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POLICY ENCASHMENT: CLUSTER POLICIES BEST PRACTICE

The ABI issues "Best Practice" note to member offices following the decision in the Joost Lobler -v- HMRC case appeal

The Joost Lobler case highlighted the problems that can arise in relation to large partial encashments under investment bonds. It is evident (and well known) that in some cases taking a large amount from a bond by a part encashment can trigger a chargeable event gain materially in excess of the economic gain resulting in a significant tax charge - as was the position in the Joost Lobler case.

By way of background, the facts of the case were that the policyholder, Mr Lobler, withdrew large amounts during the first two policy years by way of partial surrenders resulting in a significant artificial gain and a substantial tax liability even though he had not made any real gain on the policies.

In March 2013 the First-tier Tribunal (FTT) was sympathetic to the policyholder's position (he was effectively bankrupted by the tax liability) but couldn't find a way to solve the problem because, as a matter of strict law, he had been correctly taxed on the transactions he undertook.

However, in April this year, the Upper Tribunal overturned the FTT decision on appeal, ruling that Mr Lobler was entitled to be taxed on the basis that he made a tax free full surrender of the policies instead of partial surrenders.

To reach this solution, the appeal judge used the general legal concept of rectification which allows a mistake about the consequences of a transaction – which can include tax consequences – to be corrected if the mistake is sufficiently serious. In Mr Lobler's case that test was met as the judge said it was common sense that nobody would willingly contract to pay an amount of tax that would effectively lead to his own bankruptcy if there were a choice not to do so and achieve the same goal.

Mr Lobler's appeal was therefore allowed, but only on the ground of rectification. All his arguments based on public law and human rights grounds were dismissed. As a result of the decision in this case it was felt that some change to the tax legislation on chargeable events, especially in relation to deficiency claims, may result.

In the meantime, on 14 October the ABI issued a 'Best Practice' guidance note. A key statement in the Best Practice note reads:

'In simple terms, the provider needs to make sure that before a surrender or part surrender becomes irrevocable - i.e. is completed - the provider 'intervenes' to ensure the policyholder is put in a position to make an informed decision.'

The note provides further detail and guidance for member offices in relation to the possible nature and timing of the suggested intervention.

PENSION TRANSFERS: A REMINDER OF THE IHT RISK

IHTM17072 reminds us that there is an IHT risk when a pension transfer is made and the transferor is in ill health, knows it and dies within two years of the transfer

Registered pensions largely represent an "IHT free zone". There are, however, a few exceptions and one of them, it seems, is that HMRC considers a transfer of benefits from one scheme to another to be a transfer of value for IHT purposes. This, in effect, is down to the fact that the member could direct that the transfer is made to an arrangement where the estate would be entitled to the death benefit - even though, in practice, they rarely, if ever, would.

The risk only seems to exist if the transfer was made when the transferor was in ill health (and knew that) and then the transferor dies within two years of the transfer. HMRC takes the view that this can apply to clients who transfer from both company schemes and private schemes (although slightly different principles apply with transfers from company schemes).

Here's what the IHT Manual (guide to inspectors) says on the subject:

'IHTM17072 - Pensions: IHT charges: transfers between pension schemes

A pension scheme member has a statutory right to transfer their pension fund from one scheme to another. When this type of transfer is made, the member surrenders their rights under the first scheme in return for rights under the second. A person can do this regardless of their rights to benefits under the first scheme. This includes the situation where there is an existing irrevocable nomination in relation to death benefits, for example where the death benefits have been assigned on discretionary trusts. The second scheme is not subject to directions given in relation to the first scheme.

The funds do not rejoin the member's estate during transit. What is in the estate at this point is the right to determine the terms of payment of death benefits in the second scheme. This right has value because the member could direct the payment to their own estate. If payment is not directed to the estate then there may be a loss to the estate depending on the member's health at the time.

If a person is in normal health at the date of the transfer then the loss to the estate is nominal. If they are in ill-health at the date of the transfer then the loss may be significant.

Details of any transfers made within the 2 years before the death should be reported on the IHT409'.

COMMENT

The pensions freedoms rules have increased the interest in transfers. Most transferors won't die within two years of making a transfer but when they do there is this potential risk if they were in ill health when they made the transfer and knew that. One defence that can be used is that the transfer was not intended to confer any gratuitous benefit and this will be easier to argue where the transfer is made and the fund is then quickly encashed by the planholder.

The extent, and potential impact, of the risk will, of course, depend on the facts of each case. There is also a case currently going through the Courts that challenges HMRC's views on this. The taxpayer was successful in the Lower Tax Tribunal but an appeal by HMRC is expected to be heard early in 2016.

FLEXIBLE ISA CONSULTATION

It was announced in the 2015 March Budget that changes would be made to allow ISA savers to replace cash they have withdrawn from their ISA earlier in a tax year, without this replacement counting towards the annual ISA subscription limit for that tax year. This facility is not extended to Junior ISAs.

It would appear that this flexibility will be available in relation to both current year and earlier years' ISA savings where this is provided for in the terms and conditions of a 'flexible ISA'.

On 13 October HMRC published draft regulations, together with a draft explanatory memorandum and a Tax Information and Impact Note, for a period of technical consultation which closed on 8 November. The regulations are scheduled to come into force from 6 April 2016.

The current rules

Under the current rules, in 2015/16 an individual has the ability to invest the maximum of £15,240 (C) into an ISA. As an example, let's say that instead they invest a smaller amount (A). They then take a withdrawal (B) but later wish to make further investments into the ISA in the same tax year. The maximum amount of the further investment that they could potentially make is restricted to C less A. Thus it is not possible to replace the cash that has been withdrawn from the ISA. Therefore, under these rules individuals effectively lose the ability, by using the ISA wrapper, to shelter the amount withdrawn from tax in the future.

Example:

The ISA allowance for the 2015/2016 tax year is £15,240 (C).

If a person has invested £9,240 (A) in a cash ISA and withdraws £2,000 (B), the value of the cash ISA would then be £7,240 ignoring any interest. While the withdrawal does not affect the overall subscription amount, only another £6,000 can be put into the ISA in this tax year (i.e C less A which is £15,240 - £9,240 = £6,000).

The new rules

Under the new rules, from 2016/17 an individual will have the ability to invest the maximum of £15,240 (assuming the subscription limit remains unchanged for 2016/17) into an ISA (C). Instead, let’s assume that they invest a smaller amount (A). They then take a withdrawal (B) but later wish to make further investments into the ISA in the same tax year. The maximum amount of the further investment that they could potentially make is only restricted to (C - A) + B. This effectively means that investors will be able to replace the cash they have withdrawn without this replacement counting towards their annual ISA subscription limit.

Under these rules, if someone were to take money out of their ISA in the same tax year they would be able to continue to make contributions up to the full subscription amount ignoring the fact that they had made any previous withdrawals, therefore enabling them to replace the cash they have withdrawn from their ISA.

Example:

The ISA allowance for the 2016/17 tax year is assumed to be £15,240(C).

If a person has invested £9,240 (A) in a cash ISA and withdraws £2,000 (B), again the value of the cash ISA would then be £7,240 ignoring any interest. However, in this case the investor can put in another £8,000 in this tax year (i.e (C - A) + B which is £15,240 less £9,240 plus £2,000 = £8,000).

COMMENT

This particular change is good news for investors who require funds immediately but were previously reluctant to draw upon their ISA for these funds.

PENSION SCHEME NEWSLETTER 73

The HMRC Pension Scheme Newsletter 73 includes articles on the following:-

The Annual Allowance
The tapered Annual Allowance
Pension Registration statistics
Pension Flexibility (Protection)

(i) Annual Allowance charges for 2014/15

This is a reminder for advisers to remind their clients who have exceeded the Annual Allowance of £40,000 for 2014/15 to declare this on their Self-Assessment tax return. The deadline for submitting the return online is 31 January 2016, the deadline for submitting a paper Self-Assessment tax return having expired on 31 October 2015.

(ii) Tapered Annual Allowance

The tapering of the Annual Allowance comes into effect from 6 April 2016. From 6 April 2016 all pension input periods must be aligned with the tax year, even if the member is not affected by the taper.

(iii) Pension Registration Statistics

For the period 6 April 2015 to 30 September 2015 HMRC received in total 2,424 applications to register new pension schemes. This is a 38% reduction compared to the number of applications received in the same period last year. Of these schemes, 91% have been registered and HMRC has currently refused registration for about 4% of applications. No decision has yet been made on the remainder.

(iv) Pension Flexibility (Protection)

1. Taxation of lump sum benefits

HMRC explains that the tax charge on taxable lump sum death benefits paid to individuals changes to the recipient's marginal rate of income tax from 6 April 2016. Normal PAYE rules will apply to these payments. If the recipient has a P45 from a previous source/employment dated on or after 6 April in the current year, the scheme administrator should operate the code on the P45 on a Month 1 basis.

If a scheme administrator already makes payments to the recipient and has a tax code for those payments, the tax code should only be used for additional payments if the payments are being made at the same time. If more than one payment in a month is made and the same tax code is operated against each of those payments it could give the benefit of the tax allowances and rate bands twice.

In all other circumstances, scheme administrators should use the emergency code on a Month 1 basis against the payment and HMRC will issue a tax code to operate against future payments.

Where the beneficiary is receiving a lump sum payment that extinguishes the fund, the scheme administrator must issue a P45 which will enable the recipient to claim any tax refund that might be due in-year.

2. HMRC flexibility reminder

Those individuals that took advantage of the transitional easements in the run up to 6 April 2015 are reminded that they should have taken their PCLS by 6 October 2015. These included those that took advantage of the buddy transfer relaxation.

3. Transitional Protection

From April 2016 there will be two protection regimes available - Individual Protection 2016 (IP2016) and Fixed Protection 2016 (FP2016). There will be no application deadline for these Protections. However, individuals will need to apply for protection before they take their benefits as they will need the HMRC reference number if they want to rely on the protection. This means that those wanting to rely on IP2016 or FP2016 should apply before they take any benefits on or after 6 April 2016. This is so that those benefits can be tested against the higher Lifetime Allowance (LTA) provided by these protections rather than the £1 million standard LTA. This applies even when the benefits being taken are worth less than £1 million.

If the individual doesn't have the reference number then the amount of the benefit crystallisation event will be expressed as a percentage of £1 million, rather than the higher protected LTA.

HMRC is introducing a new online self-service for pension scheme members to apply for protection and this service will be available for members to use from **July 2016**. Members will no longer receive a Lifetime Allowance protection certificate. Instead, once they have successfully applied for protection the online service will provide them with a reference number which they will need to keep.

HMRC is also introducing an online service for scheme administrators to check the protection status of their scheme members. It is exploring options for what this will look like and will provide more information on this in due course.

4. The "interim process"

There will be a period between the new protection regimes becoming available in April 2016 and the introduction of the new online self-service in July 2016. For this period HMRC will introduce an interim process for pension scheme members who want to take benefits before the introduction of the new online service. Scheme members will be able to write to HMRC between April 2016 and July 2016 and HMRC will check the details of their protection and respond to the member in writing. This can then be presented to the scheme administrator in advance of the full application being made after July 2016.

5. Individual Protection 2014

As a reminder, individuals can still apply for Individual Protection 2014 to protect any pension savings built up before 6 April 2014 from the LTA charge (subject to an overall maximum of £1.5 million). Applications are made online and can be made up until 5 April 2017.

PENSIONS MINISTER ANNOUNCES DELAY IN IMPLEMENTING PENSION REFORMS

The Pensions Minister, Baroness Altmann, has announced, in the following Written Statement, a delay in implementing automatic transfers (pot follows member), defined ambition pensions and collective benefits.

'The new State Pension comes into payment from April 6 next year. This reform will bring much-needed clarity to a system that few people truly understand, and will reduce the need for pensioner means-testing. Alongside this, over 5.4 million employees have been enrolled into a work place pension by around 60,000 employers, dramatically increasing the number of people saving for later life. However, they represent around only three per cent of employers as large and medium-sized firms were first to implement automatic enrolment.

The Government's priorities are to carry through those important reforms to ensure they are a success. This means new State Pension being delivered as smoothly as possible and small and micro employers getting the help and support they need as they meet their automatic enrolment duties.

Government and the pensions industry are also currently working through the changes following from the new pension flexibilities which allow scheme members to have more freedom and choice about how and when they withdraw their pension savings.

All these reforms will increase the number of people saving into workplace pensions, introduce new freedoms allowing savers to access their cash, and implement a new State Pension that will be far easier to understand in the future. However, we are conscious of the need to ensure Government, providers, employers and members are able to focus on these changes to ensure their success.

That is why we have decided that the time is not right to implement Defined Ambition, Collective Benefits and Automatic Transfers. The time is not right to ask the pensions industry to absorb the new swathe of regulation that would be needed to make such further reforms work effectively. The market needs time and space to adjust to the other reforms underway and these areas will be revisited once there has been an opportunity for that to happen.'

COMMENT

This is perhaps a sensible move on the part of the government. The last 12 months has delivered huge changes in the retirement market, and providers and advisers alike have had to move with the times or be left behind. Indeed, the changes are still being digested so this breathing space before the next round of reforms is to be welcomed.

CLASS 3A VOLUNTARY NICS – STATE PENSION TOP UP NOW AVAILABLE

The facility to make a State Pension top up by paying Class 3A voluntary contributions became available from 12 October for anyone reaching State Pension age before 6 April 2016.

The scheme will remain open for 18 months and those who think they can benefit will be able to buy additional State Pension – worth up to £1,300 a year. In most cases, surviving spouses and civil partners will be able to inherit at least 50% of the extra pension.

Minister for Pensions, Baroness Altmann, said:

"This government's commitment is to provide security for working people at every stage of their lives, and that includes giving people the chance to enjoy a financially secure retirement. We have already committed to protecting pensioner incomes with the triple lock – uprating the basic State Pension by at least 2.5% each year of this Parliament. The new State Pension, coming in from April 2016, will ensure a simpler, more sustainable State Pension for the pensioners of tomorrow. Top up is an opportunity for people already retired, or reaching State Pension age before April 2016, to boost their later life income. It won't be right for everybody and it's important to seek guidance or advice to check if it's the right option for you. But it could be particularly attractive for those who haven't had the chance to build significant amounts of State Pension, particularly many women and people who have been self-employed."

COMMENT

The cost of a State Pension top up is based on a person's age and takes average life expectancy into account. For a 65-year-old, an extra £10 of pension a week will cost £8,900, whereas for a 75-year-old the contribution rate for the same amount of pension is £6,740.

CENTRE FOR POLICY STUDIES REPORT: AN ISA-CENTRIC SAVINGS WORLD

Michael Johnson, a research Fellow at the Centre for Policy Studies, has published a report, entitled 'An ISA-Centric Savings World', proposing a 10 point plan to replace the current pensions tax relief system with a Lifetime ISA. The 10 points are: -

1) Scrap tax relief on pension contributions: a Lifetime ISA should be introduced, eligible for upfront Treasury incentive and paid irrespective of taxpayer status up to a modest annual allowance. For example, the annual allowance could be 50p per post-tax £1 saved, subject to a maximum of £8,000 savings to count. Withdrawals before age 60 would result in repayment of the incentive.

2) Revitalisation of the Pensions Commission's vison of a 2/3rds earnings replacement rate within an auto-enrolment framework.

3) A Workplace ISA should be included in the auto-enrolment legislation.

4) The Lifetime Allowance should be scrapped.

5) Employee auto-enrolment contributions should be paid post tax and paid directly into a Lifetime ISA and be subject to the ISA rules.

6) Auto-enrolment Workplace ISA employer contributions should be taxed at the recipient's marginal rate and should be eligible for the same upfront Treasury incentive as the Lifetime ISA, sharing the annual allowance.

7) Employer contributions in the Workplace ISA and the accumulated income and growth should be locked in until age 60. The tax treatment of withdrawals, taxed at a sub-marginal rate (and possibly tax exempt), would depend on Treasury modelling and the size of the upfront incentive.

8) Consideration should be given to introducing an ISA Pension, secured with assets accumulated in the ISA and enhanced by a Treasury-funded 25% uplift on the underlying annuities. Taxation would again be subject to Treasury modelling.

9) The Lifetime and Workplace ISAs could reside in an ISA warehouse along with other ISAs dedicated to other savings purposes.

10) The Treasury should adopt a "Big Bang" approach to radically simplify the savings arena. It should name a date when an EET (contributions and fund growth exempt from tax, benefits taxed) tax framework ceases in respect of all future contributions leaving us with a TEE (contributions taxed with fund growth and benefits exempt from tax) tax framework for all savings.

INCOME WITHDRAWAL RATE FOR NOVEMBER 2015

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 November 2015 is 2.0%.