK duties.

COMMENT

The concept of tax residence is a fundamental feature of the UK tax structure. A statutory test will provide more certainty and so is to be welcomed. However, it will affect many people. Now that we are more certain of the likely shape of the new system, it is important that these people plan for the changes in the rules that are due to come into effect on 6 April 2013.

HMRC UPDATES SHARE VALUATION MANUAL

The valuation of private company shares can sometimes be a contentious issue when assessing tax liabilities. A "close-to-accurate" valuation of private company shares is important when assessing any tax liability on the transfer of private company shares. Such valuations will impact on

- IHT, when 100% business property relief is not available
- Capital gains tax, on the sale or gift of shares
- Income tax, where shares are transferred to employees outside of an approved share scheme

A valuation is usually arrived at by negotiation between HMRC and the company's professional advisers. The Shares and Assets Valuation Division of HMRC has recently updated its manual setting out its procedures and principles in arriving at a valuation of unquoted assets.

INADEQUATE SAVING FOR RETIREMENT

As part of the run up to 1 October and auto enrolment, the DWP has recently released a brief report containing estimates of the number of people facing 'inadequate retirement incomes'.

The DWP's calculations adopt a similar idea of 'replacement income' in retirement to that in several other research documents on the subject (e.g. the Pension Policy Institute's recent Extending Working Lives Report paper). This avoids the one-size-fits-all figure and varies the percentage of income to be replaced in line with average earnings from 50 to State Pension Age (SPA). Lower income groups will require a higher percentage because there will always be a minimum baseline level of income required.

Rather than reinvent the wheel, the DWP updated the original target replacement rates proposed in the first Pensions Commission report in 2004 in line with earnings growth:

Original 2004 income band	Income band in 2012 earnings terms	Target replacement rate
Up to £9,500	Up to £12,000	80%
£9,500-£17,500	£12,000-£22,100	70%
£17,500-£25,000	£22,100-£31,600	67%
£25,000-£40,000	£31,600-£50,500	60%
Over £40,000	Over £50,500	50%

The replacement income figure is assumed to rise in line with CPI from SPA. This stream of income is compared with projected retirement income, defined as state and private pensions plus income from 'non-pensions financial wealth'. Income from benefits, other than state pensions, is ignored. Thus Pension Credit is excluded. The 1.6m people of working age with income below the level of the Guarantee Credit (£7,420 for a single person in 2012/13) are excluded from the DWP's calculations completely, on the grounds that Guarantee Credit should give at least a 100% replacement rate.

The comparison of target income with projected income reveals where the shortfalls occur across individuals currently aged between 22 and SPA:

Target replacement rate	80%	70%	67%	60%	50%	All
Income bracket	Up to £12,000	£12,000 £22,100	£22,100 £31,600	£31,600 £50,500	Over £50,500	All
Total individuals	1.3m	4.3m	4.4m	8.9m	9.0m	27.8m
No. below target	0.1m	1.2m	1.7m	3.4m	4.2m	10.7m
%age below target	11	29	39	39	47	38

These figures highlight that nearly 4 out of 10 adults are not saving enough for their retirement. The introduction of auto enrolment from October this year will be an important step in increasing pension provision. However, many auto enrolment schemes will be set up with contributions at the

minimum required level, which are unlikely to provide an adequate retirement income for most individuals. It is important that members of such schemes understand how much retirement income they are likely to provide and where this falls short of their needs/aspirations consider making additional contributions.

LIABILITY FOR TAX ON A FAILED EBT SCHEME

The use of Employee Benefit Trusts (EBTs) and Employer-Financed Retirement Benefits Schemes (EFRBS) has had significant publicity over the past year or so. The Scottish Premier League debacle with Rangers is strongly linked to the use of EBTs. Inevitably, loans are usually involved, as they seem to be, in one form or another, for so many "aggressive" avoidance schemes.

The disguised remuneration provisions will have had a significant "dampening" effect on the flow of new schemes (although some have emerged) and the proposed new GAAR will have even more impact.

But new anti-avoidance legislation doesn't mean that HMRC will then just let all schemes implemented before the new legislation took effect achieve their (tax-reducing) purpose.

In a case involving an EBT established by Aberdeen Asset Management (AAM) for the payment of bonuses to senior employees via "cash-box" companies, the First-tier Tribunal held that the scheme failed. AAM accepted that decision but the issue remained as to who was liable to pay the outstanding tax on the awards made to the employees. AAM agreed that it was responsible for the National Insurance but argued that the income tax should be collected from the employees. HMRC said AAM should pay it. AAM appealed.

The First-tier Tribunal had said that the purpose of the scheme was to pay a bonus to the employee. Rather than paying cash, the scheme provided the employee with the rights of a shareholder possessing all the shares in a cash rich debt free company. This cash-box company had one shareholder with shares issued at a substantial premium.

Viewed realistically, the employee controlled the company and he could, in practice, take money out of the company whenever he wanted to. The cash-box shares in the company were a readily convertible asset and AAM effectively made a payment of income equal to the value of those shares. AAM was therefore liable to account for income tax on those sums. The Upper Tribunal (Tax and Chancery Chamber) agreed and the taxpayer company's appeal was dismissed.

COMMENT

As well as the apparent willingness of the Tribunals to be open to rule against aggressive tax avoidance and the new targeted and (forthcoming) general anti-abuse legislation, there is also the not inconsiderable factor of the effect that reported rulings, like this against the taxpayer, has on taxpayer and adviser sentiment. Without doubt, such developments, together with strong negative media and public sentiment, will significantly affect the willingness of many to undertake or recommend aggressive tax avoidance. And this is not something that will displease HMRC!

WHAT NOW FOR THOSE APPROACHING RETIREMENT?

It is a difficult time for anyone looking to take an income from their money purchase pension arrangements. Equities generally remain below their pre-financial crisis peaks, thanks to continuing Eurozone problems and slowing growth in Asia. In the UK, both quantitative easing and the 'flight to quality' have pushed down gilt yields. Thus there has been a continued decline in annuity and capped drawdown rates, with the drawdown rates reaching their floor of 2% for those commencing or reviewing capped drawdown pensions in August 2012.

To this pressure on rates must be added the effect of the ruling in the Test Achats European Court case, which will require individual annuities to be set up on a unisex basis from 21 December this year. The Government has just issued its response to the consultation initiated earlier this year by the Treasury on the effects of the ruling. Unfortunately, this has taken us little further forward because the Government is unable (or possibly unwilling) to provide definitive guidance on some of the key questions raised during the consultation. These include:

- Whether it will be possible for gender-based annuity rates to be used where an annuity is purchased on behalf of an individual by the trustees/scheme administrator of a money purchase occupational scheme or workplace pension scheme.

- How the capped drawdown rates will be adjusted as a result of this ruling. Information on this is promised later this year and before 21 December.

COMMENT

What is clear is that more than ever anyone looking to take an income from their money purchase pension funds over the next few months needs professional advice. For example, where an annuity is to be purchased, full advantage must be taken of the open market option and any enhanced annuity rate. For a male, purchasing an annuity before 21 December 2012 rather than after is likely to be advantageous, whereas a female may be best advised, where able, to defer any annuity purchase until after that date.

A LOSS ON THE SALE OF LAND AND INHERITANCE TAX

HMRC has issued a new version of the form necessary to claim inheritance tax back, subject to the satisfaction of certain conditions (see below), when property is sold at a loss within four years of death. The form in question is form IHT38. Now is therefore an appropriate time to remind ourselves of how the relief works.

The relief

Relief from IHT may be available when property (land, a building or a lease) is sold within four years of the death for a lower price than its value on death. In simple terms, the relief allows the sale price to be substituted for the value on death for the purposes of calculating (or, more precisely, recalculating) the IHT on death.

Conditions for the relief

Under section 191 IHTA 1984, "sale of land" relief may be claimed when

- the appropriate person (the person liable for the tax, usually the executors)
- sells an interest in land included in the deceased's estate
- within four years of the death
- for a value different from its value on death.

When this happens, the appropriate person may claim that the sale value should be substituted for the value on death.

Where the only interest in land included in a deceased's estate is the main residence, the application of the relief is normally straightforward.

Example

Patrick (a widower) died in August 2006. Patrick's house was valued for probate at £600,000. Patrick had no other interests in land that were sold before August 2010, and all his estate passed to his children.

In September 2008, Patrick's executors sold the house at arm's length to a complete stranger for £520,000. The executors claimed relief under section 191(1) IHTA 1984. The value of the house at the date of death for IHT purposes was reduced to £520,000. By this action the estate saved IHT of [£600,000 - £520,000] x 0.4 = £32,000.

Once the relief is claimed, the sale price of all interests in land sold within the four year period must be substituted for their value on death. This includes those interests sold for more than their value on death. In these circumstances, care should therefore be exercised over making a claim.

The relief is not available where

- the difference between the value on death and the sale price is less than £1,000 or 5% of the value on death, whichever is the lower, or

- the sale is not at arm's-length

INHERITANCE TAX SIMPLIFICATION AND TRUSTS

HMRC has issued a consultation document on the simplification of the relevant property regime.

The relevant property regime (in the past, known generally as the taxation of discretionary trusts) is an extremely complicated structure. The calculation of tax due on a periodic or exit charge is not for the faint-hearted. For this reason HMRC is proposing to simplify it and has issued a consultation document for that purpose.

The closing date for comments is 5 October 2012.

SMALL PENSION POTS

The Government has increasingly recognised the administration and other problems (e.g. annuity purchase) created by small pension pots as is evidenced by its introduction of new triviality provisions for small personal pension pots of £2,000 or less.

It also recognised that there will be a substantial increase in the number of small pension pots once auto enrolment takes effect. In December last year the DWP launched a consultation on how such small pension pots could best be handled and the Government has just issued its response to that consultation. It indicates:

- It will legislate at the earliest opportunity to enable an individual's small pension pot to be automatically transferred to their new employer's scheme. However, the maximum size of the small pot for this purpose is still to be finalised, as are the member opt out provisions and what will happen where an individual does not have a new employer's scheme.

- The Government will legislate to remove short service refunds in respect of money purchase occupational schemes. It will, however, consider whether any very small pension pots (size to be defined but probably no more than £200) can still be refunded (subject to tax, naturally).

ADVISER CHARGING AND RETIREMENT BENEFITS

The issue of adviser charging has given the industry and HMRC much pause for thought when it comes to the decumulation side of pensions business. In particular, HMRC has struggled with how the Pension Commencement Lump Sum (PCLS) should be determined when an adviser charge is deducted from the associated annuity purchase price.

After discussions with industry bodies, in February HMRC suggested that, for annuity purchase, the cost of advice on annuities would effectively be ignored in calculating the PCLS. However, where the advice was not limited to annuities alone – e.g. all retirement income options were reviewed – HMRC proposed that only the portion of the fees relating to annuity advice would be ignored if an annuity were eventually purchased. For drawdown HMRC took a slightly different line, suggesting that all pension advice charges could be ignored in PCLS calculations provided the designation of funds for drawdown occurred ***before*** fees were deducted.

The idea of apportioning fees between annuity and non-annuity retirement option advice always looked something of a non-starter, as it would have encouraged all the cost of advice to be loaded onto the annuity element. After further discussions, HMRC has now accepted that at-retirement pension advice is not easily divisible and that all costs of advice will generally be ignored in the PCLS calculation, provided that they relate directly to pension income planning. This means that, for example, if advice on the reallocation of residual uncrystallised funds is given at the same time as drawdown advice, only the fees for the latter would be ignored when calculating the PCLS.

As far as drawdown is concerned, HMRC has maintained its view that fees deducted after drawdown designation will not affect the PCLS. However, if fees are deducted before designation, the PCLS will be calculated on the net-of-fees fund.

COMMENT

It has been a long journey, but the issue of fees, PCLS and annuity purchase now seems to have been settled at status quo, i.e. PCLS = 25% of fund. For drawdown, there may still be issues where fees are deducted before, or simultaneously with, drawdown designation.

TAX RETURN AMNESTY

Higher rate taxpayers, who have failed to submit tax returns, are being offered the opportunity to come forward and pay up under a time-limited HMRC campaign.

The Tax Return Initiative, launched on 3 July, is aimed specifically at people liable to pay tax at rates of 40% and above who have been told to submit a Self Assessment tax return for 2009/10 or earlier, but have not done so. However, the campaign is also available to any individual who has tax returns to submit to HMRC for these years.

People have until 2 October 2012 to tell HMRC they want to take part, submit a completed return and pay the tax and NICs that they owe. By coming forward voluntarily through the campaign customers will receive better terms and any penalty they pay will be lower than if HMRC comes to them first. After 2 October, if they have not submitted their tax returns and paid what they owe, HMRC will use its powers to pursue outstanding returns and any unpaid tax and NICs. Penalties of up to 100 per cent of the tax due, or even criminal investigation, could follow.

COMMENT

In the past, higher rate taxpayers were automatically issued with a tax return that they were required to complete. A few years ago this changed. HMRC became more selective when issuing returns. Those higher rate taxpayers whose main income was taxed under PAYE and who had little other income ceased to be issued with returns. This has meant that those due to pay more tax because they

- *had become higher rate taxpayers, or*
- *had received a new source of taxed or untaxed income, or*
- *had received higher levels of income*

would be required to make the effort to inform HMRC, rather than wait for a tax return to be sent to them. In this respect it appears that taxpayers are not as diligent as they should be. However, this is not a surprise. Ignorance, negligence and lethargy all play their part, as well as evasion.

INCOME WITHDRAWAL RATE FOR AUGUST 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 August 2012 is 2.00%. 2.00% is its lowest ever level and the minimum level to which the rate can fall.