Technical Connection

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THE TAX AND FINANCIAL PLANNING OUTLOOK POST BREXIT VOTE

The result of the UK voting for Brexit, has caused significant political upheaval. It has also had – and will continue to have – significant economic implications:-

1. While, at the time of writing, the pound stands at a 2-week high following the Bank of England's decision to hold base rates; it is expected to come under further pressure in the months ahead which will cause inflation to increase because the cost of imports will increase.

2. Despite predictions of a 25 basis point cut, the bank base rate will remain at 0.5% in July. However, a cut still may be on the cards next month which will, in turn, cause interest rates on cash deposits to reduce.

3. Stock markets will remain uncertain. Companies particularly affected will be those with European trade links.

4. Property prices may reduce.

Of course much of this is still speculation.

Despite pre-Brexit vote concerns, the new Chancellor of the Exchequer Phillip Hammond has now ruled out an emergency budget saying "We will want to work closely with the governor of the Bank of England and

others through the summer to prepare for the Autumn Statement, when we will signal and set out the plans for the economy going forward in what are very different circumstances that we now face and then those plans will be implemented in the Budget in the spring in the usual way"As to what Phillip Hammond's first Autumn Statement might include, we don't yet know.

While we have, of course, had the pre and post vote prediction by the former chancellor of a tough budget with spending cuts and tax increases, Phillip Hammond is likely to be prevented from cutting spending or raising taxes too aggressively by Prime Minister Theresa May – who, in a speech launching her bid to become prime minister, said "we should no longer seek to reach a budget surplus by the end of the Parliament".

Now that the vote has come down in favour of Leave, there is a new large dose of uncertainty to deal with and this period of uncertainty has no clear end date. With the chances of an 'austerity Budget' now looking unlikely, the short term recessionary economic outlook suggests any fiscal move will be towards stimulation rather than tightening. Indeed, Phillip Hammond has said that while deficit reduction would have to continue, the pace and "parameters" of that were up for review now that the government is no longer tied to the commitment to bring the public finances into balance by 2020. Hinting that he may well be willing to borrow to invest in infrastructure he said "Borrowing when the cost of money is cheap has some great attractions, but this country is already highly indebted and we need to be very careful about the signal we send to markets about our intentions. So it's about getting the balance right and making sure that we borrow and invest wisely where we can make big impacts on Britain's productivity and thus get a return on that investment that will be to the benefit of the Exchequer.

Of course, the new Chancellor will want to see how markets settle before deciding on next steps However, even if the tone of any Budget is stimulative and the tax rises predicted pre-Referendum are avoided or diminished, action against aggressive tax avoidance will certainly continue. This has been confirmed by Theresa May. In relation to tax avoidance by multi-national corporations its worth remembering that the so called "Base Erosion and Profit Shifting" (BEPS) project in relation to tax avoidance is OECD driven.

It seems that there is considerable post referendum uncertainty in relation to the future of the considerable and important proposed reform to the taxation of UK resident non-domiciled individuals (non-doms). These include the acquisition of deemed UK domicile for all taxes after 15 years of UK residence and transparency in relation to IHT treatment of UK sited properties in offshore structures. Planners with non-dom clients were also awaiting information on any reliefs and the taxation of non UK trusts with which non-doms are connected. It has been reported (but with no official confirmation) that work on the non-dom legislation was put on hold by the Treasury many months ago, pending the Brexit referendum. It was indicated by Treasury sources that further information would be released either before the summer recess, which starts on 21 July, or otherwise in September or October. It now seems very questionable whether this loose timetable can or will be adhered to, in view of the other demands on governmental time. As a result, many hope that the Government will recognise the need to push the implementation of the deemed domicile rules and IHT "transparency" rule back to April 2018, unless draft legislation can be issued in September or October.

In relation to UK pension reform, the cost of pension tax relief is well known to be substantial – in excess of £30bn. No substantial change was made in the last budget but the LISA (embodying many of the characteristics of the type of ISA centric incentivised saving proposed by the Centre for Policy Studies) may represent some "market research" into a different way of incentivising retirement saving. We shall see. Of course, following the appointment of Theresa May as PM we

now have a different Chancellor and possibly, in the future, a different pensions minister. Clearly this will have an impact but the numbers mean that possible reform cannot be totally written off yet, especially given that the outlook for government finances post referendum have undoubtedly worsened. Also given the financial pressures created by Brexit, Conservative MPs may generally be less resistant to the removal of higher rate tax relief.

Post Referendum, financial advisers are likely to continue to be confronted by some worried clients. The lesson of the past is that making any changes at times of extreme volatility is dangerous, if not foolhardy. Just look at the bound in the FTSE 100 index. There could well be an element of bungee jumping in the precipitous falls we have seen. Yes, the world had changed, but how is still far from clear at this stage.

PROPOSAL TO REDUCE CORPORATION TAX TO 15%

In an interview with the FT, George Osborne, whilst he was Chancellor, suggested that he would consider the merit of delivering for Britain the lowest rate of corporation tax of any major economy. The current rate is 20%. This is already scheduled to drop to 19% in 2017 and to 17% by 2020. George Osborne talked of reducing the rate to below 15%. In comparison, Ireland currently has a rate of 12.5%.

The proposed cut to corporation tax, which would give the UK one of the lowest rates of any major economy, appears to be designed to help the country stave off businesses leaving the UK post Brexit, as well as to attract new investment and court businesses which might otherwise have been put off by the uncertainty surrounding the country's relationship with the EU.

However, commentators have warned of the potential danger of such a move to the UK’s negotiation with the EU in relation to the terms of trade that can be secured post Brexit.

The shape of tax policy will undoubtedly remain the subject of some considerable conjecture until we get some firm indication of the “direction of travel” - in the next Budget which it seems is likely to be as part of the Autumn Statement.

TRUSTS AND RESIDENCE NIL RATE BAND

The Chartered Institute of Taxation (CIOT) is urging the government to amend clause 82 of the Finance Bill 2016 which deals with downsizing provisions on the grounds that it does not deal adequately with properties held in trusts. This is, unfortunately, not the only problem with the residence nil rate band provisions.

The problem highlighted by CIOT relates to the situation where the home is held as an asset of a trust, typically an immediate post death interest (IPDI) trust. These trusts are created on an individual’s death and leave a life interest to another – usually a surviving spouse. While residential properties held in IPDIs are treated as residential interests for the purpose of the residence nil rate band (RNRB), on the current wording of the draft legislation, a disposal by trustees of the dwelling-house in which the person has an interest in possession is not a disposal by “the person”, and so cannot qualify for downsizing relief. This is clearly inconsistent with the purpose of these provisions and so it is hoped the Finance Bill will be amended.

In connection with this subject, it may be useful to consider how the RNRB provisions interact with trusts.

Under which trusts can the RNRB be claimed?

To begin with the RNRB is only available on death. So, typically, the question of whether or not RNRB will be available, will only arise where property has been left to a Will trust rather than outright to a direct descendant. In this regard, trust beneficiaries will be treated as having 'closely inherited' property only where the property has been left to one of the following:

- a bare trust for a lineal descendant (or their spouse/civil partner)
- an IPDI trust for a lineal descendant (or their spouse/civil partner)
- a disabled person's trust for a lineal descendant (or their spouse/civil partner)
- an 18-to-25 trust
- a bereaved minor's trust (BMT).

Clearly, for those who wish to maximise the use of the RNRB it is important that the Will provisions ensure that ay trust to which RNRB is left, falls within one of the categories listed above and, in this respect, the scope is clearly limited. For example, if the property is left to a discretionary trust, the RNRB will not be available, even if the only potential beneficiaries of the trust are the testator's children.

A typical grandparental settlement, "to such of my grandchildren as reach 21", also will not qualify if the grandchildren are minors at the date of the testator's death because it is a relevant property trust. To secure the RNRB the grandparents would need to opt for a bare trust or at least an IPDI trust. Remember that 18-to-25 trusts and bereaved minor trusts (BMTs) can only be created by parents.

What about existing trust interests?

In some cases, an individual may have an entitlement to a qualifying residential property interest under the terms of an existing trust. In these instances, an RNRB will be available to that beneficiary's estate only if he or she is treated as owning the property - which broadly means that the trust must either be an IPDI or disabled trust - and on the beneficiary's death a lineal descendant of the beneficiary (or the spouse etc of such a person) inherits the property under the terms of the trust.

What if the property is given away during lifetime?

The RNRB is only relevant to the estate on death. However, certain lifetime gifts may affect its availability on death.

For example, if a property is given to children (or to a trust) during lifetime but the donor/settlor remains in rent-free occupation and the new owners do not move in, this will be a gift with reservation and so the property will effectively remain as part of the taxable estate of the donor.

Interestingly, new section 8J(6) IHTA 1984 (inserted into IHTA 1984 by Finance (No.2) Act 2015) effectively provides that, where property which has been gifted during lifetime remains in the donor's estate as property subject to a reservation, that property is capable of qualifying for the RNRB. However, the RNRB will be available in such cases only where the original gift was an outright gift made to lineal descendants (or their spouses) so that the property is deemed to be 'closely inherited' by the donee(s). A gift to a trust would not qualify for this treatment.

Of course, if the property has been given away outright (and no benefit has been reserved), the "downsizing" provisions may apply.

Reinstating the RNRB after death

So what if a Will provision is such that the disposition fails the RNRB requirements? Well, post-death variations passing a residential interest to lineal descendants will attract the RNRB (assuming all the other requirements are satisfied) because under section 142 IHTA 1984, the change in distribution of the deceased's estate can be 'read back' and take effect for IHT purposes as if effected by the deceased. However, such variations may be difficult to make in practice, as a variation from a discretionary trust would require the consent of all possible beneficiaries of the trust – some of whom may be minors or even as yet unborn.

In such cases – and particularly where there is no scope to claim unused RNRB under the transferable nil rate band rules (perhaps because the deceased was unmarried or already widowed) - section 144 IHTA 1984 may be of assistance. As indicated above, a discretionary settlement will not qualify for the RNRB even if all the beneficiaries are lineal descendants. However, an appointment made within 2 years of death to the lineal descendants will be read back into the Will under section 144 IHTA 1984, which means the trustees can retrospectively secure the RNRB for the estate.
Whilst the RNRB legislation has been described by a leading practitioner as nothing short of a "shambles", advisers nevertheless have to get to grips with it. A calculation of a potential IHT liability on an estate, having regard to all the assets of an individual and the relevant Will provisions, must be the necessary first step in any estate planning exercise. And given that most clients will own a residential property, the maximisation of the use of the available nil rate bands, including the RNRB, a close second.

INSURANCE CONTRACT LAW REFORM – INSURABLE INTEREST

Progress has been made in this area and a draft Bill was published last April followed by another short consultation which closed on 20 May 2016.

The Law Commissions (LCs) published an issues paper seeking views on updated proposals for reform on 27 March 2015 (having previously consulted on insurable interest in 2008 and 2011). The LCs' proposals were well received and the LCs published the responses to consultation last April. This was followed by a short consultation on the draft Bill which closed on 20 May. The LCs expect to publish their report and the final draft Bill later this year.

The LCs have stated that the proposals are intended to be relatively permissive to ensure that broadly speaking, insurance products which insurers want to sell and policyholders want to buy, could be made available without technical concerns about insurable interest - caused by the current narrow definitions.

The draft Bill introduces the concept of "life-related" insurance. A contract of life-related insurance includes any contract of insurance under which the insured event is the "death, injury, ill-health or incapacity of an individual". Thus the same rules are to apply to life assurance and critical illness, personal accident etc. policies. It would also cover investment linked insurance products which have life insurance element and annuities.

Here are the key provisions of the current draft Bill (largely as per the 2015 proposals).

- The requirement for insurable interest to exist at the outset is to remain.

- The Bill confirms the current law about automatic insurable interest in one's life and the life of a spouse and civil partner but extends this to cover co-habitants as well as the children and grandchildren of the policyholder.

- There is to be no automatic right to insure parents and grandparents, however insurable interest will exist where the 'economic interest' test can be satisfied (see below). Examples might include where an insured could show that there was a reasonable prospect that they would end up covering any (or a proportion of) care costs incurred by their parents, or where grandparents are relied upon for childcare so that their loss or incapacity would have a financial impact on a family.

- Trustees of pension schemes and other group schemes will have automatic insurable interest in the lives of the scheme members.

- Where a person takes out a contract for the benefit of others, there will be automatic insurable interest in the lives of those beneficiaries. This will allow an employer to take out a policy for the benefit of an employee or their family without having to prove the existence of insurable interest.

- The concept of "pecuniary and recognised by law" interest which currently applies to situations where there is no automatic insurable interest is to be replaced by a broader "economic interest" test. Insurable interest will exist in such cases when there is a "reasonable prospect of suffering economic loss".

There are slightly different provisions proposed for non-life insurance, as well as a set of provisions on the consequences of the lack of insurable interest which we will cover in a separate bulletin.

It is promising to see the progress being made on this. It is hoped that the final draft Bill when produced will be suitable for the special parliamentary procedure for uncontroversial Law Commission Bills and that finally the 1772 Act will be repealed and the law brought up to the 21st century standard.

HOW DIVIDENDS RECEIVED BY TRUSTEES OF DISCRETIONARY TRUSTS ARE NOW TAXED

Following the changes in dividend taxation that apply to individuals for 2016/17, changes have also had to be made to the way that dividends received by trustees of discretionary trusts are taxed. In basic terms, this means that because dividends are paid gross, dividends that fall within the trustee's standard rate band will be taxed at 7.5%. Those above will be taxed at 38.1%.

When trustees distribute dividend income to a beneficiary, they must have paid 45% on the income distributed. This would normally mean that the trustees will need to pay an extra 6.9% (45% less 38.1%) on distribution of the income to the beneficiaries. Any credit that the trustees have in their tax pool could be offset against this tax liability.

Unfortunately there is currently a problem with the draft legislation. The Finance Bill 2016 deals with the tax pool and in particular the amount of credit that goes into the tax pool in relation to dividends received by trustees of a discretionary trust. Based on the way the legislation is currently

drafted, this will have the effect of creating an additional tax charge for discretionary trusts when they distribute dividends.

The background to this is that section 498 ITA 2007 sets the amount of tax that can be included in the tax pool. This sets the rate of tax that can enter the tax pool for dividend income as the nominal rate defined as *'a rate equal to the difference between the dividend trust rate and the dividend ordinary rate'.*

The Finance Bill 2016 sets the dividend ordinary rate at 7.5% and at the same time abolishes the tax credit available to reduce the tax liability on the dividend income. So even though the trustees physically pay 38.1% tax on income above the standard rate band, on the current wording only 30.6% (i.e. the difference between the dividend trust rate of 38.1% and the ordinary rate of 7.5%) goes into the tax pool.

Under the pre-April 2016 regime, the non-repayable tax credit attaching to dividends could not be added to the tax pool because of concerns that this could lead to it becoming repayable in the hands of a non-taxpaying beneficiary receiving a distribution from the trustees. However, now that there is no no-repayable tax credit, there seems to be no reason why the entire amount of the tax paid by the trustees should not be included in the tax pool.

In addition, the legislation, as drafted, would mean that the tax liability for trustees and beneficiaries would be considerably increased and the overall tax rate would be approximately 11 per cent more than an individual would pay if they received the dividend direct and paid tax at the dividend additional rate.

However, the good news is that following representation from STEP, HMRC has agreed to amend certain provisions in the Finance (No 2) Bill 2016 to rectify the position. HMRC have acknowledged STEP's comments and responded to confirm that they are aware of the issue and have alerted ministers, who propose to table a government amendment to the Finance (No 2) Bill 2016 which will ensure that all of the tax paid on dividends by trustees of discretionary and accumulation trusts goes into the tax pool.

This is a good outcome as it clarifies an area where there was clearly some uncertainty and concern.

SCHEME PAYS: WHEN THE MONEY PURCHASE AND/OR THE TAPERED ANNUAL ALLOWANCE IS EXCEEDED

"Scheme pays" is the system whereby if a person suffers a tax charge because they exceed their permitted annual allowance, they can give the pension scheme notice to pay the tax charge out of their pension fund. Certain conditions need to be satisfied for such a payment to be made. Also, of course, there is the complication of people being subject to different annual allowances other than the £40,000 allowance – for example the £10,000 money purchase annual allowance or a reduced tapered annual allowance because their income exceeds £150,000.

So how does "scheme pays" work in respect of an individual who is subject to either the money purchase annual allowance (MPAA) or the tapered annual allowance?

(1) Requirements for Scheme Pays

First we need to look at the general rules for Scheme Pays to apply. An individual can elect to notify their scheme administrator that they require the scheme to pay some or all of their annual

allowance charge liability in return for an appropriate reduction in their pension benefits in the scheme if the following two conditions are met:

Condition 1

The annual allowance charge liability for the tax year has exceeded £2,000 and

Condition 2

The pension input amount (PIA) for the pension scheme for the same tax year has exceeded the annual allowance amount in section 228 Finance Act 2004. This is £40,000 in 2016/17.

(2) How does Scheme Pay work where the individual's annual allowance is not £40,000?

However, it is important to understand how these conditions interact with the money purchase annual allowance (MPAA) and the tapered annual allowance:

Condition 1

Where an individual's annual allowance charge liability is calculated by reference to the MPAA, the individual cannot elect to notify the scheme administrator to pay unless the individual's annual allowance charge liability (by reference to the annual allowance that applies to them) exceeds £2,000.

Condition 2

The £40,000 PIA requirement in Condition 2 still applies even though the individual is subject to the tapered annual allowance or the MPAA.

Therefore the Scheme Pays facility will only apply where people pay more than £40,000 in the pension input period in question and the liability on the overpaid amount exceeds £2,000 – even though they may in fact be subject to a pension input account of less than £40,000.

If the statutory requirements as set out above are not met, the individual can request the scheme to make the payment on a voluntary basis; that is the scheme is not legally obliged to make the payment.

If the scheme agrees, the timeline for making the payment falls in line with the self-assessment deadlines and the individual remains liable for the charge until it is paid.

INCOME WITHDRAWAL RATE FOR JULY 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 July 2016 is 2.0%.