Technical Connection

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Published by Technical Connection Ltd,
7 Staple Inn, London, WC1V 7QH.
Tel: 020 7405 1600 Fax: 020 7405 1601
E-mail: enquiries@technicalconnection.co.uk
www.techlink.co.uk

OFFSHORE POLICIES – TIME APPORTIONMENT RELIEF

Background

In the March 2012 Budget the Government announced a consultation on reform to time apportionment reductions reflecting a policyholder's period of residence outside the UK. Issues for consultation were to include an extension of these reductions to policies issued by UK insurers and a change in the rules to reflect the residence position of previous owners of a policy. It was intended that this consultation would result in legislation for inclusion in Finance Bill 2013.

The promised consultation document, entitled "Life Insurance-Time Apportioned Reductions", was published on 13 August to which responses are invited by 5 November 2012.

The current position

When a chargeable event gain arises under a non-UK policy, if the policyholder has been resident in the UK for only part of the period during which the policy was in force, the taxable chargeable event gain is determined by reference to the policyholder's period of residence in the UK. In order to determine this, the chargeable event gain is reduced by the "appropriate fraction" of the gain.

The appropriate fraction is

$$\frac{\text{Number of days the policyholder is resident outside the UK whilst policy in force}}{\text{Total number of days the policy has been in force}}$$

Example

When Fred was working in Luxembourg he effected a single premium investment bond with a Luxembourg company for a premium of £150,000. Ten years later he returned to the UK and after five years of resumed UK residence he surrendered his bond for £400,000.

Fred had taken no withdrawals from his bond so the chargeable event gain is £250,000 (ie £400,000 less £150,000). Ignoring leap years for the sake of simplicity, the bond had been in force for 5,475 days to the date of surrender during which period Fred was non-UK resident for 3,650 days. The chargeable event gain that will be subject to income tax is reduced to £83,333 as follows:-

$$£250,000 \times \frac{3,650}{5,475} = £166,667 = \text{amount of relief.}$$

Taxable gain = £250,000 - £166,667 = £83,333.

This relief, which is known as time-apportionment relief or non-resident relief, is not available if the policy is at any time during the period in force held by one or more trustees resident outside the UK except where the policy was issued on or before 19 March 1985 and on that date the trustee in question was not UK resident.

Where the policy has been at any time owned by a "foreign institution" then, unless the policy was issued before 17 March 1998 and owned by that foreign institution on 16 March 1998, non-resident relief will not be available. Foreign institution for this purpose means a company or other institution resident or domiciled outside the United Kingdom.

For the purposes of top-slicing relief, chargeable event gains are spread over a period equal to the number of complete years the policy has been in force less the number of complete years during which the policyholder was not resident in the UK.

Non-resident relief is also not available in respect of any annuity contract.

The proposed changes

The changes are intended to:

- Provide greater alignment between the treatment of policies issued by insurers inside and outside the UK.

- Ensure that the rules on time apportionment relief provide a more appropriate reduction to gains.

- Ensure that the rules operate effectively in conjunction with the new statutory definition of residence and changes to the basic calculation of chargeable event gains included in Finance Act 2012.

In turn, the changes proposed are as follows:-

(i) Time apportionment relief will be available to UK as well as non-UK policies.

(ii) Currently, the days of residence test is based on the residence history of the policyholder, who is the legal owner. It is proposed to instead measure days of residence by reference to the residence history of the beneficial owner. Where there is more than one beneficial owner relief on their share of any chargeable event gain will be based on their residence history alone.

(iii) Instead of looking at the residence history of a policy from commencement to a chargeable event that gives rise to a gain, the residence history to be taken into account will only be that of the beneficial owner at the time of the chargeable event based on his or her period of ownership of the policy.

(iv) Currently, relief is given by applying the fraction to the gain over the life of a policy. The effect of this is that the gain derived from the payment of a top-up premium will benefit from the same percentage reduction as the initial premium. This is so even if the top-up premium is paid during a period of resumed UK residence when it is likely there would have been no period of non-UK residence since the payment of the top-up premium.

This position is used as a marketing ploy and the Government is keen for the advantage to be discontinued. This will inevitably lead to increased complexity with each top-up premium effectively giving rise to a policy to be tested separately. Views are requested as to a more equitable approach but bearing in mind the degree of complexity that could be involved.

(v) Finance Act 2012 includes provisions to restrict the deduction for gains arising earlier in the life of a policy, for example on part surrender. Given the possibility that the earlier gains may have been subject to foreign tax, consideration will be given to whether the rules for time apportioned reductions should be extended to reflect the residence history of a previous owner of rights under a life policy, or whether existing double tax relief provisions will be effective.

(vi) It is expected that a statutory definition of residence will be included in Finance Bill 2013. There will be an anti-avoidance provision which provides for chargeable event gains that arise during a period of temporary non-UK residence to be treated as income arising in the year of return to the UK. It will be necessary to ensure that the revised time apportionment rules fit in with the new residence definition.

(vii) The changes will not impact on the chargeable event gains that insurers have to report to HMRC. However, it will be necessary to include words of warning on the chargeable event certificate that in some circumstances the gain shown on the certificate is different from that which will be subject to tax.

(viii) There is no mention of the number of years for top-slicing relief and how this might be affected by the proposed changes.

LOSS RELIEF

In summer 2011 HMRC issued a consultation document entitled "High-Risk Areas of the Tax Code: Relief for income tax losses". In it HMRC posed seven questions for interested parties to consider and respond to. These questions were about the abolition or restriction of sideways loss relief, property loss relief and employment income loss relief.

It appears that HMRC believes that this consultation has been overtaken by events. There has been progress on the General Anti-Abuse Rule (GAAR) as well as the consultation on capping unrestricted income tax relief. For these reasons HMRC has decided to put the proposals on the back burner and monitor them. HMRC is probably right not to continue with these proposals at this time. If the GAAR is successful the kind of abuse of loss relief that this consultation was aimed at should be caught.

TAX AVOIDANCE – DOTAS CONSULTATIVE DOCUMENT PUBLISHED

Tax avoidance and tax avoidance schemes have been in the public eye of late. Some of the criticism for the use of these schemes can be laid at the door of the Government in that it has not done enough to close such schemes down.

Well, times are changing. The Government has announced that it intends to introduce provisions to "tighten the net round cowboy tax advisers". By this it means that it intends to bring forward legislation and regulations to crack down on the "promoters of contrived and aggressive tax avoidance schemes". The purpose of this is "to increase the pressure on advisers who market abusive schemes that artificially and aggressively reduce tax and to make it easier for taxpayers to identify such schemes."

The proposals include making the Disclosure of Tax Avoidance Schemes (DOTAS) rules an even stronger and more effective weapon in the battle against avoidance. For example, by giving HMRC stronger powers to force promoters to tell it about avoidance schemes and who is using them; and tightening the rules so that it is easier to impose penalties for failure to provide information to HMRC about a scheme.

The Government is also looking at publishing warnings about tax avoidance schemes that are effectively being mis-sold and making it easier for taxpayers to identify when they are on the receiving end of a hard sell by a less reputable promoter.

The Government is building on the work it has already done to make life difficult for those who artificially and aggressively reduce their tax bill. In its view the Government believes that these schemes damage its ability to fund public services and provide support to those who need it. They harm businesses by distorting competition. They damage public confidence. And they undermine the actions of the vast majority of taxpayers, who pay more tax as a consequence of others enjoying a free ride.

DOTAS has assisted HMRC greatly over the years, closing off around £12.5bn in avoidance opportunities. But as the avoidance landscape changes so must it.

With a view to moving forward the implementation of these proposals, the Government has issued a consultative document dealing with proposed changes to the DOTAS rules.

The consultative document describes a significant new programme of work the Government is developing to improve the information available to HMRC and customers about tax avoidance schemes and the risks of using them.

Firstly, it describes a range of options to improve the provision of information about tax avoidance to ensure that, where tax avoidance schemes are identified, the public knows about the risks of using them. That is key to the Government's strategy of ensuring that everyone pays their fair share of tax and in making it clear that tax avoidance is unacceptable.

Secondly, it considers some detailed options to improve the information available to HMRC about tax avoidance through the DOTAS regime, in order to make this an even more effective tool. In particular, it proposes changes to the descriptions of schemes required to be disclosed to HMRC. Any changes, insofar as they affect income tax, will be extended to the DOTAS National Insurance contributions regime at the same time as the tax changes come into force.

The main features of this consultative document are:-

- Chapter 3, which describes a range of options to improve the provision of public information about tax avoidance and the risks of using tax avoidance schemes.

- Chapter 4, which describes options intended to extend DOTAS to ensure that HMRC has sufficient information and documents to understand how a scheme works and who is intended to use it, and to ensure that the rules are complied with.

Headline options include:

- Extending the information disclosed to HMRC about discloseable avoidance schemes;

- Extending the information reported to HMRC about users and other parties involved in a discloseable avoidance scheme;

- Raising the threshold of 'reasonable excuse' for a promoter who fails to notify a discloseable scheme;

- Imposing additional reporting obligations on a promoter who incurs a penalty for failure to disclose a scheme; and

- Imposing a personal responsibility on an individual, to sit alongside the firm's obligations, to comply with a promoter's DOTAS obligations.

Chapter 5, which describes proposed revisions and extensions to the existing 'hallmarks'.

The proposed revisions to the existing hallmarks are:

- amending the 'confidentiality where promoter involved' hallmark to remove inconsistencies in the interpretations being applied by promoters to the hallmark;

- amending the 'confidentiality where no promoter involved' hallmark to cover instances where the firm designing the scheme for use in-house is also a promoter who is capable of selling the scheme to clients; and

- amending the 'loss scheme' hallmark to ensure that marketed loss schemes are discloseable, and extending the hallmark (currently limited to schemes intended for individuals) to schemes for corporate users.

Chapter 5 also proposes adding two new hallmarks:

1. a hallmark that targets schemes seeking to circumvent the disguised remuneration rules concerning employment income provided via intermediaries; and

2. a hallmark targeting schemes that rely upon certain financial products. In this context the consultative document states the Government intends to create a financial products hallmark, similar to the 2004 description in that it applies to arrangements that contain one or more specified financial products. Broadly these would be:

    - a loan;
    - a derivative contract;
    - an agreement for the sale and repurchase of securities;
    - a stock lending arrangement;
    - a share;
    - any arrangement which produces for any person a return that is economically equivalent to interest;
    - a contract, not being one of the above, which alone or in combination amounts to a loan or the advance or deposit of money;
    - collective investment schemes and alternative investment funds; and
    - insurance products included in section 473 of the Income Tax (Trading and Other Income) Act 2005. Investment bonds and capital redemption policies fall into this category.

COMMENT

In view of the media coverage on tax avoidance, it is hardly surprising that we have seen this development. One area that will be of interest to financial advisers is the intention to add a new hallmark that deals with schemes involving financial products. It would seem that a financial product will include insurance policies – including single premium bonds. This could apply in cases where a single premium bond was part of a new tax avoidance scheme – not in cases where a bond was effected simply as a tax-efficient investment.

TRUSTS FOR THE VULNERABLE

HMRC has issued a consultative document on the definition of "vulnerable person" in regard to those with disabilities.

Special income tax, capital gains tax and inheritance tax treatment is given to trusts that are established for the benefit of vulnerable people.

It is difficult to directly define a 'vulnerable person' in a way that can ensure certainty that the special tax treatment applies and so it is instead currently applied to two more easily defined and recognisable groups: orphaned minors and those with a severe physical or mental disability. This latter group includes those in receipt of the highest or middle rate care component of Disability Living Allowance (DLA) and those who struggle to administer or manage their affairs for reasons of mental incapacity.

DLA is being reformed to create a new benefit from 2013 called the Personal Independence Payment (PIP); and it is expected that there will be fewer claimants of the PIP than the DLA.

To help decide on how best to continue the special tax treatment for those trusts that provide for vulnerable people once DLA starts to be phased out for people of working age, the Government is seeking suggestions for an effective definition of 'vulnerable person' for tax purposes and views on including the enhanced rate daily living component of the PIP within the definition.

Apparently there are also inconsistencies in the broader qualifying conditions that limit how trustees can use the trust capital and income. The Government is seeking views on whether, and how best, to align these conditions.

The closing date for submissions to the consultation is 8 November 2012.

CHANGES TO DRAWDOWN RATES FROM 21 DECEMBER 2012

HMRC has now issued amended instructions for the calculation of the maximum drawdown amount where the commencement or review of an individual's capped drawdown benefits takes effect on or after 21 December 2012. From that date calculations for both men and women will be based on the male rates. All other things being equal, this will mean that the maximum drawdown rate will increase for women as the male rates are higher than those for women, while there will be no change for males. HMRC has also amended the instructions accompanying the drawdown tables to reflect this.

It appears that HMRC will review the calculation basis once "it becomes clearer how annuity providers will apply the judgement (*in the Test – Achats case – our italics*) in practice."

This change may mean it is worth some female members initiating a review of their maximum income using the male rates after 20 December. However, great care will need to be taken where there has been a fall in the underlying gilt yield and/or decline in fund value since the last review date, as either or both may more than outweigh the uplift given by using the male rate (currently worth about 7%-8% in the 60-65 age range, based on a 2% gilt yield).

CHANGING A PENSION INPUT PERIOD END DATE

One of the most important pension planning tools for members of money purchase schemes is the ability of a scheme member to nominate a revised pension input period end date. Such a change will often be made to ensure that contributions paid will fall in a pension input period ending in a tax year that will not result in an annual allowance tax charge.

A member of a money purchase scheme can normally nominate a revised pension input period end date in accordance with sections 238(3) and (4) of the Finance Act 2004 provided the scheme administrator had not already made a prior nomination in respect of the input period concerned.

Although the legislation provided such freedom, it has become clear that the rules of some money purchase schemes have been set with provisions indicating that the pension input period end dates for any arrangements under the scheme can only end on a set date (e.g. 5 April) each year.

HMRC has confirmed that despite the provisions of such scheme rules, the legislation is paramount and members will be able to nominate a revised pension input period end date.

TUC CALLS FOR CONSULTANCY CHARGING TO BE OUTLAWED

The FSA had initially suggested that fees for advice taken out of pension contributions could lead to employers failing to satisfy the rules on minimum contribution rates for qualifying pension schemes. However, the DWP subsequently explained that this only applies where fees are paid before contributions enter an individual's pension pot - and therefore consultancy charging is lawful if fees are paid after contributions have entered the pension scheme. HMRC has also recently updated RPSM 09106040 to confirm the circumstances where consultancy charges would not be an unauthorised member payment.

The TUC has written to Steve Webb, the Pensions Minister, to ask him to use his powers to cap charges in pension schemes to outlaw consultancy charging.

The TUC is concerned that many small/medium sized employers will seek to have the cost of the advice they have received on automatic enrolment recovered by charges being taken from the arrangements of members in the employer's chosen qualifying pension scheme.

INCOME WITHDRAWAL RATE FOR SEPTEMBER 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 September 2012 is 2.00%, unchanged from last month.