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THE OFFICIAL RATE OF INTEREST

"The official rate of interest" that applies to employment-related loans will be held at 3.0% for the tax year 2016/17.

If an employer makes a cheap loan to an employee or a relative (as defined in section 176(4) ITEPA 2003) of the employee 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 £10,000, no tax charge is made.

TAX EXEMPTIONS FOR TRIVIAL BENEFITS

Draft guidance published

On 9 December 2015 the government published draft legislation introducing a new income tax exemption for trivial benefits, for inclusion in Finance Bill 2016, together with a technical note setting out how the exemption would work in practice. Draft regulations were also published to extend the exemption to trivial benefits provided to former employees and to give effect to a matching disregard for National Insurance contributions (NICs).

HMRC has now produced draft guidance that sets out its interpretation of the new legislation. Both exemptions will apply from the 2016/2017 tax year.

In broad terms, the new section 323A ITEPA 2003 provides that any benefit provided by an employer to its employees will be exempt from tax as employment income if all of the following conditions are satisfied:

- the cost of providing the benefit does not exceed £50 (or an average cost of £50 per employee where the benefit is provided to a group of employees);
- the benefit is not cash or a cash voucher;
- the employee is not entitled to the benefit as part of any contractual obligation (including under salary sacrifice arrangements); and
- the benefit is not provided in recognition of particular services performed by the employee as part of their employment duties (or in anticipation of such services)

The exemption applies equally to benefits provided to the employee or to a member of the employee's family or household as well as where the trivial benefit is provided on behalf of the employer by a third party. The exemption is capped at a total cost of £300 in the tax year where the employer is a close company and the benefit is provided to an individual who is a director or other office holder of the company (or a member of their family or household).

If any of these conditions are not satisfied then the benefit is taxed in the normal way, subject to any other exemptions or allowable deductions.

The draft guidance explains, with examples, how HMRC will seek to apply the new legislation and will be reflected in HMRC's Employment Income Manual once the legislation comes into force. Comment is invited on this draft guidance and the final text will take account of comments received and any changes to the draft legislation.

COMMENT

At present, unless a benefit is subject to a specific exemption, it is taxable. Although HMRC can agree that certain trivial benefits fall outside the tax net, this has to be on the application of the employer. Where employers have not obtained this agreement, HMRC may seek to recover tax and NICs on the benefit. The introduction of a new statutory exemption for trivial benefits will considerably reduce the administrative burden on employers who provide such benefits to their employees.

A corresponding disregard for NICs will be introduced by regulations once Finance Bill 2016 has received Royal Assent. The existing Employer-Financed Retirement Benefits (Excluded Benefits for Tax Purposes) Regulations 2007 will be amended to extend the exemption to trivial benefits provided to former employees, backdated to the start of the 2016/17 tax year.

THE IHT TREATMENT OF BY-PASS TRUSTS

By-pass trusts can play an important role in IHT planning using lump sum death benefits from pension schemes. How they are subject to inheritance tax (IHT) at the 10 year anniversary (periodic charges) or when property leaves the trust (exit charges) going forward can be important. In this respect HMRC seems to have recently changed its interpretation on an important aspect.

Advisers will need to bear this in mind when giving tax advice on such a trust.

Background

For some years, financial planners have used by-pass trusts as a means of holding lump sum death benefits from a pension scheme. The by-pass trust has two advantages in these circumstances:-

(i) it enables third party trustees chosen by the member to decide who benefits from the fund at a later date. Such trustees are likely to be more familiar with the member's circumstances than the pension scheme trustees and they can be guided by a letter of wishes from the pension scheme member; and

(ii) it means that the lump sum is not aggregated with any one individual's taxable estate – for example, that of a surviving spouse. Instead, cash can be released from the trust as and when it is needed.

It is questionable whether by-pass trusts are as useful in the new era of flexi-access pensions where pension funds can be rolled down through the generations with no adverse inheritance tax implications. However, because of the greater control they offer, by-pass trusts will undoubtedly continue to remain useful for some people.

Inheritance tax on by-pass trusts

By-pass trusts are generally established in one of two ways. First, the pension scheme member sets up a pilot discretionary trust with a small gift of, say, £10 and then completes a letter of wishes requesting the Scheme Administrator to pay lump sum death benefits to the by-pass trust as a member of the discretionary trust under the Rules. This is generally known as a pilot by-pass trust.

Alternatively, the individual may (if the Scheme Rules permit) declare a trust of the death benefits under the Pension Plan. In the event of death, the Scheme Administrator must then pay death benefits to those trustees. Thus the element of discretion imposed on the Scheme Administrator is removed. Instead, the trustees of this personal trust will take over the power to appoint benefits. This is known as an integrated trust.

In both cases, it is necessary to know what the IHT treatment will be of any funds held within the by-pass trust in the future. The removal of the 2 year IHT rules by the Taxation of Pensions Act 2015 means that there should now be no IHT when payments are made from the pension scheme to the trust. Instead, we have the special lump sum death benefit charge (SLSDBC) to consider which, where it applies, is charged at 45%.

Periodic and exit charges

As is generally well known, a discretionary trust, as a relevant property trust, can be subject to IHT on every 10 year anniversary of the trust (periodic charge) as well as when property is paid out of the trust (exit charge).

For these purposes, HMRC takes the view that where the money in the by-pass trust originated from a trust-based pension scheme, then the trust will be treated as commencing when the individual joined the pension scheme. This is because the member will be treated as the settlor of a trust, comprising of their pension rights, when they join the scheme. In turn, this means that section 81 IHT Act 1984 will apply so that the member's trust of their pension rights and the by-pass trust are rolled together and treated as one trust for IHT purposes.

Examples

Dolly

Dolly joins the ABC Personal Pension Scheme (PPS) on 1 August 2012 paying contributions of £1,000 per month. No transfer payment is made. Dolly creates a by-pass trust for £10. On her death on 14 June 2019, the Scheme Administrator exercises its discretion to pay death benefits to the by-pass trust. For IHT purposes the by-pass trust is treated as commencing when Dolly set up her ABC PPS on 1 August 2012 and the first 10-year anniversary will take place on 1 August 2022 – even though this is just 3 years after her death.

Brenda

Brenda started an ABC PPS on 1 August 2012 with a transfer from her trust-based pension plan with Transindental Life which she set up on 1 June 1987. No other contributions have been made to the ABC PPS. Brenda also creates a by-pass trust. On her death, the Scheme Administrator exercises its discretion to pay benefits to the by-pass trust.

In these circumstances, for IHT purposes, the cash representing the transferred amount would be treated as being held in a discretionary trust that was created on 1 June 1987.

So far so good. But what exactly does HMRC regard as a trust-based pension scheme? What if Brenda had joined a pension scheme which was governed by a deed poll (rather than a master trust) with supporting rules?

Well, in this situation in the past, there may have been a tendency to classify a scheme constituted by a deed poll as a "contract-based" scheme. Therefore, logic would suggest that any by-pass trust would only commence when it was physically established (ie. by the nominal £10) and/or when cash was added to it from the pension scheme.

However, HMRC has now confirmed to us in detailed correspondence that this is not the case. It seems that if, under the contract-based scheme, the Scheme Administrator has a discretion to pay death benefits to anybody in the discretionary class, HMRC would regard those funds as being held in a settlement. This means that if the Scheme Administrator exercise their discretion to pay the cash to a by-pass trust, section 81 would apply. This is because the death benefits would have been treated as being held in trust from the date the member joined the scheme (or the date of joining any earlier trust-based scheme the benefits from which have been transferred to the contract-based scheme). The commencement date of the trust, for the purposes of calculating any 10-year or exit charges, would then be the date the member joined the scheme (or any earlier trust-based scheme from which a transfer has been made).

Integrated by-pass trust

This raises the question of what the position is in relation to an integrated by-pass trust. This, remember, is one that the Scheme Administrator **must** pay lump sum death benefits to if such a trust is declared.

The commencement date of the trust, in this situation, will depend on when the integrated trust is declared, as we set out below:-

(a) If an integrated trust is declared immediately

If the integrated trust is declared immediately the member joins the new scheme, the trust will be treated as commencing then. If the funds in the Pension Plan comprise of funds that were a part of a previous trust-based pension scheme that had been transferred to the new scheme, section 81 will apply with the effect that it is the date of joining the first trust-based pension scheme that determines future 10-year anniversaries.

(b) Integrated trust not declared immediately

If the integrated trust is not declared immediately and, in the meantime, the death benefits are payable at the Scheme Administrator's discretion, HMRC will regard the death benefits as being in trust - regardless of whether or not an integrated trust is later declared.

The effect of this will be that section 81 would apply to the subsequent declaration of an integrated trust and the relevant date for determining 10-year periodic charges would be the date of joining the scheme (or the date of joining any earlier trust-based pension scheme if there had been a transfer into the current scheme). The date the integrated trust was itself declared would only be relevant if, in the unlikely event that prior to that time, the Scheme Administrator had no discretion over the payment of any death benefits.

This would appear to be a change in practice by HMRC and should be brought to the attention of any trustees who are calculating IHT on death benefits held in by-pass trusts where the trust fund is derived from a contract-based scheme.

It should also be noted that where death benefits are paid out of a pension scheme and into a trust on or after 6 April 2016 and a 45% SLSDBC arises (mainly in cases where the member dies at age 75 or over), a credit for this tax charge will be available where a later payment is made to an individual beneficiary. This means that if the beneficiary's income tax charge on the payment is at a rate of less than 45%, it may be possible to offset the excess credit against tax on other income in that tax year. Full details of this provision are contained in section 21 Finance (No. 2) Act 2015.

TAX CODES AND IMPENDING CHANGES TO DIVIDEND TAXATION AND INTEREST

It is the time of the season when HMRC issues PAYE codes for the forthcoming tax year. These are generally based on the most recently received self assessment return, eg the 2014/15 return will provide data on which HMRC will attempt to set 2016/17 codes.

Reports are coming in that HMRC is allowing for the revised tax treatment of dividends and for the personal savings allowance and payment of some interest gross in the codes now being sent out. This has a number of consequences:

(a) Dividends

- Basic rate taxpayers, who are within self assessment and had dividend income of over £5,000 in 2014/15, could find themselves with a line in their coding which states "dividend tax". The accompanying note states 'This is to collect the basic rate of tax due on your dividend income,' although it is unlikely that many recipients will realise that 'basic rate' in this instance means 7.5%.

- The code adjustment figure is calculated to produce the appropriate amount of tax by reducing personal and other allowances and will not look anything like the actual dividend income received. For example, a basic rate taxpaying company director who had £25,000 of dividend income in 2014/15 will, in 2016/17, be presumed to have a dividend tax liability of £1,500 ([£25,000 - £5,000] @ 7.5%), assuming their personal allowance is fully covered by other income. To collect this HMRC would apply a dividend tax adjustment of £7,500 as this would yield tax of £1,500 (£7,500 @ 20%). For a higher rate taxpayer, the corresponding tax bill would be £6,500 ([£25,000 - £5,000] @ 32.5%) and the dividend tax adjustment £16,250 – probably enough to produce a K code, ie a negative tax code.

- Basic rate taxpayers outside the self assessment system slip through the net for now as HMRC will not have details of their 2014/15 dividend income. However, they will be caught for 2018/19 because of the need to complete a self assessment return for 2016/17 if they have a dividend tax liability. In those circumstances the need to file a return and the 2016/17 balance payment due on 31 January 2018 could both come as unwelcome surprises.

- The taxpayer can appeal against the coding using a form, which amounts almost to a mini-tax return based on expected 2016/17 income.

Tax returns allow taxpayers who put an X in the box to request that HMRC does *not* collect tax due for the current tax year on dividends and other sundry income via a 'coding out' – the default is HMRC will take the amount due as soon as it can. However, some accountants are reporting HMRC has ignored the all-important X, while others are now suggesting HMRC will want conformation of no coding out each year, outside of the tax return.

(b) Interest

It is not only dividend tax which changes on 6 April 2016. From that date the personal savings allowance comes into being and at the same time banks and building societies will start to pay interest gross, as will NS&I on products where it currently deducts tax from interest.

The changes appear to be causing some difficulties for HMRC:

- Anyone who has not put an X in the box to stop HMRC collecting in-year tax on interest should find that if their interest income exceeds their personal savings allowance, then an adjustment to their tax code is made to take account of the new regime. As with the dividend adjustment, the HMRC calculation is based on the taxpayer's interest income in 2014/15 (ie on the latest tax return).

  For example, a higher rate taxpayer who received £600 of *net* interest in 2014/15 will be assumed to earn £750 *gross* interest in 2016/17. £500 of this could be set against their personal savings allowance, leaving £250 taxable at 40% (£100). To collect this tax, the coding would have a £250 reduction.

- In practice, this adjustment does not always seem to be made correctly. There are reports of HMRC ignoring the personal savings allowance and making an adjustment equal to the full 2014/15 reported interest (grossed up, if necessary). In the example this would mean an (incorrect) code adjustment of £750.

- As has happened with dividends, HMRC also appears to not always take account of taxpayers who state they do not want in-year collection of tax. This might be the hand of the Treasury, ever anxious about cash flow.

- Basic rate taxpayers outside the self assessment system will slip through the net for now, as HMRC will not have tax return details of their 2014/15 interest income. However, those with interest income over £1,000 (not many, in practice) will be caught for 2018/19 because of the need to complete a self assessment return for 2016/17. As we remarked in considering the dividend tax changes, the requirement to file a return and the 2016/17 balance payment due on 31 January 2018 could both come as unwelcome surprises.

- Using 2014/15 interest data may well produce an inflated interest figure as although base rate has not moved since then, many deposit takers have cut the rate of interest on both variable and fixed rate offerings.

- As for dividends, the taxpayer can appeal against the coding.

COMMENT

There is a case for saying that PAYE codes are not worth arguing about, especially given HMRC's miserable response times. However, while the numbers should all balance in the end, some people will want to defer as much tax as possible for as long as possible, while for others a monthly tax collection – even in advance – is a sensible way of budgeting.

STATE PENSION SHARING GUIDANCE

The Department for Work and Pensions (DWP) has recently published guidance on how State Pension sharing will work in the light of the new Single-tier State Pension rules being introduced from 6 April 2016.

The information is aimed at legal and financial advisers, as well as the Courts that make sharing orders.

In simple terms, it will no longer be possible for spouses or civil partners, where the transferor's National Insurance (NI) record starts on or after 6 April 2016, to be awarded by the Courts a shared pension based on the transferor's NI record because the new Single-tier State Pension cannot be subject to a sharing order. However, the Protected Payment element of the transitional rate of new State Pension for those whose NI record straddles 6 April 2016 may be shareable.

GLASGOW RANGERS EBT AND SALARY SACRIFICE

Salary sacrifice is an area under the government's spotlight. Salary sacrifice arrangements, for example, using childcare and pension plans come with a significant cost to the UK government. Given the government's need to plug the tax gap, salary sacrifice is thought to be an area where the government could take future action to save revenue. Many believe that this could be part of a more general review of pensions tax relief - as sacrifice into pensions.

Whilst an announcement on salary sacrifice is anticipated in the 2016 Budget, it may well be that the recent Court decision in the Court of Session in the Glasgow Rangers case (the Advocate General for Scotland v Murray Group Holdings Ltd (2015) CS1H 77) may well offer another challenge to the efficiency of salary sacrifice arrangements.

This case concerned employee benefit trusts (EBTs). The Court found that the arrangements to "pay" players by way of loans did not work to avoid income tax. However, HMRC also raised the issue of the tax implications which involved a "redirection of earnings" which the Court of Session accepted. The Court held that the contributions to the EBT by Rangers FC were taxable as earnings. They should therefore be subject to PAYE at the point of payment to the EBT because HMRC considered that they were merely a redirection of the earnings made with the employee player's agreement.

Whilst this decision is now subject to an appeal, it has raised a concern that if an employee has a flexible benefit arrangement and waives an amount of salary in return for benefits or indicates a preference as to how any non-contractual discretionary bonus might be "paid", this could be regarded as a "reduction of earnings". If so, this may mean that employers would need to apply PAYE/NIC on the salary or bonus that would have been paid to the employee in the absence of the flexible benefit arrangement – regardless of the benefit provided.

Whilst an appeal is pending, HMRC is unlikely to make any comment on the wider implications of the Rangers decision.

However, we understand that HMRC has told the Chartered Institute of Taxation that the decision in the Rangers case would represent a significant change of HMRC policy and, if such a policy change took place, it would only have prospective effect from the date of announcement of the change.

COMMENT

It is reassuring that HMRC would not apply such a change with retrospective effect. So, at least for the time being current salary sacrifice still survives.

However, future salary sacrifice is undoubtedly under attack on two fronts:-

- *a possible change in law announced in the forthcoming Budget; and*
- *a possible change in tax law as a result of the Supreme Court's decision in the Rangers case.*

INCOME WITHDRAWAL RATE FOR MARCH 2016

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 2016 is 2.0%.