Technical CONNECTION

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GOVERNMENT TO REFORM THE RULES ON THE TAXATION OF CHARGEABLE EVENT GAINS ON PART SURRENDERS

At the March 2016 Budget, the government announced its intention to change the tax rules for calculating chargeable event gains on part surrenders and part assignments for value under life assurance policies. The problem here is that under the current chargeable event system chargeable event gains can arise which are disproportionate to the policy's underlying economic gain. Following this announcement, HMRC has released a consultation document looking at ways in which the current position can be improved.

The background to this issue is that artificial chargeable event gains on life assurance policies can frequently arise where a large part surrender is taken early in the lifetime of the policy. Because the gain on a part surrender is calculated as the excess over 5% allowances, this can result in income tax liabilities for a higher rate taxpayer even though the investment has in reality shown little or no growth.

The inequity of this aspect of the chargeable event regime was highlighted in March 2013 in the Joost Lobler case where the First-tier Tribunal (FTT) was sympathetic to Mr Lobler's positon (he was effectively bankrupted by the tax liability) but could not find a way to resolve the problem because, as a matter of strict law, he had been correctly taxed on the transactions. The FTT described the decision against Mr Lobler as "repugnant to common fairness". On appeal, however, in April 2015, the Upper

Tribunal overturned the FTT decision by applying the doctrine of rectification and ruling that Mr Lobler was entitled to be taxed on the basis that he made a full surrender of the policies instead of part surrenders. This resulted in no chargeable event gain.

The consultation, which runs from 20 April to 13 July 2016, invites views on three options for change designed to ensure disproportionate gains, which do not reflect the economic reality of the situation, no longer arise for both new and existing policyholders, while maintaining the familiar and popular 5% tax-deferred allowances.

These options are:

- **Taxing the economic gain** - this option would retain the current 5% tax-deferred allowances but would bring into charge a proportionate fraction of any underlying economic gain whenever an amount in excess of 5% was withdrawn.

- **The 100% allowance** – under this option no gain would arise until all of the premium(s) paid have been withdrawn, after which all withdrawals would be taxed in full, effectively changing the current cumulative annual 5% tax-deferred allowances into a lifetime 100% tax-deferred allowance. This is the simplest of the three options.

- **Deferral of excessive gains** – this more complicated option would maintain the current method for calculating gains but would limit the amount of gain that could be brought into charge on a part surrender (or part assignment for value) to a pre-determined amount of the premium (e.g. a cumulative 3% for each year since the policy commenced), holding the remaining gain over until the next part surrender or part assignment when the process would begin again until final surrender when all deferred gains would be brought into charge.

The consultation document sets out the options in detail with comprehensive examples illustrating how they would work in practice and considers the potential impacts on policyholders and insurers. Space does not permit the inclusion of worked examples here but the HMRC examples can be found in the consultation document ‘Part surrenders and part assignments of life insurance policies’ published on 20 April 2016.

The options will be reviewed in the light of representations received and a response will be published in Autumn 2016 with a view to including legislation for the preferred option in Finance Bill 2017.

We will, of course, keep readers advised of developments. In the meantime, insurance companies and advisers should follow the guidance in the ‘Best Practice’ guidance note issued by the ABI on 14 October 2015.

COMMENT

Changes to the regime will provide relief for those policyholders who currently make ill-advised partial withdrawals instead of fully surrendering individual policies. However, the changes could involve significant system changes for the industry, have an effect on the market for life assurance products and/or add further complexity to the legislation depending upon which option is chosen to carry forward. In addition, the new rules are to apply to both new and existing policies as a result of which any transitional rules are likely to be very complicated. There is no reference in the consultation document to transitional provisions.

OPG TO REVIEW GUIDANCE TO ATTORNEYS ON THE DELEGATION OF INVESTMENT MANAGEMENT

In September 2015 the Office of the Public Guardian (OPG) published an updated version of its guidance 'Make and Register your Lasting Power of Attorney (LPA): A Guide (LP12)'. The updated guidance stated that an attorney under a financial LPA would not be able to use, sign up to or continue acting under a discretionary investment management arrangement without specific authority being contained in the LPA itself.

The guidance goes on to state that, in the absence of express permission from the donor in the LPA, the attorney will have to apply to the Court of Protection for authority to appoint a professional investment manager on a discretionary basis.

This represented a significant change of practice and raised a number of legal issues – particularly for those attorneys who are already operating a discretionary management system under a registered LPA without such specific authorisation.

Following representations from a number of concerned professional bodies, the OPG has confirmed that the guidance is now under review and that a test case may well be taken to clarify whether the delegation of investment management by an attorney to a discretionary investment manager is, in fact, already legally permissible.

COMMENT

Practitioners will welcome clarification on this matter which, as it stands, leaves many attorneys in a position where they have no choice other than to apply to the Court of Protection for specific authority to employ a discretionary investment manager - a process which is expensive, can take some time and which could lead to valuable investment opportunities being lost in the meantime.

COURT SETS ASIDE A TRUST ON THE BASIS OF THE SETTLOR'S MISTAKE AS TO THE INHERITANCE TAX CONSEQUENCES

The England and Wales High Court has agreed to unwind an arrangement by which a couple took steps to transfer their home into trust shortly after the date on which the *Finance Act 2006* made such transactions liable to an immediate inheritance tax (IHT) charge and subsequent ten-year anniversary charges. Philip Van Der Merwe and Deborah Goldman - who were both non-UK domiciled at the date of the settlement - were not aware of the Budget announcement of 22 March 2006 when they executed the relevant documents on 24 and 27 March 2006 (*Der Merwe* v *Goldman & Ors*, 2016 EWHC 790 Ch).

The placing of the house into a trust, under which the settlor had an interest in possession, at a time when the settlor was non-UK domiciled for IHT purposes, provided the couple with certain IHT advantages (that incidentally are no longer relevant following legislation on excluded liabilities introduced in Finance Act 2013). Further, prior to 22 March 2006, the transfer of property into such a trust would not have given rise to any immediate or other IHT consequences due to the fact that the settlor would have been treated as remaining beneficially entitled to the trust property by virtue of section 49(1) IHTA.

As it was, it was announced at Budget 2006 that all lifetime trusts, other than bare trusts or trusts for the disabled, created on or after Budget Day (22 March 2006) would be subject to the relevant property regime. For Mr Van der Merwe – who did not become aware of these changes until some years later - this meant an IHT liability of around £200,000 arising as a result of the transfer to the trust, interest and penalties for late payment of around £60,000 and a 10-year anniversary charge – on 27 March 2016 - of around £120,000.

The Court accepted that had Mr Van der Merwe been aware of the changes announced in the 2006 Budget, he would not have pursued the idea of a settlement after that date; and so, taking account of the relevant legal principles pertaining to gifts made as the result of a mistake (as restated in Pitt v Holt, 2013), the trust was set aside on those grounds.

COMMENT

While recent cases might appear to pave the way for an onslaught of rescission claims where ignorance of the law has led to a false belief or assumption about the tax consequences of a transaction, it is important to note the distinction between a mistake that involves running a risk of a possible liability to pay tax and the situation in the present case where the claimants believed there to be no question of a charge to tax by reason of their actions. It is considerably less likely that applications for transactions to be overturned will be successful where tax avoidance is the prime motivating factor.

GOVERNMENT DROPS 'GRANNY ANNEXE' STAMP DUTY HIKE

The recent stamp duty increase for second homes will not apply to the majority of 'granny annexes' despite the fact that they may be treated as a separate dwelling.

In last year's Autumn Statement the Chancellor, George Osborne, announced plans to increase stamp duty on buy-to-let properties by 3%.

Based on this announcement alone it appeared that family homes with a 'granny annexe' could also be hit by this tax increase on the basis that it would be classed as a second property. Essentially, the buyer would be deemed to be acquiring a second home if the so-called 'granny annexe' is part of the dwelling on the basis that it could be deemed to be a separate dwelling regardless of whether it shares a wall with the main property. Campaigners have raised concern about the position and the topic has also been the subject of recent press coverage.

However, the Treasury minister, David Gauke, has now reassured campaigners this was not the intention and legislation will be put in place which will exempt the majority of 'granny annexes' from the tax increase.

Former Secretary of State for communities and government, Eric Pickles, who has campaigned for the exemption, welcomed the change. He said, "it is important in terms of social policy, as annexes are used not only by elderly relatives but by other family members, disabled children with special needs and so on".

COMMENT

This is a welcome change as one wonders whether or not this potential issue was considered when the legislation was initially drafted.

CGT DEFERRAL RELIEF

The change in CGT rates for 2016/17 has created an anomaly for EIS investors.

One of the features of the Enterprise Investment Scheme (EIS), which is not mirrored by Venture Capital Trusts (VCTs), is CGT deferral relief. This relief allows an EIS investor to defer the CGT liability on gains realised up to three years before the EIS investment is made or one year afterwards. Thus, in 2016/17, it is possible to make a claim in respect of gains realised as far back as 2013/14, provided there is no more than a 36-month gap between realisation and the EIS investment.

The relief is a deferral, not outright, so when the EIS investment is itself realised the amount of the deferred gain becomes liable to tax (gains under the EIS are otherwise CGT-free after three years of ownership). The tax payable on the formerly deferred gain is at the rate applying when the EIS investment is realised.

With the 8% cut in CGT rates, the result is that gains deferred from an earlier tax year are likely to suffer less tax when finally realised – typically 20% rather than 28%.

COMMENT

This sort of anomaly has arisen before and, in isolation, is no reason for an EIS investment. However, for someone choosing between an EIS and VCT investment, it is a point to be borne in mind.

DOTAS - REVISED DRAFT IHT HALLMARK PUBLISHED FOR FURTHER CONSULTATION

HMRC is seeking views on a revised draft of the IHT hallmark regulations having considered responses to an earlier consultation voicing concerns that the original proposals were too widely drafted. The new proposal focuses on arrangements that are contrived or abnormal, or that contain contrived or abnormal steps.

The IHT hallmark was introduced with effect from 6 April 2011 and has historically applied only to arrangements that seek to avoid IHT charges during a person’s lifetime. In July 2015 draft regulations expanding the existing hallmark to ensure that all types of IHT avoidance would have to be disclosed, and removing the existing “grandfathering” provisions, were published for consultation. While the revised draft regulations specifically exempted certain insurance-based schemes, many who responded to the consultation expressed concerns that the hallmark was so widely drafted it could be construed to catch a wide range of non-abusive arrangements, including loan trust arrangements where there was no initial gift, as well as bare trust versions of loan trusts and discounted gift trusts, on the basis that there was no ‘settlement’.

In the response document to the technical consultation published in July, the Government committed to revising the hallmark to take account of these concerns and has duly published, for further consultation, revised draft hallmark regulations, which now focus on arrangements that are contrived or abnormal, or that contain contrived or abnormal steps.

The conditions applicable to the revised hallmark, both of which need to be met for an arrangement to be disclosable, are that:

- The main purposes, or one of the main purposes, of the arrangements is to enable a person to obtain a tax advantage; and

- The arrangements are contrived or abnormal or involve one or more contrived or abnormal steps without which a tax advantage could not be obtained.

The latest consultation document provides examples of ordinary tax planning arrangements which may result in a tax advantage yet are not, in the eyes of the Government, caught by the revised hallmark because they are not contrived or abnormal (and so fail to meet the second condition). These include:

- Straightforward, outright gifts;

- Lifetime transfers into flexible or discretionary trusts;

- Investment into assets that qualify for relief from inheritance tax; and

- Arrangements that are within a statutory exemption – for example paying full consideration for the continued use of land or chattels that have been given away

Certain other insurance-based arrangements, that could potentially be caught, are specifically excepted under the revised draft regulations. These are:

- Loan trusts – whether discretionary or bare and whether or not there is an initial gift;

- Discounted gift schemes – again whether based on discretionary or bare trusts and whether established in conjunction with a life assurance or a capital redemption policy;

- Flexible reversionary trusts – including arrangements where the retained rights can be varied or defeated by the trustees; and

- Split or retained interest trusts

The consultation on the revised draft hallmark runs until 13 July 2016.

COMMENT

The revised draft hallmark regulations address many of the concerns voiced in response to the earlier consultation and will provide reassurance that the use of legitimate, mainstream tax-planning tools, such as loan trusts and discounted gift trusts, should not be caught under the DOTAS rules regardless of how they are structured.

This is a sensible approach from the Government as there is a clear difference between these arrangements and the avoidance schemes which are under threat from HMRC's efforts to strengthen the tax-avoidance disclosure regime.

It should also be noted that the fact that a scheme is disclosable under the DOTAS regulations does not mean it does not "work" for tax purposes. DOTAS is simply a means by which HMRC is made aware of tax planning schemes that are currently being marketed.

REPORT PUTS THE AVERAGE PRICE OF A BASIC WILL AT £168

Research commissioned by the Legal Services Board published recently has revealed the average prices that consumers pay for the most commonly used legal services including Will-writing, probate applications, estate administration and powers of attorney.

The survey, which comprised 1,506 telephone interviews with a range of legal services providers, found the following average prices:

- Standard Will – £168
- Complex Will – £206
- Lasting power of attorney (LPA) – £414
- Grant of probate – £829
- Estate administration – £1,926

Unsurprisingly, unregulated Will-writing firms charged significantly less for individual Wills and LPAs than solicitors (average of £136 for a standard individual Will and £263 for a LPA as compared to the higher averages of £176 and £440 respectively charged by solicitors). Further, the majority of Will-writing firms did not offer grant of probate or estate administration services.

It was also apparent that while providers are still more likely to charge either an hourly rate or estimate the total cost for more complex services, such as probate and estate administration, fixed fees now predominate for less complex matters such as individual Wills and LPAs.

COMMENT

This research shows that there is often a significant variation in the price that consumers pay for the same service (from £90 to £200 for a standard Will), so it pays to shop around. The research also reveals a lack of price transparency, with the twenty per cent or so of firms who display their prices on their websites generally being cheaper than those who do not. More positively, the research suggests the wide availability of fixed fees, even for some complex services.

INTESTACY FOLLOWING THE DEATH OF A MINOR CHILD

The current rules, under which both natural parents benefit following the death of a minor child, seem unfair to single parents and there have been calls for new rules to be introduced.

To be able to make a Will in England and Wales and in Northern Ireland (*) a person must be over 18 years old (with the exception of members of HM Forces in active service where the age limit is 16) and have the capacity to do so. If the individual is over 18 years old but lacks capacity it is possible to apply to the Court of Protection for a statutory Will. However, when a person is under age 18, that option is not available.

When a child dies before reaching age 18 their estate falls to be distributed under the rules of intestacy. In England and Wales this means that both the natural parents are equally entitled. In most cases the estate of the child is not likely to be considerable but a recently highlighted problem is illustrated by the case of a disabled child who has become entitled to compensation, which is frequently substantial. In a single parent family the chances are that the single mother (or, less likely, the single father) would have looked after her disabled child for many years, successfully pursuing a claim for compensation and dedicating her life to that child's welfare, frequently without any help from the child's other parent.

In the event of the child's death each parent is entitled under the law to 50% of the child's estate after inheritance tax and other liabilities have been paid. This could represent a very significant sum and it is this result that is being called into question as unfair and unreasonable. Under the current rules there is no solution to this problem. It has been suggested that the problem could be avoided if the powers of the Court of Protection were extended to allow the making of statutory Wills for a child under age 18. The Court is probably ideally placed to consider what should be the best outcome in these circumstances.

(*) In Scotland the age limit is 12.

COMMENT

The Law Commission is considering changes in this area of the law so hopefully it will address this issue as well. Some of the difficulties outlined above may also be possible to avoid by using an appropriate trust to hold any compensation funds. Specialist advice should always be sought in such circumstances.

INCOME WITHDRAWAL RATE FOR MAY 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 May 2016 is 2.0%.