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HMT CONSULTS ON AMENDING THE DEFINITION OF FINANCIAL ADVICE

HM Treasury has published a consultation document relating to proposals to amend the definition of financial advice. The consultation closes on 15 November.

As announced at Budget 2016, the Government is consulting on amending the UK definition of financial advice. This will give firms the confidence to develop better and more tailored guidance services to help consumers make informed financial decisions. Some consumers have relatively straightforward financial needs or small amounts to invest. For such consumers, the cost of full regulated advice may outweigh the benefits, or it may be uneconomic for firms to provide them with regulated advice.

Currently, firms are reluctant to offer guidance services to these consumers, increasing the risk of them making poor investment decisions on their own. A key reason for this reluctance is uncertainty around what constitutes regulated advice and what does not.

The main reason for the uncertainty is the fact that UK firms face two definitions of financial advice. The UK currently defines regulated financial advice as 'advising on investments', which is set out in the Regulated Activities Order (RAO). This definition is broader and less specific than the definition used in the Markets in Financial Instruments Directive (MiFID), which is based upon a firm giving a customer a personal recommendation. The Financial Adviser Market Review (FAMR) found that the MiFID definition is clearer for firms and consumers and is also much easier for firms to build into their compliance processes.

The consultation proposes to amend the wording in article 53 of the RAO to reflect the text set out in the MiFID, so that consumers only receive “regulated advice” when they are offered a personal recommendation for a specific product.

MEMBER PERSONAL PENSION CONTRIBUTIONS THAT DO NOT QUALIFY FOR RELIEF AT SOURCE

We have had a number of questions in respect of member contributions to a personal pension arrangement that do not qualify for tax relief at source.

This article considers the position in respect of member contributions to a personal pension arrangement made prior to the individual attaining age 75.

We had occasion to write to HMRC about the exact position in respect of an individual, aged under age 75, making a pension contribution that was greater than the level at which they qualify to claim income tax relief in a tax year ie. the greater of:

- the ‘basic amount’ - currently £3,600 - and
- the amount of the individual’s relevant UK earnings that are chargeable to income tax for that tax year.

The question therefore is whether it is possible for a PPP/SIPP scheme administrator that normally applies relief at source (RAS) to member contributions to accept a gross contribution in a case where the contribution is greater than the level which will qualify for income tax relief, or is it necessary for the scheme to apply RAS in all instances?

The text of our question was:

‘I am aware of a response, made by HMRC PSS on 3 November 2015 at 14:50, to an enquiry relating to a refund of excess contributions lump sum that stated ‘HMRC does not impose limits on the level of contributions that members can pay into registered pension schemes, only on the amount of contributions on which a member can have relief. Thus PSS’s rules don’t require the excess to be refunded and the scheme administrator could not use them to insist that the member accepts the refund.

I am also aware that in PTM044210 it states that a ‘member cannot choose which method of tax relief applies to their contributions; this is determined by the method the pension scheme is allowed to operate under the legislation.

However, I wonder if it is possible for a PPP/SIPP operator to knowingly accept a member contribution which is not eligible for RAS and treat it as a gross pension contribution? As such they would have to claim RAS on the contribution.

If this is not possible, and the PPP/SIPP operator must apply RAS on member contributions, even in a case where the member making the contribution has no relevant UK earnings and the contribution is greater than the ‘basic amount’ of £3,600, what does this mean in practice?’

The response we received stated as follows:

'A RAS scheme can accept a contribution which is not entitled to tax relief (though many choose not to). Relief should not be claimed to which the member is not entitled (e.g. if the contribution is in excess of our limits or the member is over 75). If relief has been claimed by mistake, the next claim form (APSS105 or 106) should be adjusted to take it out.'

HMRC's response to our question will give a degree of reassurance to scheme administrators that choose to accept such contributions that they are doing nothing that will result in HMRC's disapproval. In the majority of cases though scheme administrators are still likely to decline such payments as they do not have the systems in place to administer gross contributions.

UTILISING THE NORMAL EXPENDITURE OUT OF INCOME EXEMPTION

Inheritance tax (IHT) is becoming a concern to more and more people. A simple yet effective way of planning is to use exemptions and reliefs. Use of the normal expenditure out of income exemption can be particularly useful.

It is a fact that inheritance tax receipts are increasing. The number of families paying inheritance tax is now at a 35 year high. In 2009/10 2.6% of deaths gave rise to IHT. In 2015/16 this was 7.1%. And the expectation is that the tax receipts will increase still further with a prediction of £5.6 billion from tax year 2020/21.

Inheritance tax is obviously affecting more estates and will continue to do so.

Many people will be keen to take practical action that can reduce the impact of the tax without materially affecting their standard of living or financial security.

One of the accepted forms of IHT planning is to make lifetime gifts. Provided these are potentially exempt transfers (PETs) and the donor lives seven years these will be totally free of inheritance tax.

The drawback with PETs is that, in general, they need to be outright gifts and so ongoing control is lost. This can be overcome by making the gift to a trust (usually a discretionary trust) where the donor can be a trustee and decide who should benefit in the future. The drawback with discretionary trusts is the need to not exceed the donor's nil rate band taking account of what has been gifted in the preceding 7 years.

Many people may not, however, have assets that they can easily gift to the next generation but do have substantial levels of income – some of which may be surplus to their requirements.

Income in this respect means earned income and investment income (including buy-to-let income).

Such people can therefore make regular gifts of income.

Provided such gifts are

- regular; and
- made out of income; and
- do not affect the donor's usual standard of living

they will be exempt from IHT when made.

This means that there is no requirement that the donor need to survive them by 7 years as with other gifts.

And that applies irrespective of whether the gifts are outright (PETs) or to a discretionary trust (chargeable lifetime transfers).

How can an individual utilise such a gifting strategy if he/she has surplus income?

There are a number of opportunities and here are a few to ponder over:

- a grandparent (or parent) makes regular payments into a Child Trust Fund/JISA for the benefit of a grandchild;

- parents paying premiums into a joint lives last survivor whole of life policy in trust for children to provide a lump sum fund to meet IHT on the second death; or

- parents making a regular (annual) contribution to a single premium bond held in trust for their family.

The key issue is that the payments must be made regularly.

Finally, another important point. On an individual's death, HMRC may want evidence that the payments did not affect the deceased's standard of living and this may prove difficult for the executors to demonstrate – given that they will now be unable to discuss it with the deceased!

To avoid this problem, the donor should keep records of his/her regular gifts and his/her associated financial circumstances as and when he/she makes gifts. This can be recorded on Form IHT 403 – the normal expenditure form that needs to be completed as part of the estate return on a person's death.

PENSION CONTRIBUTIONS AND THE REDUCTION OF TAX

Contributions to registered pension plans are highly tax efficient. Indeed, they are so tax efficient that the tax reliefs will inevitably remain under Government scrutiny and so change cannot be ruled out in the future.

Not only will they give tax relief on contributions (at the individual's top rate(s) of tax on income) but contributions are then invested in a fund that is free of tax on investment income and capital gains and a part of the benefits can be drawn in the form of tax free cash.

However, the payment of pension contributions can confer other tax planning benefits for people in certain circumstances.

One of these is due to the way that higher rate tax relief is given on payments to personal pension plans by certain people. As we all know, basic rate tax relief is given at source so that 20% tax at source is deducted from any pension contribution paid to the provider. Higher rate tax relief is given by increasing the individual's basic rate tax band. This means more of the individual's income falls within basic rate tax rather than higher rate tax.

As we mentioned above, it is fairly well known that the current tax reliefs under personal pensions are under threat. The reliefs currently available may not be available in the future. What is not so readily appreciated is that because of the way relief is given, contributions to personal pension plans can indirectly provide other tax advantages.

For example, the way that the income tax system works these days is that certain income tax allowances are cut back at key income thresholds.

Consider the following situations:

(a) People who are entitled to child benefit will find that if their adjusted net income exceeds £50,000, they will be subject to a high income child benefit tax charge which, in effect, gradually neutralises the entitlement to child benefit. At £60,000 all of the child benefit is effectively lost.

For people who have income in this £50,000-£60,000 band, a payment of a contribution to a personal pension plan can be very worthwhile. As well as providing all the normal benefits given to pension plans, it can reduce adjusted net income and, in effect, restore some of the child benefit.

(b) Similarly, if a person has adjusted net income of more than £100,000, they will find that they start to lose a part of their personal allowance on the basis of a £1 reduction for every £2 of adjusted net income over £100,000. On 2016/17 rates, this means that when a person's adjusted net income reaches £122,000 all of their personal allowance is lost.

It also means that any non-dividend income in this £22,000 range is effectively taxed at 60% - 40% as usual and an extra 20% in respect of the reduction of the personal allowance.

As pension contributions to a registered pension scheme can reduce adjusted net income, if there is scope to do so it makes sense for such people to make contributions – to in effect obtain tax relief at 60% - whilst it is available.

Example – Jack

Jack's annual salary package in 2016/17 is £95,000. He is delighted when he learns that his annual bonus will be £15,000. He is not so happy when he realises that £10,000 of this will effectively be taxed at 60% - because it will cause him to lose £5,000 of his personal allowance.

By making an additional net contribution of £8,000 to his employer's group personal pension plan, he can reduce his adjusted net income (after the bonus) to £100,000 meaning that he is now entitled to his full £11,000 personal allowance.

In effect, his additional £10,000 pension contribution benefits from tax relief at 60%.

(c) Pension contributions can reduce tax on capital gains. Take Joe for example.

Example – Joe

Joe has earned income of £25,000 in tax year 2016/17. The higher rate threshold for this tax year is £43,000 and the personal allowance £11,000.

Joe has realised some shares in his employer company (that he acquired under an approved profit sharing scheme) for £63,100. He plans to use the proceeds to help buy a caravan for £55,000 so has about £8,000 free for other use – including, of course, meeting any tax bill on the realisation. He paid £30,000 for the shares so his taxable capital gain is therefore £33,100. From this he can deduct his annual exemption of £11,100 leaving £22,000 taxable in 2016/17. As things stand his tax bill will therefore be:-

£18,000 @ 10%	=	£1,800
£4,000 @ 20%	=	£ 800
Total		£2,600

This CGT bill will be payable on 31 January 2018 and eat into the £8,000 in cash he has available after purchase of the caravan.

To reduce this tax bill Joe could consider making a net contribution of £3,200 to a personal pension plan.

For income tax purposes, this will increase his basic rate tax band from £32,000 to £36,000. This now means that all of the taxable capital gain is taxed at 10% meaning he saves tax of £400.

So out of the £8,000 of cash after purchase of the caravan, Joe will use

- £3,200 to make a contribution to a personal pension plan and
- earmark £2,200 for payment of the reduced CGT bill on 31 January 2018

(d) People who are encashing single premium bonds will pay income tax on any chargeable event gains. But if those bonds are UK bonds, the investor will only pay higher rate tax. And in determining the amount of higher rate tax payable, the individual can take account of top-slicing relief. For such a person the payment of a contribution to a personal pension plan in the same tax year as the bond is encashed can lead to a reduction in the tax liability on the encashment of the bond. Take Helen for example.

Example - Helen

Helen has earned income of £40,000 in 2016/17. She is about to encash a single premium bond for £100,000. She purchased the bond 5 years ago for £75,000 out of an inheritance from her aunt.

As the top-sliced gain of £5,000 will cause Helen's higher rate tax threshold (£43,000) to be exceeded by £2,000 the tax computation on the chargeable event gain will be as follows:-

Chargeable event gain		£25,000
Top-sliced gain		£ 5,000
Tax on gain	£3,000 – within basic rate tax band	£ 0
	£500 PSA @ 0% =	£ 0
	£1,500 @ 20% =	£ 300
Tax on whole gain		£300 x 5
		= £1,500

To reduce the impact of the tax on the chargeable event gain, Helen could pay a net contribution of £1,600 into a personal pension plan. Basic rate tax relief would be given at source. But in order to give higher rate tax relief her basic rate tax band will be increased by the grossed-up contribution of £2,000 to £34,000. This means that the whole top-sliced chargeable event gain under the bond falls within the basic rate tax band. In turn this means that there will be no income tax on the chargeable event gain under the single premium bond.

BUY-TO-LET INVESTORS REASSURED ON TAX TREATMENT OF PROPERTY DISPOSALS

HMRC has reassured the National Landlords Association (NLA) that an unannounced amendment to the Finance Bill 2016, which provides that gains from certain property disposals will be charged to income or corporation tax rather than capital gains tax, will not adversely affect the majority of buy-to-let investors.

Ordinarily, investors expect any profit made on the disposal of a buy-to-let property to be charged to capital gains tax (CGT) rather than income tax. However, legislation included in clauses 75-78 of the Finance Bill 2016 at committee stage provides that profits made from UK property sold on or after 5 July 2016 will be taxed as trading income (and so subject to income or corporation tax) if certain conditions apply.

Many commentators had previously voiced concerns that the change, which was made at committee stage in July without consultation, could increase the tax payable by thousands of individuals and companies invested in UK properties. Implying that investors in UK property will be subject to income tax rather than capital gains tax on their disposal gains, if 'one of the main purposes in acquiring the land' was to make a profit or if they held the land as trading stock, the change would significantly increase the tax payable on the disposal. Individuals, of course, pay CGT at just 18% or 28% on gains from residential property and at 20%, 40% or 45% (plus National Insurance of 9% or 2%) on trading income.

However, HMRC’s Capital Taxes division has now confirmed in a letter to the NLA that ‘generally property investors that buy properties to let out to generate property income, and some years later sell the properties, will [continue to] be subject to capital gains on their disposals rather than being charged to income on the disposal'. The confirmation follows a statement from Treasury minister, David Gauke, who was responsible for the amendment, explaining that the measure is targeted at those ‘who have a property building trade' and should not impact the ordinary tax profile for investors in UK property.

However, there are exceptional cases in which the gains will be charged to income tax. These include:

- where the investor decides to undertake development prior to sale. In this case the profit on the developed part, from the date of the decision to develop for sale, will be trading income; and
- where the investor sells the land under a contract with a 'slice of the action' clause allowing them to benefit from future development of the property. In this case the 'slice of the action' profit will be taxed under the new legislation.

It is understood that the function of the new clauses is to ensure that profits generated by an individual from dealing in or developing land will always be chargeable to UK income tax. The confirmation that the legislation should not affect the majority of buy-to-let investors will be especially welcome given the onslaught of tax changes that the buy-to-let market has already seen this year.

HMRC will shortly be issuing draft guidance to stakeholders. In the meantime, the NLA says it will “continue to monitor the situation closely and ensure the government's intention is made clear at both Report Stage next week and in the guidance.”

COMMENT

By-to-let property (despite the mass of largely detrimental tax changes) remains an important asset class for many investors in the UK. This may continue given the relatively low yield achievable on other asset classes.

This latest clarification will come as a relief to those investors who may otherwise have feared another blow from HMRC to their hopes of receiving a decent (post-tax) return on their investment.

HMRC PENSIONS NEWSLETTER 81

This recently published Newsletter covers:-

1) The tax treatment of serious ill health lump sums
2) Inaccuracies in the Event Report
3) RAS annual returns 2015/16
4) Secondary annuities
5) Lifetime Allowance
6) Annual Allowance calculator
7) Pension flexibility and scams

INCOME WITHDRAWAL RATE FOR OCTOBER 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 October 2016 is 2.0%.