Technical Connection

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INCOME WITHDRAWAL RATE FOR OCTOBER 2017

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SELF-ASSESSMENT – ENDING THE TAX RETURN FOR MANY

From this September HMRC will remove the need for some customers to complete a tax return, starting with two groups:

- new state pensioners with income of more than the personal tax allowance in the tax year 2016/17
- PAYE customers, who have underpaid tax and who cannot have that tax collected through their tax code

All existing state pensioners who complete a tax return because their state pension is more than their personal allowance will be removed from Self-Assessment for the next tax year 2017/18.

The new system will broadly work by HMRC using the data it already holds to calculate the tax which is owed. Those with more complex affairs will, however, have to continue to complete a Self-Assessment form.

HMRC has been writing to customers from this September with a tax calculation and if customers believe the calculation is correct they can pay their tax bill online. However, should they believe the information is incorrect they have 60 days within which to contact HMRC to prevent any penalties being levied. And, if customers are unhappy with a follow-up response from HMRC, they have 30 days within which to appeal the decision.

FUEL RATES FOR COMPANY CARS

HMRC has announced the new fuel rates for company cars applicable to all journeys from 1 September 2017 until further notice.

The rates per mile are based on fuel prices and adjusted miles per gallon figures.

For one month from the date of the change, employers may use either the previous or the latest rates. They may make or require supplementary payments, but are under no obligation to do either. Hybrid cars are treated as either petrol or diesel cars for this purpose. The rates are as follows:

Engine size	*Petrol*	*LPG*	*Engine size*	*Diesel*
1,400 cc or less	11p	7p	1,600 or less	9p
1,401cc to 2,000cc	13p	8p	1,601cc to 2,000cc	11p
Over 2,000cc	21p	13p	Over 2,000cc	12p

IHT ARISING ON PENSION TRANSFERS BY PEOPLE IN SERIOUS ILL HEALTH

Where a person in serious ill health makes a transfer of a pension plan this can, in certain cases, lead to a chargeable lifetime transfer for IHT purposes. However, for those aged 55 or over, special rules apply to quantify the size of the chargeable transfer as we explain below.

In cases where an individual transfers from one pension scheme to another and dies within 2 years of the transfer, HMRC takes the view that, in certain cases, the pension transfer may have given rise to a lifetime transfer for IHT purposes.

In essence, this could be a problem where:-

(a) the individual dies within 2 years of making the transfer

(b) at the time of transfer, the member knew he/she was in serious ill health and

(c) it is not possible to demonstrate that, in making the transfer, the scheme member had no donative intent to others

If it is possible to show that there was no donative intent, the defence in section 10 IHTA 1984 will apply (no intention to confer a gratuitous benefit). This, for example, would be the case if the member was clearly only acting for himself and so immediately encashed the plan following transfer or had in place a plan for a regular systematic encashment. The Staveley case (on which we understood HMRC intend to make an appeal) is an indication of HMRC's resolve to only allow the section 10 defence in very specific cases.

HMRC will collect information on "vulnerable" pension transfers via the form IHT 409 – the pensions supplement to the Estate Return on Death (IHT 400). Not everyone will complete an IHT 400. For less complicated estates, which are termed "Excepted Estates" (assets of less than £1 million which pass mainly to a spouse/civil partner or charity), the legal personal representatives (LPRs) can complete the short form IHT 205. However, if an "offending" pension transfer is involved, the LPRs will need to switch over to using the longer form IHT 400.

For people who transfer at an age when they can draw benefits, the process for calculating the IHT transfer of value has, in the past, been complex. This involved determining the value of the pension scheme rights that the scheme member has the ability to give away and deducting the value of retained rights to which he/she is entitled immediately before death. This would typically be the right to the PCLS and the present value of any guaranteed annuity. Assumptions need to be made for future investment growth and the discount issues that arise with the purchase of such a financial product for notional purchasers.

Fortunately, the days of some of these complications may now be numbered.

In cases where an individual transfers to a pension plan that offers flexible access and that individual is aged 55 or over, we understand that HMRC will now be open to a valuation of retained rights on flexi-access principles. So, for example, the retained rights of an individual will be the entitlement to the PCLS and the residual encashment of the balance of the fund after income tax. This will, we believe, considerably reduce the likely transfer of value in many of these cases and so, even if clients are caught, transfers of value are more likely to fall within the available nil rate band.

Example - Oliver

Oliver aged 61 makes a pension transfer with a CETV of £1 million. At the time he makes the transfer he knows that he is suffering from pancreatic cancer and he has a life expectancy of one year. He unfortunately dies 8 months later having not encashed any of his pension fund.

Oliver's LPRs will need to report the transfer in boxes 17-21 of the form IHT 409. It is extremely likely that HMRC will take the view that an IHT transfer of value arose when Oliver made the pension transfer.

Let's say that the value of rights before the transfer (taking account of assumed investment growth and appropriately discounted) that is agreed is £950,000.

The net transfer of value will need to take account of retained benefits. On the basis that Oliver had other taxable income on his death of £100,000 these would be calculated as follows:

PCLS		£250,000
Remaining fund	£750,000	
Tax	£335,000	
		£415,000
Value of retained rights		£665,000

The transfer of value for IHT purposes will therefore be £285,000 (£950,000 less £665,000). Indeed as this is a chargeable lifetime transfer (CLT), annual exemptions of up to £6,000 may be available to reduce the value of the CLT still further.

If Oliver had predeceased his wife and had not made any CLTs/failed PETs in the last 7 years, all of this notional chargeable lifetime transfer will fall within his nil rate band and so no immediate IHT will be payable. It will, however, mean that there will be less of a transferable nil rate band available for his widow.

Of course, in the old days the value of retained benefits could, in appropriate cases, be treated as a lifetime transfer of value immediately before death under the 'omission to exercise a right' rule in section 3(3) IHTA 1984. As regards uncrystallised pension rights that rule was abolished by amendments to the IHT legislation in the Finance Act 2011. Furthermore, it no longer applies to crystallised pension rights following changes made in the Finance Act 2016.

THE VALIDITY OF A TRUST UNDER SCOTS LAW

In a recent Scottish case (referred to as *X and Y*) a trust of a life assurance policy was held to be invalid for lack of intimation. As a matter of fact it was also invalid for lack of delivery.

This was the decision of Sheriff William Holligan at the Sheriff Court in Edinburgh [2017] SC EDIN 52 in the petition of *X and Y* for the appointment of a new trustee in relation to two trusts of life assurance policies taken out by the late Mr A who died intestate.

The facts could be said to be typical of an individual taking out a policy using a standard trust deed provided by the life office in question; as such they will ring a bell with many readers.

The petitioners were the parents of the deceased. They were appointed executors dative on the estate of the deceased. They sought to be appointed as trustees in relation to two trusts said to have been created by the deceased. The petition was opposed by the cohabitant of the deceased who had brought proceedings for financial provision under section 29 of the Family Law (Scotland) Act 2006 ("the cohabitation proceedings"). These proceedings were, in turn, defended by the executors.

The claim by an unmarried cohabitant following the death of their partner was at the heart of this case. Such a claim relates to the assets personally held by the deceased partner. Assets held in trust would be outside such a claim.

In 2011 Mr A took out two life policies, with critical illness cover, each subject to a request (on a "standard" trust form) that the insurance company issue the policy to the "Settlor as Trustee", to hold it irrevocably on trust as further provided. Mr A was the sole trustee.

In order to obtain control of these policies following Mr A's death, the executors applied to the Court to be appointed as trustees to replace the deceased. However, the argument from the surviving cohabitant was that the trust deed paperwork had not been completed correctly and, accordingly, there was in fact no valid trust relationship and so the policies remained in the personal estate of the deceased and available to be part of the pot for the cohabitant.

In short, the cohabitant's argument was successful. As the trust deed paperwork had not been completed correctly there was no trust.

There was no trust as there is a rule in Scots law that the settlor cannot also be the sole trustee where they do not take steps to intimate the existence of the trust relationship to at least one beneficiary. Intending there to be a trust relationship is not enough (it is, of course, different in England).

In Scotland there needs to be another trustee or intimation to at least one beneficiary.

This rule is designed partly to prevent attempts to defraud creditors by an individual claiming (without any notice to anyone) that assets are in fact held in trust and outside the reaches of a creditor ("an important safeguard against manipulation of the trust mechanism in insolvency" as the Sheriff neatly put it in *X and Y*).

The failure to appreciate this rule when completing the trust deed was fatal to the trust's validity. This meant that the policies were not outside of the deceased's personal estate and the attempt to ensure the policies would definitely pay out for the benefit of the intended beneficiaries also failed.

The Sheriff considered all the relevant case law, namely Allan's Trustees v Lord Advocate 1971 SC (HL) 45; Clark's Trustees v Lord Advocate 1972 SC 177; Clark Taylor & Co Ltd v Quality Site Development (Edinburgh) Ltd 1981 SC 111; Kerr's Trustees v Inland Revenue 1974 SLT 193; Jarvie's Trustee v Jarvie's Trustees (1887) 14R 411, before drawing his conclusion.

Specifically, he confirmed that intimation to the life office is not sufficient, as determined in previous case law - any intimation must be to a beneficiary.

COMMENT

Interestingly the Sheriff also commented on the trust deed in question which did have some useful guidance notes. It said, 'It is important to appoint at least one additional trustee to act with you as soon possible so the trust will be effective.' If only Mr A had followed that guidance.

Most readers will, of course, be aware of this requirement. In the light of this latest decision it cannot be stressed enough how important it is to ensure that a trust is set up correctly and that the requirement to appoint additional trustees is not left "until later". This will put beyond doubt the validity of the trust, whereas relying on the "intimation to a beneficiary" route is likely to cause delays or have to be argued in Court.

As an aside, had Mr A been properly advised he would surely also have made a valid Will, but that's another story.

THE COST OF PENSIONS TAX RELIEF

HMRC statistics on pension contributions are rarely up-to-date. The delays necessarily built into the self-assessment system mean that the numbers often emerge 18 months after the end of the tax year. So it is with the latest set of data, focused mainly on personal pensions.

The set contains eight tables, with provisional figures for 2015/16, the latest reported tax year. Comparison with 2014/15 needs treating with some care as there were nearly 0.5m non-employer sponsored minimum contribution only personal pensions in 2014/15, the last year of personal pension contracting out.

The highlights from the latest statistics will make interesting, if uncomfortable reading, for the Chancellor ahead of his Autumn Budget:

- Contributions to personal pensions reached £24.3bn in 2015/16, 19.7% up on the previous year and a new record – the previous peak was £20.9bn in 2007/08 (when the annual allowance was £225,000). However, adjusted for (CPI) inflation, the pre-financial crisis figure is 5.7% higher in real terms.

- Employer contributions to personal pensions in 2015/16 jumped by 30.2% over the 2014/15 level, to £14.32bn. Individual contributions (including self-employed and old retirement annuities) rose by 7.4% to £10bn.

- The jump in employer contributions is much greater than the increase in membership of employer-sponsored personal pension schemes, which rose by 9.1% to 7.79m. Overall personal pension scheme membership rose by 6.8% to 12.76m.

- The average annual total personal pension contributions per individual were £2,570 for 8.53m employees (+4.5% on 2014/15) and £5,310 for the 350,000 self-employed (+30.5%).

- The total cost of tax reliefs on *all* pension contributions (personal and occupational) in 2015/16 was £38.2bn, a rise of 9.5% on 2014/15. £18.5bn (+11.4%) of this was in respect of employer contributions to occupational schemes. NIC relief (for employers and employees) on employer pension contributions added another £15.7bn (+14.6%) to the Treasury's bill. In the Treasury's perverse offset calculation, there was a £24.8bn (+13.8%) counterweight from tax on pensions in payment (boosted by the first year of pensions flexibility).

COMMENT

£53.9bn of tax and NIC relief cannot help but be a tempting target for Mr Hammond as he considers his Autumn Budget. Add in the fact that in 2018/19 automatic enrolment will be fully in force (it was not in 2015/16) with contributions 150% higher than now at 5% of rather than 2% of band earnings and the temptation to do something is all the greater.

USING THE 45% TAX CREDIT ON THE PAYMENT OF LUMP SUM PENSION DEATH BENEFITS

As is reasonably well known, in the case of a member of a pension scheme dying aged 75 or over and a lump sum being paid to a personal discretionary/flexible trust (such as a by-pass trust), a 45% SLSDBC income tax charge will arise. On later payment of some or all of this amount to a beneficiary, the beneficiary will be taxed on the grossed-up amount but be entitled to a credit for tax previously suffered by the trustees. Two issues arise out of this:-

(i) Where the individual has a tax liability on other income that is **less** than the tax credit on the payment out of the trust, can the excess tax suffered be recovered from HMRC?

(ii) Where a payment is made out of a trust to a beneficiary, how is that payment attributed to the earlier lump sum payment from the pension scheme? This will be relevant where the lump sum has grown in value or other payments have also been made to the trust.

We now address these issues in more detail.

(1) Reclaiming the 45% tax deduction

Section 21 Finance Act (No. 2) 2015 amended section 206 of the Finance Act 2004 to deal with cases where a lump sum is paid to a non-qualifying person (such as trustees) from a registered pension scheme and that lump sum attracts a 45% tax charge, and a subsequent payment is made to a beneficiary. It provides as follows:-

'*the amount received by the beneficiary, together with so much of the tax charged under this section on the lump sum as is attributable to the amount received by the beneficiary, is income of the beneficiary for income tax purposes but the beneficiary may claim to deduct that much of that tax from the income tax charged on the beneficiary's total income for the tax year in which the payment is made to the beneficiary.'*

Further explanation on the interpretation of this section is given in part 3 of Pension Flexibility in Pension Schemes Newsletter 77. Here it states that:

'the individual will be able to set off the tax paid on the lump sum death benefit by the Scheme Administrator (or a proportion of it, where the trust payment is funded by only part of the lump sum death benefit the trustees received) against the tax due on this trust payment. This may lead to a refund of tax.'

Does this mean that the payment (grossed up by 45%) from the trust will be treated as part of the individual's total income for that year so that some of the deemed 45% tax payment would be recoverable if the individual does not pay tax at 45% on all of the payment from the trust and the tax on other income in that year? Or is any tax that is "recoverable" limited to the tax the individual pays on other income in that tax year?

Let's take an example. Assume that in 2017/18 an individual has other taxable income of £10,000 on which he has a £2,000 tax charge. Say he receives £10,000 from a pension scheme trust on which the 45% SLSDBC had been paid on receipt by the trustees.

The £10,000 is treated as a grossed-up payment of £18,182 to the individual and so is treated as having suffered tax of £8,182.

The individual's actual tax bill on the grossed-up £18,182 is £3,636. Therefore there is overpaid tax of £4,546.

The question is:-

(i) can he offset £2,000 of this £4,546 against the tax on his other income and the balance, £2,546 against the deemed tax paid on the distribution from the trust? This would mean he could recover £4,546 (assuming he has already settled the £2,000 basic rate tax charge on the other income) or

(ii) can he only offset £2,000 of £4,546 against the tax paid on the other income in that tax year?

HMRC has confirmed to us that section 206(8) Finance Act 2004 requires the beneficiary to include both the lump sum received and the tax attributable as pension income – so both elements are part of total income. On the basis that the individual would declare £18,182 as pension income and tax previously paid of £8,182, there is no requirement that any resulting overpayment of tax should be restricted and therefore, in the above example, it would be possible to obtain a repayment of tax of the full £4,546 (assuming the tax on the other income had been paid).

(2) Attribution of payments made to beneficiaries

In what way is any payment made to a beneficiary attributed to the original payment from the Scheme Administrator to the trustees?

For example, say a member died aged 76 and lump sum death benefits of £100,000 were payable. If these were paid to the trustees of a personal trust, the Scheme Administrator would deduct tax of £45,000 and pay that to HMRC leaving them with £55,000 to pay to the trustees. Let's say the trustees invested the £55,000 and after 5 years the trust fund is worth £85,000, having enjoyed capital growth and accumulated income. The trustees then make a capital distribution of £10,000 to a beneficiary. How much of that payment is attributed to the original £55,000 payment?

It would seem to us that there are 2 possibilities, as follows:-

(i) The whole of the payment to the beneficiary is attributed to the original payment to the trustees. So, in this case, the beneficiary would be treated as having received a grossed-up payment of £18,182 on which tax of £8,182 had been suffered. This would give the beneficiary a tax credit of £8,182.

(ii) A proportionate part of the payment to the beneficiary is attributed to the original payment to the trustees and a part to capital growth.

So, in this situation £6,471 (55/85 of £10,000) would be treated as being attributable to the original payment with £3,529 representing the capital growth. This would give the beneficiary a tax credit of £5,294 on the overall payment.

In this case, HMRC has confirmed to us that it is up to the trustees to decide how to attribute the lump sum death benefit to beneficiaries within the trust rules. Section 206(8)(b) Finance Act 2004 states that payment of any part of that lump sum received by the beneficiary is treated as pension income. The treatment therefore can apply only to the part of any payment attributable to that original amount of lump sum or, it seems, the whole payment. The trustees can make this decision.

INCOME WITHDRAWAL RATE FOR OCTOBER 2017

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 2017 is 1.75%.