Technical Connection

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THE OFFICIAL RATE OF INTEREST FOR 2014/15

"The official rate of interest" that applies to employment-related loans will drop from 4.0% to 3.25% for the tax year 2014/15.

If an employer makes a cheap loan to a higher paid employee (one earning £8,500 a year or more) or a director then the official rate is used to measure the benefit to the employee which is subject to tax as a benefit in kind. The benefit is the difference between the interest (if any) paid by the employee and interest at the official rate. An employer will pay Class 1A National Insurance contributions on any taxable benefit.

There is a de minimis provision which operates so that if the loan or total loans for an individual at no time in the tax year exceeds £5,000, no tax charge is made.

HIGH COURT RULING ON THE INTERPRETATION OF THE CRAG

The High Court has prevented a local authority from selling an elderly lady's house to pay for her care fees on account of the fact that the woman's daughter had demonstrated a degree of attachment to the property.

Following Mary Walford's admission into permanent local authority care in November 2006, a dispute arose between Worcestershire County Council and Mary's daughter, Glen, as to whether the value of the house should be included in the means-tested assessment (as would usually be the case).

Mrs Walford’s daughter (who was already over 60 when her mother went into care) argued that the property should be disregarded on the basis that her occupation fell within paragraph 2(1)(b)(ii) of Schedule 4 of the *National Assistance (Assessment of Resources) Regulations 1992* (as qualified by Section 7 of the Charging For Residential Accommodation Guide (CRAG) rules).

The relevant passage states that the value of any premises is to be disregarded for a residential care fees assessment if it is 'occupied in whole or in part as their home by the resident's other family member or relative who is aged 60 or over'.

Glen Walford argued that although she rented a studio flat in London (where she worked), she considered her mother’s property to be her permanent home. This was evidenced by the considerable sum she had spent maintaining it, the fact that she had kept a bedroom, office and shed there for her own use and her intention to retire there in the near future. Worcestershire County Council rejected her arguments saying that her occasional occupation of the property could more accurately be likened to a person’s occupation of a holiday home. Defining "home" as "a place to which a person has a degree of attachment both physical and emotional", the Judge concluded that the local authority had incorrectly interpreted and applied the test (by apparently applying a test of actual occupation and/or permanent residence) and ordered it to "redetermine" its decision in accordance with the terms of the judgment.

COMMENT

This is the first occasion that this particular issue has come before the Courts and while Worcestershire County Council is planning to appeal the decision, the case may set a precedent for others if allowed to stand. Even then though, the scope for similar claims is likely to be limited to children over the age of 60 who have invested in or shown other forms of commitment to the property. The decision should not affect those children aged over 60 who permanently occupy a parent’s property.

FCA THEMATIC REVIEW

The Financial Conduct Authority (FCA) has published the results of its thematic review of the annuity market

If there is one thing the annuity market has not been lacking in recent times it is reviews, initiatives and criticism (both informed and uninformed). For example, in the last couple of months there has been a broadside from the Financial Services Consumer Panel, incorporating both a literature review and three qualitative studies and the somewhat bizarre promise from Rachel Reeves, Shadow Work and Pensions Secretary, that a future Labour government would make independent annuity broking compulsory for money purchase schemes.

In theory the latest report to emerge on the annuity market, a Thematic Review from the FCA, ought to have brought some finality to the matter. After all, the FCA has the regulatory power to reach parts of the annuity market others cannot and has spent over a year on its investigations. However, what we now have is the promise of another review – a “market study” – pushing matters up to a year down the road.

The FCA's review starts from an analysis of 330,000 annuity sales in (pre-RDR and largely pre-gender neutral) 2012, which it thinks accounts for about 78% of all sales of annuities stemming from contract-based arrangements (occupational DC was not considered). The FCA also excluded investment-linked (less than 5% of sales), escalating (about 5%) and guaranteed rate annuities (12%). The paper is supported by a separate independently produced review of consumer behaviour relating to annuity purchase.

The FCA's main conclusions from its own review are:

- In 2012, 60% of annuities were purchased from the existing pension provider or a third party with which the provider had an arrangement.

- "Based on the rates quoted for two dates in 2013", the FCA found that providers operating on the open market offered the same (or, in two cases, better) annuity rates to their existing pension and open market customers. However, where third party providers were involved, the FCA discovered that "In some cases the annuity rate these … providers offer … may be worse than the rate consumers could obtain from that same provider on the open market." The FCA accepts that there could be genuine reasons for this difference, but it will be looking further into "the associated sales practices".

- "In general, for customers with pension funds over £10,000, the annuity rate outcome (after commission or an adviser charge is paid) for an open market customer is the same regardless of whether they purchase directly from the firm, via a non-advised intermediary or with advice."

- The FCA estimates that 80% of those purchasing an annuity from their existing pension provider would benefit from switching to the open market. It supports this with the following table:

	Standard	**Enhanced**	**All annuitants**
Average fund size used for annuity purchase	£17,000	£26,800	£17,700
Average annual income achieved from existing pension provider	£1,000	£1,630	£1,030
Average amount of annual increase in income	£67	£135	£71
Average proportion annual income could be increased by	6.7%	8.3%	6.8%

The average purchase prices are actually median figures, which is why they differ from the £30,000ish often quoted. The latter is distorted by a relatively small number of very high purchase amounts. In reality nearly half of all annuity purchases are below £15,000 (a view supported by Pensions Institute research). The FCA's own investigations revealed that 27% of annuities bought in 2012 had a purchase price of under £5,000.

The FCA says that the average gain numbers in their table hide a wide variation, from £171 to virtually zero for standard annuities and £278 to about £25 for enhanced rates. Looked at another way, the FCA estimates that half of those purchasing an annuity from their existing pension provider could increase their income by more than 5% on the open market. The regulator then succumbs to headline-grabbing calculations of how much more income that would be each year for *all* consumers affected.

- On the subject of small pots of under £5,000, the FCA reckons about half of their owners get the best rate by staying put and that going on the open market would on average yield a gain of less than 5%. It goes on to say, somewhat in contradiction of its own findings, that although the lower rates for small pots are likely to be due in part to fixed costs, "…it is clear that those with small pension funds are not well served in this market."

- The FCA's research into providers (it counted 25 taking 98% of the market in 2012) throws up some interesting data:

    - Of the six firms offering standard annuities in the open market in 2012, three took 97% (57%+21%+19%) of the market as measured by premium.

    - The concentration is not so great for enhanced annuities, where the FCA says there are ten providers at present "with the expectation that two more will be entering the market soon." Even so, the top three enhanced providers took 79% (33%+26%+20%) of the market.

    - Only 5% of annuities purchased from an existing pension provider were on an enhanced basis, while for the open market half of sales were enhanced. This in part reflects the fact that of the 22 providers that offered annuities to existing pension plan holders, only 10 quoted them enhanced annuities (either directly or via a third party).

    - The FCA looked at "expected profitability" of current annuity business with the assistance of Towers Watson – actual profit will only be known many years' hence. The conclusion was not surprising: "Overall standard annuities offered to existing pension customers were expected to be more profitable than annuities written in the open market." There was also a suggestion that the profitability of standard annuities "may be higher when compared to enhanced annuities," but more research was needed.

    - Retention rates between providers who offered their own (as opposed to third party) annuities varied considerably, from 70% to 10%. "Retention strategies" is an area the FCA will look at in further detail.

Alongside the Thematic Review the FCA has issued a guidance consultation on annuity comparison websites. The FCA research found that "12 of the 13 websites… examined did not satisfy the key requirement to be 'fair, clear, and not misleading', for example describing the service as 'free' when commission would be received by the firm." As a result the FCA has drafted just over a page of fairly basic guidance.

The FCA's next step on from the Thematic Review is to launch a "competition market study into retirement income", which will embrace not only annuities, but also income drawdown. The regulator hopes such a study will help it "to assess how well competition works for consumers in these markets with a view to exploring whether any remedies are required to drive competition and improve consumer outcomes in this area." It highlights three particular areas of focus:

1. Seeking to identify ways of improving consumer engagement to prompt shopping around;

2. Looking at market dynamics (eg patterns of market entry and exit) to understand what drives the high levels of market concentration; and

3. Examining how markets are likely to develop in response to changing retirement patterns and needs.

There is a promise that this fresh study will "include a supervisory element looking at pension providers' sales of annuities to their existing customers" with a clear warning that "poor sales practices" will be in the firing line. An interim report is due in the Summer, with the final report "within 12 months from launch."

COMMENT
After a year of effort, the FCA has produced a report which tells us hardly anything new. Perhaps that 27% of sub-£5,000 pots has given the FCA food for thought…

COURT CONFIRMS EFFECT OF NIL RATE BAND LEGACY WORDING

The Chancery Division of the High Court has, for the first time, provided clarity on the effect of nil rate band legacy clauses where there is a transferable nil rate band accruing from an earlier marriage.

Since the introduction of the transferable nil rate band, it has been necessary for clients and their professional advisers to review Wills drawn up before 2007 and carefully consider the effect of the wording of any clause designed to leave the nil rate band to a discretionary trust. Where clients have a transferable nil rate band accruing from an earlier marriage, a decision would need to be made as to whether the client would now like the basic or the uplifted nil rate band to pass to the trust on their death.

In many cases, clients (especially those who do not have a nil rate band accruing from an earlier marriage) will have decided to do away with the nil rate band trust altogether on the basis that substantially the same advantage can now be achieved through the transferable nil rate band rules.

For the rest, advisers can adopt the model clause produced by the Society of Trust and Estate Practitioners (STEP) to ensure that the maximum (ie the deceased's nil rate band and any transferable nil rate band) amount enters the trust. HMRC's website also has a number of examples of what HMRC believes will and will not achieve the desired effect. However, until the recent case of Loring v Woodland Trust [2013] EWHC 4400 Ch, the effectiveness or otherwise of these clauses has never been considered by the Courts.

In this case, the testatrix had made a Will leaving a legacy of "such sum as is at the date of my death the amount of my unused nil-rate band for inheritance tax" on discretionary trusts for the benefit of family members, with the residue going to charity. At the time of her death her unused nil rate band was £30,805.

The Will was executed in 2001, prior to the introduction of the transferable nil rate band, and the question for the Court, given that the testratrix had inherited her husband's full nil rate band, was whether the testatrix had intended to leave £30,805 or £355,805 to charity.

Having considered the language of the legacy clause in the context of the Will as a whole, giving the words used their ordinary meaning and then taking account of the relevant background which informed the meaning of the words used, the Judge concluded that the legacy clause should be construed as including the uplift. The use of the word 'my' was found to be significant as it indicated that the testatrix intended for the total nil rate band available to her to pass to the trust (rather than an amount equal to whatever the nil rate band might be at the time of her death).

COMMENT

Loring v Woodland Trust is a useful first decision on the interpretation of a clause giving a nil rate band legacy where the deceased had the benefit of a transferable nil rate band. The decision will provide comfort to clients and advisers who have adopted the STEP model clause or indeed one of the example wordings put forward by HMRC.

DECLINE IN THE NUMBER OF FAMILY TRUSTS FILING RETURNS

The latest HMRC trust statistics, which cover discretionary trusts, interest in possession trusts, accumulation trusts and mixed trusts, show that over the years the number of trust and estate returns have declined, but does this reflect all cases?

These latest statistics show that the number of family trusts, where trustees are required to complete a self-assessment return, has remained broadly steady at 163,000 in 2011/12. However, looking across the years, the overall long-term trend shows a decline in the number of trusts - a 19% fall since 2007/08. The results show that the decrease was more pronounced in 2009/10 and 2010/11 which saw year-on-year falls of 7% and 8% respectively.

Since Budget 2006, most types of trust are now subject to inheritance tax under the relevant property regime. This means that, for larger trusts, a more onerous tax regime applies, together with the need to fulfil reporting requirements and potentially pay inheritance tax on entry, exit and each ten-year anniversary. In practice, this will mean that these days settlors would be expected to keep their gifts within 80% of the available nil rate band meaning no initial disclosure is required on form IHT 100 and with less likelihood of the 10-yearly and exit charges applying. Because of the more onerous IHT trust rules, the level of investments held in trusts has probably reduced meaning there is less income and capital gains to declare in the self -assessment return.

Trusts which hold non-income producing assets will not generally be part of the self-assessment regime which means trust administration is simplified.

Note the HMRC statistics do not include trusts which hold non-income producing assets because self-assessment returns are not generally required for such trusts. Given the increase in trustee tax rates over the years in question, trustees may be more inclined to invest in non-income producing assets such as single premium bonds. Moreover, in the case of single premium bonds, the settlor will be the taxable person on any chargeable event gains while alive and UK resident.

COMMENT

Inheritance tax planning using trusts can be complicated. However, in cases where there is no requirement to pay income under the trust and capital growth is necessary, a single premium bond may be appropriate and, provided it meets the client's overall objectives, matters can be kept simple.

Of course, the need to declare trust income on the self-assessment return can be onerous and, in the case of discretionary trusts, can lead to taxation at a rate of up to 45%. To avoid such problems a *number of trusts invest in more tax-efficient ways, for example by investing for capital growth (to use any available annual CGT exemption) or in ways that do not generate income (e.g. a single premium bond).*

THE REASONABLENESS OF TRUSTEES' CHARGES

In the case of AM Pullan v Wilson & two others (2014) EWCH126(Ch) the High Court ruled a beneficiary was unable to challenge the reasonableness of the trustees' charges, despite the fact that they were considered to be more than what would be considered appropriate.

On setting up a trust the settlor has to take great care in appointing their trustees. In most private trusts, especially those involving life assurance policies, the trustees would normally be the family members. However, often a professional trustee, such as an accountant or a lawyer, may be appointed, especially where trusts of substantial assets are involved which necessitate sometimes complex administration such as the filing of tax returns and the preparation of accounts. Obviously, professional trustees are going to charge fees. When creating a trust, the settlor should be clear on what the provisions of the trust are with regard to the trustees' power to charge fees although, since the introduction of the Trustee Act 2000, even if there is no express power to charge fees professional trustees would have the power to charge professional fees as long as they are reasonable.

In the above - mentioned case, an accountant/tax adviser had been appointed as a professional trustee in respect of ten family trusts. He was also appointed as a non-executive director of three companies in which the trusts held shares. The trustee charged fees of £400 per hour for his services and £250 per hour for the services of his assistant. After a while one of the beneficiaries objected to the level of his charges, despite the fact that he had initially agreed the hourly rates. The beneficiaries jointly appointed an expert who produced a report which concluded that the hourly rates were excessive and a discount should be applied to reflect excessive administration time as well as the fact that some work related to the companies of which the trustee was also a director. The beneficiary then instituted proceedings against the trustee arguing that the amount charged exceeded the proper and reasonable remuneration to which he was entitled.

The High Court dismissed the case deciding that, although the hourly rate charged by the trustees exceeded what would ordinarily be considered to be appropriate, the beneficiary's failure to challenge the level of fees at outset amounted to acquiescence, which meant he was debarred from challenging them subsequently.

In this case it was decided that the appropriate hourly rate would have been £330 for the trustee (as a partner) and £165 for his assistant. However, as the beneficiary had initially agreed to the original rates, he was not able to dispute them later.

COMMENT

This case illustrates how important it is to take great care when appointing trustees as well as ensuring that all the matters with regard to the fees charged by professional trustees are fully understood and agreed at outset. It also illustrates the level of fees currently charged by professionals, such as accountants, which often comes as a surprise to lay persons. Clearly, it is recommended that any fees for particular dealings by the trustees should be agreed at outset to avoid subsequent disputes.

A RECENT CASE ILLUSTRATES THE NEED TO PLAN WISELY FOR THE FUTURE OF A BUSINESS

In the recent case of Harding & Anor v Edwards & Ors, [2014] EWCH 247 Ch, the High Court has ruled that a profitable farming business in Cambridgeshire be wound up and sold following a family dispute.

Broadly, the said farm was incorporated over 50 years ago by the deceased (Brian Harding) and his father-in-law (Mr Brand). Mr Brand later transferred his shares to his daughter who was the deceased's spouse (Janet Harding). Later both Brian and Janet transferred a substantial number of their shares to their three daughters, Sally, Rosemary and Elizabeth.

On Mr Harding's death in 2001 he left most of his shares in the family business in trust for his wife and three daughters. Shortly afterwards the daughters, together with their mother, were appointed as directors. Mr Harding expressed the wish that his daughter, Sally, should continue to provide administrative services but, following a dispute as to how efficiently she carried out this work, she stopped doing so in 2002. After this her sister, Elizabeth, with the help of her husband, gradually took over most of the farm's day-to-day financial affairs – although the actual farming was done by a contractor.

Over the years there were a number of family disputes one of which involved Elizabeth and her husband attempting to remove Sally and Rosemary as directors. These disputes finally led to Sally and Rosemary bringing Insolvency Act proceedings to have the company wound up based on the fact that it could not be managed. Taking account of the circumstances of this particular case, the High Court ruled in their favour on the basis that it was unlikely that matters would improve and that any future disputes would worsen the position.

COMMENT

In an ideal world there would be no disputes between family members and thus it would be possible to live in the hope that a business could be passed on to family members and continue to be successful. However, the reality of these situations is somewhat different. Business owner clients should consider whether any succession planning they have in place is suitable given their overall circumstances, and possibly review the position if need be.

INCOME WITHDRAWAL RATE FOR MARCH 2014

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 March 2014 is 3.0%.