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ANNUITIES – WHAT IS THEIR FUTURE?

In the wake of the last Budget there were plenty of quick predictions about the demise of annuity business. Choose your news source and you could take your pick from between about 75% and 90% of the annuity market disappearing.

Hymans Robertson, the pension consultants, have addressed the future of annuities by polling 1,000 DC scheme members for their views. It found:

- 25% would use "most or all" of their pension pot to buy an annuity;
- 24% would take most of their pension pot as cash to spend in other ways and use some to buy an annuity;
- 24% would not buy an annuity, but would keep control of their money and designate funds for drawdown;
- 9% would draw their entire pension pot as cash, not buy an annuity and spend the cash in other ways;
- 34% of scheme members aged over 51 felt that annuities "are not flexible enough for [my] retirement plans" and classed them as "poor value for [my] savings". Those aged 50 and under were less antagonistic towards annuities with 20% ranking them

insufficiently flexible and 21% considering them poor value; and

- 61% felt confident about self-managing the money built up in their pension pots throughout their retirement, compared to 19% who did not. Men (64%) were more bullish than women (56%) on managing their own pots. People (70%) on higher incomes (£34,000 a year plus) were more confident than those (56%) on lower incomes (less than £21,000 a year).

These results need to be treated with a little circumspection. At this early stage, it is not surprising that many will grab the new-found opportunity to avoid an annuity, which is how Mr Osborne sold the reform. When push comes to shove and the same people are looking at an end to the monthly pay cheque, they may be more interested in the future certainty provided by an annuity. The power of the guarantee is a strong one - witness the volume of savings sitting in banks and building societies, despite negligible interest rates. Future developments must also be considered: we are at a consultation stage and it is quite possible there will be further tweaks to the new regime.

One aspect which has not been considered much so far is the spread of annuity business. There is a big difference between:

- the *median* purchase price (about £17,000), which means half of all purchases are £17,000 or less; and

- the *average* purchase price, which is about £34,000. The average is much higher than the mean because there are some substantial purchase prices at the fat tail end of the annuity sales distribution – an area where income drawdown is already an option.

It must also be said that the FCA does not like drawdown from ‘small pots’ of under £100,000 and has grown increasingly interested in capacity for loss alongside attitude to risk. While that loss has so far mainly focused on capital, the same argument applies to retirement income. There is already a regulatory requirement (COBS 9.4.10G) to warn “when maximum withdrawals are taken or the maximum short-term annuity is purchased, high levels of income may not be sustainable”, although how this applies with the move from a 120% to 150% drawdown cap is interesting to ponder. The FCA’s Risk Outlook 2014 has “Retirement income products and distribution” as one of its seven “forward-looking areas of focus”, so more is likely to emerge from them on this.

In the unlimited drawdown world, the regulatory stance will almost certainly still place an emphasis on capacity for loss, which could mean at the larger end of the pension pot scale, a mix of annuity to give a base income level (and fixed interest exposure) with drawdown (and equity exposure) on top.

Turning back to that median £17,000, it seems reasonable to expect most of that half of total annuity purchases will disappear to a cash total withdrawal when given the opportunity, as generally it will produce less than £100 a month gross income. Further up the purchase price ladder, income – and hence the guarantee – becomes more meaningful. So although it is conceivable that the *number* of annuity purchases will fall by 75%, the *value* of the market may not shrink proportionately as much.

COMMENT

These are early days. Reactions given to a sudden change of rules may themselves be revised when the theoretical option becomes an actual choice at retirement and consultation has had its impact on the Government’s plans. In any event, one slice of the annuity market, bulk purchase, will not be disappearing – witness a £36.5m DB de-risking deal which completed in early April.

CAPITAL GAINS TAX ON UK PROPERTY DISPOSALS BY NON-UK RESIDENTS

In the 2013Autumn Statement the Chancellor announced that the Government would consult on extending, from April 2015, the payment of capital gains tax (CGT) to non-UK residents who dispose of UK property. Following this announcement the Government has published its initial consultation document.

Historically, non-UK resident individuals, companies and trusts were outside the scope of UK CGT so that their investment gains were not taxed. In April 2013 the Government introduced a CGT charge, payable by companies and some collectives at 28%, on gains made on the disposal of an interest in high-value residential (personal-use) properties that are subject to the Annual Tax on Enveloped Dwellings (ATED). However, dwellings which are purchased purely on a commercial basis (for example a property rental business), or held for charitable purposes, are exempt from the ATED-related charges.

The consultation paper referred to above is aimed at improving the ‘fairness’ of the UK tax system and, to that end, proposes the extension of CGT to gains made on the disposal of UK residential properties to all non-UK residents – whether individuals, partners, companies or trusts.

Individuals who come within the scope of the new rules will be charged to CGT at the same rates as UK resident individuals, subject to an annual exemption; and companies will be chargeable to corporation tax in the same way as UK resident companies, but a specific CGT regime (the ‘tailored charge’) will be applied to them, at a rate of tax to be announced.

Further, it appears that no exemptions from the charge are being considered for commercial property aside from communal-use properties, such as care homes, boarding schools and student halls of residence. This means that genuine property rental businesses could be caught within the new regime as it stands.

However, it does seem that the principal private residence (PPR) relief will be extended to non-UK resident owners. But, in order to prevent non-UK residents simply electing that the UK residence is their PPR, it is proposed that this will have to be determined as a question of fact by looking at which residence someone has mainly occupied during the year.

This effective removal of the right to elect for PPR will also, it seems, apply to UK resident multiple property owners who will have the factual test (possibly based on actual days of residence) applied to them too. Some commentators have observed that this proposed new PPR test will give rise to considerable evidential difficulty.

The consultation period runs until 20 June 2014 and it is expected that legislation will be drafted following the Autumn Statement next December.

COMMENT

As ever, until the details of these changes are fully known it is difficult to comment on any viable planning options. That said, the outcome of the consultation will no doubt prove to be interesting given that a wider group of taxpayers (i.e UK residents as well as non-UK residents) will be caught by some of these changes. Further, in relation to non-UK resident property owners, it will also inevitably be important to take account of any double taxation agreements and the effect that these changes will have on those affected.

THE NUMBER OF ESTATES LIABLE TO IHT IS ON THE RISE

According to recent research carried out by the Institute for Fiscal Studies (IFS), the number of estates which will be liable to inheritance tax (IHT) will quadruple from 2.6% in 2009/10 to 10% in 2018/19.

The nil rate band has remained static at £325,000 since 2009/10 and is likely to remain so until 2017/18.

It appears from the study that this eight-year freeze represents a cut of 22% or £70,700 relative to inflation as measured by the Consumer Prices Index. As a result, the revenue received from IHT will increase to £5.8 billion in 2018/19. In that year, IHT liabilities will take a bigger share of the national income than at any time in the past 45 years, says the IFS – unless the tax is reformed.

COMMENT

With the nil rate band being frozen for so many years, clients ought to consider whether or not they are maximising the use of all available IHT exemptions and planning options where possible given their individual circumstances.

UK OPPOSES THE EU'S FOURTH MONEY LAUNDERING DIRECTIVE

The UK Government has recently confirmed that it will oppose clauses in the EU's Fourth Money Laundering Directive that would force all trusts to identify their beneficiaries in publicly accessible registries.

The draft Fourth Money Laundering Directive did not originally require public registries of trusts, but the clauses were later inserted into the draft legislation, that was extending disclosure of the shareholders of companies, to bring trusts within the scope of the legislation.

The legislation, as it stands, has been approved at committee stage, followed by a plenary vote in the European Parliament, thereby making it difficult for the UK to attempt to block the measures at the Council of Ministers level later this year. However, the UK government has indicated that it will not welcome an open registry of trust beneficiaries on the basis that trusts are specifically used for private purposes. With this in mind the UK government would like to reach a compromise by restricting the obligations imposed by the Fourth Money Laundering Directive to trusts that hold financial assets.

As a result the Treasury is now negotiating for this change to be made. If the legislation is amended to limit the scope of obligations to trusts which hold financial assets, it appears that these obligations would be satisfied through existing reporting requirements, domestic reporting requirements and automatic exchange of tax information agreements.

COMMENT

We now have to wait to see whether or not the Treasury will be successful in its negotiations. Regardless of this, even if the EU Council is persuaded to accept the UK position, the final outcome will need to be decided by a qualified majority vote which could prove to be difficult given the current progress of the Directive.

LUMP SUMS FROM ENHANCED OR PRIMARY PROTECTED FUNDS

Where an individual with enhanced or primary protection had a tax-free cash sum entitlement of £375,000 as at 5 April 2006, their tax-free cash entitlement was based on either the normal pension cash lump sum (PCLS) calculation rules or, where appropriate, the scheme specific protected cash rules.

Assuming the individual does not have scheme specific protected cash, the general principle is that they may not draw a PCLS of greater than 25% of the available portion of their lump sum allowance. In determining this, the following formula is used:

(CSLA - AAC) / 4

where:

CSLA = The current standard lifetime allowance at the time benefits are crystallised, and

AAC = The aggregate of the amounts crystallised by each Benefit Crystallisation Event (BCE) in respect of the member, and any tax-free cash sum paid prior to 5 April 2006 which will have been deemed to have crystallised on 6 April 2006.

In calculating AAC, the value of the amounts crystallised in each previous BCE are adjusted in line with the formula:

CSLA / PSLA

where

CSLA = The current standard lifetime allowance at the time benefits are crystallised, and

PSLA = The standard lifetime allowance applicable at the time of each previous BCE.

The following example demonstrates how these formulae work:

Adrian set up a lifetime annuity and took a PCLS in tax year 2008/09. In total he crystallised benefits with a value of £1,000,000. The then standard lifetime allowance was £1,650,000. This was the first time he had drawn any retirement benefits.

In tax year 2014/15 he could take a maximum PCLS of up to £123,106 – see below. The PCLS would have to be taken alongside a relevant pension (i.e. drawdown pension, lifetime annuity or scheme pension) and, in total, benefits (including the PCLS) with a value of £492,424 would need to be crystallised to enable the maximum PCLS to be taken without giving rise to either:

- A lifetime allowance charge, or
- An unauthorised payments charge.

The maximum available PCLS is determined as follows, assuming Adrian has no primary or enhanced protection:

(£1,250,000 - £1,000,000 x (£1.25m / £1.65m)) / 4 =

(£1,250,000 - £757,758) / 4 = £123,106

The adjusted AAC element of the formula will enable the maximum PCLS to be increased – in this case, from £62,500 (ie £250,000/4) to £123,106.

Pensions Schemes Newsletter 57 confirmed that …"Individuals with existing A-day primary or enhanced protection but who do not have lump sum protection will retain a right to a tax free lump sum of up to 25 per cent of £1.5 million when the standard lifetime allowance is reduced to £1.25million. This change ensures that individuals in this position do not have a reduced tax free lump sum when the lifetime allowance is reduced".

This change was implemented by paragraph 8 of Schedule 22 of the Finance Act 2013, which amended paragraph 2 of Schedule 29 of the Finance Act 2004. This provided that where the PCLS was determined for such individuals, in respect of a further benefit crystallisation event on or after 6 April 2014, that CSLA in the above formula will be based on the greater of the standard lifetime allowance in the tax year concerned and £1.5 million.

Returning to the example of Adrian above, and assuming he *had* elected for enhanced and/or primary protection but had a cash entitlement of £375,000 or less as at 5 April 2006, his maximum tax-free cash entitlement would be £147,727.25 where a BCE occurred in 2014/15, calculated as follows:

(£1,500,000 - £1,000,000 x (£1.5m / £1.65m)) / 4 =

(£1,500,000 - £909,091) / 4 = £147,727.25

However, while the new legislation works for the first BCE on or after 6 April 2014, its current provisions can result in a reduced maximum cash entitlement where there is a subsequent BCE on or after this date. This is because each BCE (including any on or after 6 April 2014) will be increased in line with the revised formula. This means that any BCE on or after 6 April 2014 will have its AAC value uplifted by 20%, as demonstrated by the example below:

Sophie has enhanced protection, but her tax-free cash is calculated according to the normal PCLS rules as her tax-free cash as at 5 April 2006 was £375,000 or less. She has no scheme specific protected cash and has not crystallised any benefits.

In June 2014, when her fund is valued at £1.8 million, she crystallises £1.25 million in her SIPP and takes a lump sum of 25% of this (i.e. £312,500). In December 2014 she crystallises her remaining £550,000 fund. As she has had a BCE in June 2014, account must be taken of this when assessing whether she can take any further tax-free cash. Applying the (CSLA - AAC) / 4 formula, there is no further scope for any more cash. The AAC element of the calculation is determined as follows:

(£1,500,000 - £1,250,000 x (£1.5m / £1.25m)) / 4 =

(£1,500,000 - £1,500,000) / 4 = £Nil

Had Sophie drawn her total £1.8 million fund in June 2014, she would have been able to take a maximum PCLS of £375,000 (i.e. 25% of £1,500,000).

The result of the Finance Act 2013 amendment is that, depending on fund size, it will only meet its desired intention where the individual crystallises *all of* their remaining benefits on one occasion on or after 6 April 2014 (or where they at least crystallise sufficient benefits at that first BCE in 2014/15 or later to enable them to take their maximum available cash entitlement at that time). If they phase in the drawing of their benefits on or after 6 April 2014, they may be unable to take their maximum potential tax-free cash sum.

OFFSHORE TAX EVASION

Over recent years it has been evident that the Government has been working with various countries to implement agreements to share information about tax evasion. At present, offshore tax evaders can be fined twice the amount they owe, and can face criminal prosecution and a possible prison sentence.

Now the Government is proposing to create a new criminal offence for those who fail to declare taxable offshore income. The offence, which is outlined in HMRC’s strategy document, ‘No Safe Havens’, will be one of strict liability, which removes the need for HMRC to show intent to avoid tax before prosecution. Therefore, there will be no need to prove that someone intended to hide their money offshore with a view to evading tax - just that they did and, as a result, didn’t pay tax.

Offshore account holders who avoid paying tax could face bigger fines and be jailed more easily if new criminal standards are adopted. Chancellor George Osborne said that he will change the law to make it easier for the tax man to mount criminal prosecutions. The Government will consult on a new criminal standard, harsher fines and increased jail time.

The key message is clear – there are no safe havens for someone who is evading tax!

HMRC ISSUES ADDITIONAL GUIDANCE ON THE TAX TREATMENT OF COMMISSION REBATES

Last June HMRC issued further guidance on the tax treatment of commission rebates on life policies, following on from R&C Brief 04/13. Since then HMRC has said nothing and the world has moved on with many platforms in the process of switching or already having moved to clean priced funds, where the issue does not generally arise.

It was therefore something of a surprise when HMRC published "Additional guidance for collective investment scheme holdings" in mid-April 2014. This document adopts a similar format to the further guidance. Most of the new guidance reiterates the original material from last year, but it has been updated in a few areas:

- HMRC says "References to 'rebates', 'trail commission', 'annual management charge' or 'fees' … all refer to payments which may be received by an investor. The principles set out … apply equally to these payments (no matter what they are called)."

- The treatment of payments as 'annual payments' will apply even if payments are not made each year. The guidance states "If a financial intermediary agrees to make payments to the investor whenever the trail commission or fee paid to the financial intermediary by the fund manager or other intermediary exceeds the fees chargeable to the investor, then these payments will be annual payments (*even if they do not occur every year*)" [our italics].

- SI 2013 No 1770 and SI 2013 No 1772 now mean that there is no requirement to deduct tax from payments that relate to offshore funds and authorised investment funds held by investors who are not resident in the UK.

- UK investors who are non-taxpayers can reclaim the tax deducted, but there is no R85 type procedure to permit gross payments to such individuals.

- Since 8 June 2013 switches from dirty to clean share classes are now covered by SI 2013 No 1400. These regulations mean that any single instruction from an investor to switch or exchange funds will not create a liability to capital gains tax provided the time necessary to achieve the transaction is kept to the minimum – which HMRC says is "normally expected to be no more than one to two working days."

INCOME WITHDRAWAL RATE FOR MAY 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 May 2014 is 3.0%, the same as for April.