JOHN LAMB
FINANCIAL PLANNING

Insights

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LARGE CHARGEABLE EVENT GAINS ON PART SURRENDERS

Over the last few years, it has become apparent that if a person makes a large part surrender from a single premium bond (Bond), particularly in the early years, a taxable chargeable event gain can arise under the 5% rules, even though the Bond shows no or little investment growth. In effect the 5% part surrender rules mean that only unused 5% allowances are deducted from the proceeds of the partial surrender leaving the balance amount taxable. This means that the amount taxable may bear no relationship to the real economic profit under the Bond. Although this problem can be avoided by the policyholder making full surrenders of individual segments/policies, and evidence suggests that more policyholders are going down this route, some are still making large part surrenders and so the legislation needs to be changed to deal with the problem.

HMRC issued a Consultative Document in the Summer of 2016 which put forward three possible ways in which the legislation could be amended to overcome the problem. Following responses to the Consultative Document, the government announced that it would not be proceeding with any of these three proposals, but would instead introduce a provision that gives HMRC the ability to give discretionary relief to those policyholders affected by this trap.

Draft clause 13 Finance Bill 2017 introduces new sections 507A and 512A to ITTOIA 2005 and will have effect from 6 April 2017. These amendments introduce an application process by which policyholders who have surrendered their life assurance policies, and in doing so generated a wholly disproportionate tax charge, can apply to HMRC to have their gain recalculated on a just and reasonable basis.

However, this draft legislation has been criticised because it does not give enough protection to the policyholder. As drafted, this is a discretionary relief granted by an officer of HMRC. It is thought that the relief should be backed up with safeguards. In particular, there should be a statutory right of appeal to the First-tier Tribunal on the officer's decision of what constitutes a just and reasonable basis of recalculation and on other points which are relevant to the officer's decision. Such points could be whether the chargeable event gain is "wholly disproportionate" or whether, in certain circumstances, an extension should be given to the time permitted for the application to be made.

Whilst HMRC intends to issue "comprehensive guidance" on how it will apply this discretionary remedy, the concept of guidance does not provide the necessary protection to the policyholder. For example, guidance can be changed or withdrawn. Also, the reason behind the guidance can be changed or withdrawn. This is why a number of professional bodies believe that the legislation should include a statutory provision for appeal against an officer's decision.

Representations are being made to HMRC on this matter.

ISA TAX ADVANTAGES TO BE EXTENDED TO DECEASED ESTATES

HMRC has published draft regulations which will allow Individual Savings Accounts (ISAs) to retain their tax-advantaged status during the administration of a deceased ISA saver's estate.

The draft legislation provides that investments retained in an ISA after the death of the account holder will be deemed to be 'administration-period investments' held in a 'continuing deceased's account' until the earlier of the finalisation of the administration of the estate and three years after the account holder's death. This means that personal representatives and beneficiaries or legatees should not face income tax or capital gains tax on the investments during this period. The draft legislation confirms that no new subscriptions can be made to a continuing deceased's account after the death of the account holder, and the account cannot be transferred between ISA providers other than in specified circumstances.

To take account of the change, the regulations also allow for the additional permitted subscription available to surviving spouses and civil partners of deceased savers to be the higher of the value of investments held in a deceased's account on the deceased's death and the date on which the account ceases to be a continuing deceased's account. The legislation also amends the capital gains tax rules to provide that a legatee will be treated as having acquired an administration-period investment at the market value at the date it is transferred to them. This will set the base value for a future disposal of that asset by the legatee.

The draft regulations have been published together with a draft explanatory memorandum for a period of technical consultation which closes on 7 April 2017. Neither of these documents indicates the date from which these regulations take effect.

COMMENT

The changes will reduce the tax liability and simplify the transfer of ISA funds owned by the deceased for those administering the deceased's estate.

PENSIONS ADVICE ALLOWANCE CONSULTATION RESPONSE PUBLISHED

HM Treasury has published its response to the consultation on the Pensions Advice Allowance.

The government announced at Budget 2016 that, as recommended by the Financial Advice Market Review (FAMR), it would consult on introducing a Pensions Advice Allowance. This would allow people to take £500 tax free from their defined contribution pension scheme to redeem against the cost of financial advice. The purpose of the Allowance is to, in appropriate cases, encourage people to take advice by making the cost of the advice more affordable because it would be paid for out of tax-relieved pension funds and not out of their net income. The main outcomes of the consultation are as follows:

- the Allowance will be limited to up to £500 per use;
- the Allowance will be available at any age;
- individuals will be permitted three uses of the Allowance in their lifetime, no more than once per tax year;
- a £500 encashment that is within the Allowance will not be taxed on withdrawal from the pension pot, regardless of the individual's income;
- the Allowance can be withdrawn from defined contribution pensions and hybrid pensions with a money purchase or cash balance element and the payment of the Allowance must be made direct from the pension scheme to the adviser;
- the Allowance will only be available for regulated financial advice;
- the Allowance can be used alongside the tax exemption for employer-arranged pensions advice; and
- the Allowance will be available from April 2017

HMRC will publish full guidance on the Allowance shortly after it becomes available.

COMMENT

This has to be a positive move alongside all the pension freedoms, encouraging more people to take advice about their retirement. It is great news that it isn't just a one-off payment and that it will be allowed before age 55 to help with planning for retirement rather than just dealing with the issue when it arises.

AUTOMATIC ENROLMENT REGULATIONS AMENDED

The Occupational and Personal Pension Schemes (Automatic Enrolment) (Amendment) Regulations 2017/79 have been laid.

These regulations amend the employer's duty to automatically enrol their workers into a qualifying pension scheme so that, in appropriate cases, employers will not be forced to enrol employees. Existing regulations give employers discretion to automatically enrol their workers into a qualifying pension scheme in certain circumstances, including where an individual worker may be financially disadvantaged by being enrolled into pensions saving. These regulations add to the circumstances in which employers have discretion on enrolment in cases where the employee may be affected by the lifetime allowance and to ensure this aligns with changes to the value of the lifetime allowance as set out in the Finance Act 2016.

Under these new regulations workers who have elected for Fixed Protection 2016 and/or Individual Protection 2016 do not now need to be automatically enrolled. Without the amendment the employer would have been obliged to continue making contributions (unless the individual took action to opt out), and this could result in the worker being subject to penalty tax charges on their accrued pension benefits that exceed the annual allowance.

SCOTLAND AND THE HIGHER RATE TAX THRESHOLD

In early January HMRC issued a technical note purporting to explain how Scottish income tax will work. The note makes it clear that:

- The income to which Scottish rates apply is non-savings, non-dividend dividend, ie broadly speaking earnings, pensions and property income: and
- "All aspects of the income tax base, for example reliefs, allowances (including the personal allowance) and the definition of taxable income remain reserved matters".

Subsequently, the Scottish Budget has been agreed, with a surprise twist for higher rate taxpayers.

Last December saw the Scottish National Party (SNP) introduce a draft Scottish Budget that would have created the first break between Scotland and the remainder of the UK in terms of income tax. Whereas the UK ignoring Scotland will have a higher rate tax threshold of £45,000 in 2017/18 (already legislated for in the Finance Act 2016), the draft Scottish Budget proposed a corresponding figure of £43,430. At that time, we commented that "In practice, it is possible the Scottish change will not happen because the Budget is only in draft and the governing SNP does not have a majority in the Holyrood parliament. There is to be a vote on income tax rates and thresholds separate from the rest of the Budget." The threshold in question here is the one that applies broadly to earnings, pensions and property income.

That warning remark has proved to be prescient, as the SNP has been forced into a last-minute deal with the Scottish Greens to get the Budget passed. In their manifesto before the last Scottish election, the Greens had called for increased taxes on the wealthiest and a top income tax rate of 60%.

The net result of the political horse-trading is that rather than increase the higher rate threshold in line with inflation, as originally planned, the Scottish Budget will freeze the 2017/18 threshold at the 2016/17 figure of £43,000 (which currently applies to the whole of the UK). The 2017/18 personal allowance will be £11,500, as this is still set UK-wide (in Finance Act 2016) and is outside the Scottish Government's control. Thus, in Scotland the basic rate band will shrink next tax year by £500 to £31,500 so that the higher rate threshold remains unaltered at £43,000. The corresponding UK (non-Scotland) basic rate band figure will be £33,500, a £1,500 increase.

COMMENT

Remember, this frozen £43,000 threshold in Scotland will only apply to non-savings and non-dividend income ie. broadly earnings, pensions and property income. It does not affect CGT rates. So in effect Scotland has 2 higher rate tax thresholds – depending on the type of income involved.

TRUSTEES' DUTIES WHEN INVESTING TRUST FUNDS

The case of Daniel and Another v Tee and Others [2016] EWHC 1538 (Ch) involved two beneficiaries of a Will trust suing the trustees of the trust for losses resulting from allegedly bad investment decisions.

The facts of the case were as follows. Mr Daniel senior died in 1999 and under his Will a trust was created for his two children, then aged 13 and 16, with the trustees being Mr Daniel's solicitors. The value of the trust fund at outset was about £3.5m. The trustees had no personal expertise in managing investments and during the years 2000 to 2002 relied on the advice of an IFA. Based on that advice the trustees decided to invest in a range of equities linked to the technology sector with around 80% of the fund being in those equities. Needless to say the funds performed poorly and suffered heavy losses on book values and realisations in 2000 and 2001.

Many years later the beneficiaries claimed compensation of over £1.4 million for breach of trust. They claimed that the trustees were at fault in failing to take appropriate care to formulate and implement a suitable investment strategy and to review the investments made and in relying on the IFA's advice and recommendations which in fact turned out to be poor advice and costly to follow. The trustees denied the claims and relied on section 61 of the Trustee Act 1925 which gives the Court discretion to absolve trustees in situations where the trustees have acted reasonably and honestly.

On the face of it the trustees, having obtained investment advice from an IFA, clearly acted reasonably and, indeed, in accordance with their duty under the Trustee Act 2000. Nevertheless, the Court held that the decision to opt for an investment portfolio comprising of 80% equities was "one which no trustee could have reasonably made whilst complying with his duty to act prudently". However, the High Court agreed that the trustees had acted to the best of their abilities and in reliance of what they reasonably believed to be competent professional advice. As such, had they been found liable for breach of trust, then it was most likely that the Court would have granted relief under section 61 of the Trustee Act 1925. In any event, the Court decided that, whilst certain breaches may have occurred, the claimants had failed to prove that those breaches had resulted in any losses which would otherwise not have occurred. Therefore the beneficiaries' claim for compensation was rejected.

COMMENT

This case illustrates the point that if the trustees can show they have sought appropriate professional advice and otherwise acted in accordance with the provisions of the trust, then they are very unlikely to be found liable for any breach of trust. Nevertheless, it is

important to note the judge's criticism of the trustees' approach to trust investments. Specifically, the judge stated that the trustees "adopted an approach which was less balanced and diversified" than, in his opinion, many trustees would have thought appropriate.

This confirms that even where the trustees instruct a professional, such as an IFA, to advise them on investments, this does not absolve them from taking an active part in making decisions, bearing in mind the objectives and risk profile of the trust. Whilst trustees will generally not be, and are not expected to be, experts in investments, they do need to ensure that investments are reviewed periodically bearing in mind all the relevant factors.

UPDATED GUIDE TO CLIENT NOTIFICATION LETTER ISSUED

Since 30 September 2016 tax advisers have had to issue an HMRC branded notification letter to any client to whom they provide financial advice or services about overseas income or assets. The letter is essentially to warn clients of the levels of information that HMRC now has access to in order to be able to check that the right amount of tax has been paid.

HMRC has now updated its guide to sending the client notification letter which sets out which clients must be notified and the process which needs to be followed.

SUPREME COURT JUDGEMENT – LGPS SURVIVOR'S PENSION PAYABLE WITHOUT NOMINATION

This case and judgement concerns a requirement in the Local Government Pension Scheme (Benefits, Membership and Contributions) Regulations 2009 (the "2009 Regulations") that unmarried co-habiting partners must be nominated by their pension scheme member partner in order to be eligible for a survivor's pension. The survivor must also show that he or she has been a cohabitant for two years before the date on which the member sent the nomination and has been in that position for two years before the date of death. There is no similar nomination requirement for married or civil partner survivors.

The appellant, Ms Brewster, had lived with her partner, Mr McMullan, for over ten years and, days before his death, they had got engaged. Ms Brewster thought that the nomination had been completed by Mr McMullan and therefore thought she would be entitled to a survivor's pension, which was refused by the LGPS. Mrs Brewster brought an action challenging this decision.

The judge ruled that under the European Convention on Human Rights and Fundamental Freedoms the requirement for a nomination was discrimination and that Ms Brewster was entitled to the survivor's pension.

COMMENT

Although this related to a public sector pension scheme, this may now encourage private sector defined benefit schemes to review their rules and processes.

CURRENCY FLUCTUATIONS AND THE CALCULATION OF CAPITAL GAINS AND CHARGEABLE EVENT GAINS

BACKGROUND

The weakness of sterling following the result of the Brexit Referendum has prompted some to review the calculation of gains/losses arising on the disposal of assets denominated in foreign currency. What do these calculations involve?

CAPITAL GAINS TAX AND FOREIGN CURRENCY

Since 6 April 2012 currency gains and losses realised within an individual's, trustees' or personal representatives' foreign currency bank account have been wholly exempt from capital gains tax.
Also exempt, under section 269 Taxation of Chargeable Gains Act 1992, is foreign currency for personal expenditure outside the UK incurred by an individual or their family or their dependants. Included in this exemption is expenditure on the provision or maintenance of any residence outside the UK.

CAPITAL GAINS TAX AND OTHER ASSETS

When an asset is purchased in sterling and realised for sterling the sterling capital gain will not include any gain/loss from currency fluctuations. In contrast, where an asset is purchased in a foreign currency and sold in that foreign currency, in calculating the capital gain for UK tax purposes the acquisition cost at the date of purchase has to be converted to sterling at the exchange rate applying on that date and the disposal proceeds converted to sterling at the exchange rate applying on the date of disposal. A sterling gain/loss is thus computed for UK tax purposes.

Take Bill for example:

In 2003 Bill bought shares in a French company for $200,000. They cost him £109,000 (exchange rate $1.83 to the £). He sold the shares in December 2016 for $250,000 – a gain of 25% in $ terms. However, in December 2016 the $ stood at $1.25 to the £, so the sale proceeds of $250,000 valued the shares at £200,000. The sterling gain of £91,000 is subject to capital gains tax. The gain of £91,000 represents a gain of 45.5% in sterling terms when the exchange rate fluctuations are factored in.

CHARGEABLE EVENT GAINS

When a UK resident investor takes out a single premium bond (Bond) it may be denominated in sterling or in a foreign currency (highly unlikely for a UK bond). For the purposes of calculating a chargeable event gain when the Bond is denominated in sterling throughout, the position is straightforward, ie. the chargeable event gain calculation is carried out in the usual way and the investor will be subject to UK income tax in accordance with their own tax position.

When the Bond is denominated in another currency, HMRC gives guidance in its Insurance Policyholder Taxation Manual (IPTM3700) on the calculation of the chargeable event gain. In these circumstances **the gain** should be computed in the foreign currency and then converted to sterling at the exchange rate applicable **at the date of the chargeable event.** The example below illustrates this.

Using the same figures as for Bill, the single premium for the Bond would be $200,000. Assuming no withdrawals from the Bond, the $ gain is $50,000 which gives a sterling equivalent of £40,000 at an exchange rate of $1.25 to the £. Unlike with shares which are subject to capital gains tax, the chargeable event gain of £40,000 would be subject to income tax. Again there is no provision for an adjustment to be made for currency fluctuations.

When a policyholder has enjoyed a period of tax residence outside the UK in certain circumstances the chargeable event gain can be reduced to reflect the period of non-UK residence. This is known as "time-apportionment" or, more commonly, "non-resident" relief.

In brief terms, the benefit of a period of non-UK residence is that the amount of any chargeable event gain that arises on encashment of the policy could be reduced by a fraction. This fraction reflects the period of time the person liable to pay the tax on the chargeable event gain has been non-UK resident during the period the policy has been in force or owned by them (depending on the circumstances).

As it is the sterling chargeable event gain that is reduced the fact that the policy may have been denominated in a currency that is not sterling will not impact on non-resident relief.

COMMENT

The examples above highlight the difference in the calculation of gains under a life assurance policy and other assets which are denominated in a foreign currency. It demonstrates how gains can be accentuated (or reduced) quite arbitrarily by currency movements.

THE LIFETIME ISA LAUNCHES 6 APRIL 2017

The launch of the Lifetime ISA is fast approaching. With this in mind HMRC has recently published an overview of the product details. By way of summary, the Lifetime ISA can be opened by anyone who is aged 18 or over but under 40. They must be either resident in the UK, a Crown Servant (for example a diplomat or civil servant) or the spouse or civil partner of a Crown Servant.

As with other ISAs, there will be no tax to pay on any interest, income or capital gains from cash or investments held within a Lifetime ISA.

It will be possible to save up to £4,000 each year although this limit, if used, will form part of the overall annual ISA limit. For 2017/18 the overall annual ISA subscription limit will be £20,000.

The product benefits from a 25% government bonus based on the amount saved, with a maximum of £1,000 each year. In the first year (ie from 6 April 2017 to 5 April 2018) only, the bonus will be paid at the end of the tax year, after which it will be paid monthly.

The main purpose of the product is to either use the money for a first home purchase (for a property valued at £250,000 or £450,000 in London), or to use the money in retirement - after age 60. This means that, unless the saver is terminally ill, if the money is withdrawn for any other purpose a withdrawal charge of 25% will apply. It will therefore be interesting to see how many actually take advantage of this new savings vehicle when it launches.

INCOME WITHDRAWAL RATE FOR MARCH 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 March 2017 is 2.0%.