

Alternatively secured pensions (ASP) - Take 2

In December 2002 Gordon Brown announced that pension simplification would be introduced, stripping away complex rules which covered 8 different pension regimes, to make pensions easier to understand. Within those changes was the removal of the requirement for individuals to purchase an annuity before reaching age 75. This was a highly praised initiative which recognised it was nonsense to impose such a restrictive condition just because someone had reached a certain age.

The new rules, which came into effect from 6 April 2006, allow an individual to take income from the invested pension fund rather than have to pay it over to an insurance company in exchange for an annuity. Such a facility had been in place for some time but it was only from 6 April 2006 that it was extended to individuals past age 75. To protect the individual member, there is a limit to the amount of income that can be taken. The maximum income is 70% of the amount of annuity that could have been purchased on the open market by a 75 year old. The limit is to protect the individual by reducing the likelihood of running out of funds, especially if the investments fall in value. As a further precaution, the exercise has to be repeated every 12 months.

There is a major advantage in that any residual funds on the death of the individual (or his / her spouse) can be passed on to other scheme members, after inheritance tax has been paid. As other scheme members could include family members, it was seen as an opportunity for the remaining funds to be passed down to future generations. When compared to annuity purchase, this seemed to be a win win situation where the Government received extra taxes and the whole of the pension fund did not disappear upon death, as would be the case with an annuity.

For reasons that are unclear, Ed Balls - the Economic Secretary to the Treasury - decided during the summer of 2006 to intervene and said that the relaxation of the age 75 rule was intended to be for the benefit of Plymouth Brethren only and new legislation would be introduced in due course. The December 2006 Pre-Budget Report proposes that the Finance Act 2007 should introduce changes effective from 6 April 2007. The maximum level of income that can be taken from an ASP will be raised from 70% to



90% (thereby reducing the protection previously considered to be necessary) and a minimum level of income must be taken which is to be 65% of the annuity rate, whereas currently there is no need to take any income at all. Also, on death, unless the fund is to pass to charity, the lump sum death benefit will be treated as an unauthorised payment from the scheme and when the 40% inheritance tax charge is included, the total tax rate could be 82%. Exactly how the tax charges will apply is yet to be clarified.

For some individuals, an ASP will still be relatively attractive, especially if they prefer to have investment control or if they intend a charity to benefit in the event of their death. But what is clear, is any individual having high expectations of what ASPs can offer should seek professional advice well in advance of age 75. In addition, a completely different investment strategy may be required for funds depending on whether an annuity purchase or an ASP is likely to be the most preferred option.

This is a specialist area of advice and if you require any further information please contact us.

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Act now on trusts to defer inheritance tax

In order to determine the inheritance tax (IHT) treatment for the next generation of trust beneficiaries, life tenants of life interest trusts are now in the unenviable position of needing to decide if any action is required, by them, before 6 April 2008.

On the death of a life tenant, their IHT liability has historically been calculated by including the entire value of the trust fund which gives rise to their life interest. If their total estate is not large, the nil rate band could mean that no significant IHT liability arises. For life interests in existence at 22 March 2006 this position is protected.

Where a life interest is created after 22 March 2006, the underlying trust fund will no longer form part of the life tenant's estate, unless the life interest is created on the death of an existing life tenant and the new life tenant is their spouse or civil partner. Instead, the trust fund will be subject to its own IHT regime. This regime will see IHT liabilities arise periodically during the life tenant's lifetime (hence eating into trust capital and potential growth) rather than being delayed until the life tenant's death.

However, there is an interim period from 22 March 2006 to 5 April 2008. During this period, a new life interest may be created, whereby the existing life tenancy is terminated and replaced with a new and

younger life tenant or tenants. This is known as a Transitional Serial Interest (TSI). The new life tenant will continue to be subject to the old rules and will have the capital value of the fund treated as part of their estate on death. By creating a TSI, the funds within the trust will not be liable to IHT until the death of the new life tenant. Provided the old life tenant survives seven years from the termination of their life interest, this defers the IHT bill by a generation and also allows the trustees more time to consider options for future beneficiaries.

The termination of a life interest will of course have financial implications for the life tenant. However, it provides an opportunity to undertake IHT planning if the life tenant is not reliant on the income from the trust and has sufficient other assets or sources of income.

Mercer & Hole will of course be undertaking reviews of the trusts for whom we act. However, if you are the beneficiary of a trust for which we do not act it may be appropriate for a review to be undertaken, taking into account all your personal circumstances. It will be necessary to review the trust deed and, by acting now, there is still time to make a considered decision. Please contact us if you wish to discuss your position.

Is Revenue guidance on residence reliable?

The Revenue's current guidance notes determine that an individual is resident in the UK if either of the following apply in any year of assessment:

- a) individual is present for more than 182 days in the tax year; or
- b) visits to the UK average more than 90 days per tax year over a period of at least four years.

Very importantly, days of arrival to and departure from the UK are usually excluded. It was this particular point that Mr Gaines-Cooper relied upon when he claimed to be non-UK resident in the period 1993/1994 to 2003/2004.

The Gaines-Cooper case

Although born and brought up in the UK, Mr Gaines-Cooper went to the Seychelles in the 1970's on business and decided to stay there. He subsequently considered himself resident and domiciled there. However, he continued to make some visits to the UK and accordingly ignored all visits where he spent

only one night in the UK and departed the following day, when he calculated the days he was physically present in the UK.

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Is Revenue guidance on residence reliable?... continued

The Revenue disputed his claim and took the case to the Special Commissioners, who held that Mr Gaines-Cooper was resident and ordinarily resident in the UK throughout the period in question. They found that his visits to the UK could not be regarded as 'for some temporary purpose only'. The evidence was that he had visited his family who lived, during part of the period, in a house he had retained in the UK. The Special Commissioners decided these visits had a more 'permanent purpose' as they had recurred year after year. Taking the number of days Mr Gaines-Cooper had been present in the UK based on the number of nights he had spent in the UK, he very clearly qualified as being UK resident for the whole period. Moreover, they treated his absence from the UK as no more than occasional residence.

Significance of the decision

Understandably the decision in this case has caused some concern as to how this could impact on others, but it seems to be currently confined to the case of Gaines-Cooper.

The Revenue have since confirmed their position when considering UK residence, stating that they will:

- Follow the published guidance on residence issues and apply this guidance fairly and consistently;
- Treat an individual who has not left the UK as remaining resident here;
- Consider all the relevant evidence, including the pattern of presence in the UK and elsewhere, in deciding whether or not an individual has left the UK.

Revenue practice is to consider all facts of an individual case and their published comment gives some comfort. However, the Gaines-Cooper case reminds us that they will dismiss guidance and invoke the law where they consider it more appropriate. In terms of leaving the UK to establish residence overseas, breaking all ties with the UK continues to be as important as ever.

Planning gain supplement (PGS)

The Chancellor announced proposals (originally in 2005) for a new tax on the increase in land value following the grant of planning permission. These were re-energised in the 2006 Pre-Budget Report and have been subject to consultation.

PGS is, apparently, designed to raise funds from development (based on the value created by the planning process) to help finance the infrastructure needed for new housing and growth.

The proposals so far outlined on PGS are, broadly, as follows:

- Charged on the difference between the value of the land in its current use (CUV) and that with full planning permission (PV);
- No formal decision has yet been taken as to the rate - 20% has been suggested;
- Self-assessed with the taxpayer making his own valuations;
- Filing the return and tax payment required when development begins rather than planning permission granted;
- Worryingly, failure to comply could lead to HMRC halting the development.

PGS is the latest attempt by the Government to tax increases in land values. This attempt may prove difficult to administer partly because of the valuation issues. It is likely also to increase red tape and could result in the reduction (in the short term) of



development land with landowners waiting to see if the law changes - if this were to be the case prices may rise.

One key problem is that at the time the tax is levied, the developer is still a long way from generating any income from the development. Penalties are proposed for late payment.

The good news is that the Chancellor has announced PGS will not be introduced before 2009! If you are likely to be affected there is probably little to be done at present other than to wait and see what comes out of the consultation and hope for some more detailed proposals on precisely how the tax will be levied. At that stage we will be able to provide more information and advice.

Why invest in REITs?

The introduction of UK Real Estate Investment Trusts (UK REITs) in January this year has opened up exciting new opportunities for small investors in the UK, where access to commercial property investments has always been limited. Significantly, it enables individual investors to invest in a diversified property portfolio, buying low cost and easily tradeable units instead of having to finance the purchase of whole properties. Other investors in UK REITs are likely to be institutions such as pension funds and insurance companies.

For small investors, the benefit of investing in UK REITs lies in diversity and the ability to be able to participate in the economies of scale enjoyed by these bigger market investors. A major advantage of UK REITs is their tax-efficient nature. Investors avoid the double taxation faced by normal investors in property company shares, as tax is not payable on rental or capital gains within a UK REIT. Investors are only liable for the tax due on income received as dividends and possibly capital gains tax when the REIT shares are sold.

This double layer of tax suffered by most investors is one of the reasons why shares in property companies have historically traded at a discount to the net asset value of their property assets. The relative lack of liquidity of the underlying property assets is also a factor. UK REITs should address these concerns and experience has shown that in established markets, REITs can regularly trade at a premium to the value of their underlying assets. UK REITs are also attractive to income-seeking investors because they have to pay out such a large part (90%) of their profits in dividends.

One clear advantage is the lower transaction costs compared to buying property directly. Stamp duty on direct property is up to 4%, whereas buying shares in a UK REIT will only suffer stamp duty of 0.5%.

Many existing quoted property companies such as British Land, Land Securities and Great Portland Estates have already converted and other major landlords - including pension funds, major retailers and pub and hotel chains - might also be tempted to convert their property assets into UK REITs.

Some 'dividends' to be taxed as earnings!

The Government intends to legislate, in the Finance Bill 2007, against what it sees as the avoidance of employment taxes and national insurance through the use of Managed Service Companies (MSCs).

MSCs are intermediary companies through which the services of a worker are provided to an end client, usually via an agency. There may be a one worker per company structure or a composite company with as many as twenty unrelated individuals, each with a different class of share. The MSC normally pays each individual worker a small salary and the balance of the company profits are distributed by way of monthly dividends. As the dividends are not earnings there is a saving of both employers' and employees' national insurance and for basic rate taxpayers there is no additional income tax to pay.

The scheme provider exercises full financial and management control of the company including carrying out all the administration and invoicing for the company. After taking an administration fee, the MSC passes funds to the individual worker. The Government have identified that there are a significant and expanding number of MSC workers

and providers.

The draft legislation, if enacted, will oblige MSCs to operate pay as you earn and national insurance from 6 April 2007 on all income received by workers in the MSC in relation to their services whether they are paid in dividends, salary or in a non-cash form.

Further clauses will enable the Revenue to recover unpaid PAYE and national insurance in relation to MSCs from so called "appropriate third parties". However this includes the companies engaging the contractors, if they have encouraged the use of a MSC.

These moves are part of the Government's continuing effort to ensure what it perceives as disguised employment income is taxed as such. It is easy to see how the wording of some of the key passages of this draft legislation could be adapted to cover situations other than MSCs, such as husband and wife and other close companies who distribute profits mostly by dividends. Our fear is that the Government are 'road testing' clauses which may in the end have far wider implications than managed service companies. Time will tell.