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MONEY NEWS

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THE TROUBLE WITH THE FINANCE BILL

Our last Newsletter explored, in detail, what had been announced in the March 2017 Budget. Little did we know at the time, that so much would happen between then and now.

The announcement of the General Election on 8th June led to the Government, in April, publishing a list of amendments it proposed to make in the Finance (No 2) Bill 2017. Almost 80% of the Bill was put on hold, including announcements such as the reduction of the dividend tax allowance from £5,000 to £2,000; the introduction of new rules dealing with the taxation of non-domiciliaries and offshore trusts established by them; and reduction of the Money Purchase Annual Allowance (MPAA) from £10,000 to £4,000.

The result of the election meant that the predictions of virtually every political pundit and pollster had been proven wrong. The Conservatives, having won 316 seats, were to form a minority Government. After weeks of political wrangling, the Conservative Party signed a "confidence and supply" agreement with the Democratic Unionist Party to bring them to a joint majority.

Far from the “strong and stable” government that was the mantra at the start of the campaign, it was unclear where the Finance Bill would go.

On 14th July, and with little fanfare, supporting documents for Finance (No 2) Bill 2017 were published. These supporting documents included many of the provisions that were removed from the earlier Finance Bill. The Government has confirmed its intention that all the MPAA and non-domicile rules will be effective from 6 April 2017.

It is with this element of uncertainty, and the possibility of change that we present this current newsletter.

MPAA CHANGES

As touched upon above, in the Budget 2017, the Chancellor confirmed that, following the consultation on the reduction in the MPAA, the government has seen no grounds to change its view on reducing the MPAA from £10,000 to £4,000.

The lead up to the election had put this change on hold, but in the written statement - HCWS47 made by Mel Stride, Financial Secretary to the Treasury, it was confirmed that where policies were announced to have started at the beginning of the 2017/18 tax year there would be no changes to these plans.

We read this to mean that policies such as the reduction in the MPAA will be applicable from 6/4/2017 for those who have triggered the MPAA, although this isn't specifically mentioned in the statement.

The statement says "The Government confirms that intention. It expects to introduce a Finance Bill as soon as possible after the summer recess containing the withdrawn provisions. Where policies have been announced as applying from the start of the 2017/18 tax year or other point before the introduction of the forthcoming Finance Bill, there is no change of policy and these dates of application will be retained. Those affected by the provisions should continue to assume that they will apply as originally announced."

So, assuming the reduction is to happen, are there any specific actions that those that have already triggered the MPAA should take?

The short answer is *not really*! Once the MPAA is triggered, the ability to carry forward any unused relief is lost, so although there is no direct action to take in relation to the reduction, you should use up the £10,000 allowance, or lose it.

What becomes even important is being aware of the triggers for the MPAA and remembering that once it has been triggered, there is no getting the annual allowance back for money purchase schemes.

As a reminder, the triggers are:

- Income from flexi access drawdown – just taking PCLS will not trigger the MPAA.
- UFPLS
- Exceeding permitted maximum for capped drawdown/conversion to flexi access with income payable
- Scheme pension payable from a scheme will less than 12 pensioners
- Flexible annuity (the amount payable can reduce)
- Stand-alone lump sums
- Payments from an overseas pension scheme of income described above eg flexi access drawdown that has benefited from UK tax relief.

Before taking a UFPLS/drawdown of £10,000 or less, it's worth investigating to see if *small pot commutation* can be used instead. A small pot commutation is not a BCE and is not a trigger for the MPAA.

IHT ON PENSION TRANSFERS

In recent months one of the most common issues raised by our clients is HMRC's ability to treat a pension scheme as being within a client's estate on death.

It is against this backdrop that we thought it would be useful to remind you of the circumstances under which this may happen.

There are three common sets of circumstances in which a special IHT charge can arise in relation to a member's interest in a registered pension scheme because of action taken by a pension scheme member during his lifetime. These concern:

- the payment of contributions;
- the transfer of death benefits by, say, declaring a trust "Lifetime transfers of death benefits"; and
- the transfer of pension scheme rights to a different pension plan "pension transfers."

Contributions

Normally, when a person makes a pension contribution, the prime intention will be to enhance his or her retirement provision. Therefore, even though death benefits are subject to a discretionary trust, the actuarial likelihood of the member dying before retirement is remote and so no transfer of value is likely to arise when the contribution is paid. And even if there is a measurable loss, s.10 IHTA 1984 can provide relief. This section states that there will be no transfer of value in cases where there was no intention by the transferor to confer a gratuitous benefit, i.e. when the contribution was paid.

However, the situation changes if, when the contribution was paid, the member knew he was in serious ill health. In such cases, the protection of s.10 IHTA 1984 – "no intention to confer a gratuitous benefit" – would not be available and so a measurable transfer of value could arise under s.3(1) IHTA 1984. In these circumstances, HMRC adopts a "two-year test". This means that, in general, it will only consider such cases as possibly giving rise to a transfer of value if the member dies within two years of making the contribution. In other words, if the member survives for two years, HMRC will assume (unless there is clear evidence to the contrary) that the member was in normal health at the time of the contribution so there is no transfer of value. To capture this information, Box 22 of IHT 409 (the pension supplement to the inheritance tax account on death) requests details of contributions paid in the two years before death.

This is obviously more likely to be relevant in cases of larger contributions, as any transfer of value arising on smaller contributions may well be covered by the IHT annual exemption, etc.

Example 1

Archie, aged 61, knowing he is in serious ill health, decides to pay a substantial contribution of £25,000 to his personal pension plan which is subject to a master trust and personal discretionary trust. He dies four months later.

Because Archie was in serious ill health when he made the contribution a transfer of value will take place. Archie will not be helped by the s.10 exemption ("no intention to confer a gratuitous benefit") as he knew he was in serious ill health when he paid the contribution. A part of this contribution will therefore give rise to a loss to his estate that can be actuarially determined. This will be a chargeable lifetime transfer.

Example 2

Sally, aged 57, who believes she is in excellent health, pays a contribution of £40,000 to a personal pension plan effected subject to trust. Two and a half years later and out of the blue she has a heart attack and dies. Even if she was actually in poor health when she made the contribution, the s.10 exemption should apply because, at the time she made the contribution, she had no reason to believe that she was likely to die before drawing retirement benefits. In any event, as she survived the contribution by two years, HMRC are unlikely to investigate the case and no entry is needed on form IHT 409.

Example 3

Bob is aged 68. He pays a contribution of £40,000 to his personal pension plan under which death benefits are held subject to a discretionary trust. At the time of the contribution he has lung cancer but doesn't realise this until some four months later. He dies 15 months after making the contribution. The payment of the contribution could give rise to a chargeable lifetime transfer.

Because Bob died within two years of the contribution it is reportable on form IHT 409. However, because he was unaware of his illness when he made the contribution, his personal representative may be able to claim that any transfer was covered by the s.10 exemption ("no intention to confer a gratuitous benefit").

Even if an individual does die within two years of making a contribution, knowing he is in serious ill health at the time of the contribution, the question arises as to whether s.12 IHTA 1984 would help him.

Section 12 provides that a disposition is not a transfer of value if it is allowable in computing the transferor's profits or gains for the purposes of income tax. Payments of contributions to a registered pension scheme may be allowable for income tax purposes, but the allowance is in the form of a deduction or set off against the "relevant UK earnings" of the person making the contribution. HMRC takes the view that relief under s.12 is therefore not available in this scenario – the payment of the contribution is not allowable in computing the contributor's profits for income tax purposes. Rather the contribution is, or may be, a deduction from "relevant UK earnings" and these are calculated after computing the person's profits for income tax purposes.

Lifetime transfers of death benefits

Where a member of a pension scheme transfers his death benefits to a trust, he may be considered to have made a transfer of value under IHTA 1984, s.3(1).

In most cases, any transfer of value will have a nominal value because the member will be in good health and it is likely that he will survive to draw his retirement benefits, at which time the death benefits will lapse.

In this respect (and assuming there is no evidence to the contrary), provided the member survived the transfer by two years, HMRC will assume that the member was in good health at the time of the transfer and no further investigation will be necessary. On the other hand, if a member makes such a transfer and does die within two years, Box 17 in IHT 409 will need to be completed.

This provision could apply to a situation where an individual places a retirement annuity policy in trust or (depending on the circumstances) declares a personal trust of the death benefits of a personal pension plan. In both of these cases, if the member is in ill health, careful thought should be given before declaring the trust. For example, if the rules of a personal pension plan permit a member to declare a trust of the actual death benefits under his plan (so that any death benefits must be paid to those personal trustees), extreme caution should be exercised if the member knows that he is then in serious ill health.

In such circumstances, if possible, it may be better to establish a pilot trust to which the Scheme Administrators may exercise their discretion to make an appointment of lump sum death benefits. This would not give rise to the “two-year ill-health” consequences.

Pension transfers

From time to time a number of people will consider the transfer of their pension rights from one pension scheme to another – perhaps with a view to increasing investment choice, improving investment performance and/ or reducing administration costs.

However, a note of caution needs to be sounded on making a pension transfer from an inheritance tax standpoint.

Where the pension scheme member knows he is in serious ill health, the transfer may give rise to inheritance tax problems. This may mean that, by making the transfer, the member goes from a position of freedom from inheritance tax (on current pension funds) to one of liability to inheritance tax (on new pension funds).

The reason for this somewhat startling consequence is because HMRC takes the view that, when a person makes a transfer he, in effect, surrenders the rights under the existing pension plan and

so brings to an end any existing trusts that apply to those death benefits. Because he can then control which new pension provider the funds are transferred to, he can, by implication, determine what new trusts the death benefits are subject to. Those trusts could be trusts under which the member's personal representatives are beneficiaries and under which the member can appoint benefits. By exercising his right to transfer, the individual is therefore bringing the death benefits under the first scheme back into his taxable estate.

In turn, this means that unless the member directs that death benefits under the new plan are to be paid to his own estate, there will be a transfer of value for IHT purposes when the transfer of pension rights occurs. The reality of the situation is that the new pension plan will include trusts of the death benefits which will exclude the member as a beneficiary and so, according to the HMRC rationale, a transfer of value will occur under s.3(1) IHTA 1984.

In practice, however, HMRC will only treat this as a transfer of value which has more than a nominal value if the member is in serious ill health when making the transfer. As with the position on contributions, it seems that HMRC will, in general, assume that the member was in good health at the time of the transfer unless he dies within two years of the transfer, in which circumstances HMRC will require boxes 17 to 21 of the IHT 409 death return to be completed. Even if the member did die within two years and a return is made under IHT 409, if the member did not know he was suffering from a life-threatening illness when he made the transfer, there is an argument to say that the s.10 exemption (no intention to confer a gratuitous benefit) should apply.

As will be appreciated, the transfer of pension benefits for people in this position could have serious IHT consequences. The moral therefore is very clear – if an individual is in serious ill health and is concerned about inheritance tax, a transfer of pension rights to a new plan should only be undertaken with extreme caution.

FUNDING THE COSTS OF EDUCATION

It is that time of the year again. As students await their grades, and wonder whether they will be able to get in to their chosen path of further education, parents and grandparents are wondering how they can help finance these paths. The problem is when should parents be thinking about the costs of education?

According to recent research by HSBC a quarter of UK parents regret not saving earlier for their child's education and one is five say they wish they had saved more. Funding the cost of education is a big and important issue.

It seems that more than 70% of parents contribute towards the cost of their child's education, at a "rich mix" of fee-paying schools, colleges or university. Despite this, less than half of those questioned in the research said they had started thinking about these costs before their child

had started primary school. This compares to 60% of parents in the rest of the world. Blimey, we're way behind!

20% of those British parents interviewed said they would be willing to cut back on holidays to fund their child's education and 14% said they would work longer hours to keep up with education costs. Nearly three-quarters of parents said they relied on day-to-day income to fund their child's education.

HSBC say almost half of UK parents admitted to not knowing how much they were spending on their child's education. This was the highest proportion of any country in the survey; the global average was 22%. For parents in the UK with a child in paid-for education can spend about £128,600 over the course of primary, secondary and tertiary education.

It seems, from the HSBC report, that parents in Asia lead the way in terms of planning ahead. More than half of parents in China said they funded their child's education through general savings, investments or insurance and more than two-fifths through a specific education savings plan. In contrast, fewer than one in 10 parents in the UK (5%), Australia (8%) and Mexico (8%) choose to fund their child's education through a specific education plan.

HSBC said that in nine of the fifteen countries surveyed, paying for their child's education is most likely to be parents' biggest financial commitment, above others such as mortgage or rent payments and household bills.

Against this background, if savings for a child's education is an important part of your long term saving plans, what do you need to consider?

There are special rules to consider when investments are made for the benefit of, or on behalf of, minor children.

Legal fundamentals

It is important to ascertain whose money is being invested, as this will impact on investment choice.

For example, cash may have been gifted to a child or left to a child under a Will – in these circumstances, there is likely to be a trust (whether expressed or implied by law) and the investment will need to be made by the trustee(s) i.e. the adult who has legal control over the money.

In some cases, further questions will need to be asked to establish who owns the funds. For example, where cash has originated from a grandparent, then it would equally possible that the gift was made to the parent in the hope that the money would be used for the benefit of the grandchild, but without conferring any legal obligation on the parent to that effect. This is a

simple, but nonetheless, important point which needs to be ascertained so that the correct tax and legal consequences can flow.

Remember that in England, Wales and Northern Ireland, a child attains majority at age 18 and, until then, his/ her rights to make contracts are restricted (different rules apply in Scotland). This means that, generally speaking, a minor child cannot make an investment in his/ her own name, so even if, on the face of it, the funds belong to the child, any investment will usually need to be made by an adult – as a donor, nominee or trustee (although special rules apply to bank accounts - see below).

Tax fundamentals

Subject to the special rule applicable when the sums invested for the benefit of a minor originate from the child's parent (see below), for tax purposes, a child is treated in the same way as an adult and so is subject to income tax and capital gains tax on his/ her income and gains with the benefit of a personal income tax allowance, a personal savings allowance, dividend allowance, a starting rate tax band and a capital gains tax annual exempt amount.

However, where income is produced as a result of a "settlement" (which covers all gifts) made by a parent for his unmarried minor child who is not in a civil partnership, the income is assessed on the parent unless the total gross income which comes from capital provided by the parent for the child does not exceed £100 gross in a tax year (known as the parental settlement rule).

Planning

The tax rules outlined above mean that there are opportunities to take advantage of the child's personal allowances and CGT annual exempt amount when investing for children. However, when parents make gifts for the benefit of their own minor unmarried children, greater care is needed in finding a tax effective solution. Subject to not unduly compromising the investment balance, this may be achieved with some non-income producing investments or with certain trusts.

Investing in the name of the child

In some cases, it may be possible (and desirable) to invest money that belongs to a child as of right (i.e. where there is no trust) in the child's own name. There are a number of options in this regard:

(i) Bank or building society accounts

A child aged 7 or over may usually open a bank account. However, where larger sums are involved, accounts would usually be opened either as designated accounts or trustee accounts.

Legally, a designated account will normally be construed as a bare trust. However, the person who created the trust might have to demonstrate (to their Inspector of Taxes for example) a clear intention to make an irrevocable gift.

(ii) Junior ISA (JISA)

These were made available from 1 November 2011, for any child under 18 years of age, who is UK resident and does not hold a Child Trust Fund (see viii below). JISAs permit up to £4,128 for 2017/18 per child to be invested in total (in a cash account and/ or stock and shares JISA) by any one or more persons (e.g. parents or grandparents) for tax free accumulation of income and capital until age 18 when the JISA will convert to an ordinary (adult) ISA.

(iii) Registered pensions

It is possible for anybody to provide funds to be contributed to a registered pension plan for a child. The obvious disadvantage is that no funds will generally be available until the beneficiary is aged 55.

(iv) National Savings Children's Bond

The Bond is issued for a particular child but controlled by the child's parent, guardian or (great) grandparent until the child reaches age 16. No trusts are necessary. The bond is designed to be held for a fixed term of 5 years, but can be cashed in early subject to a penalty equivalent to 90 days interest on the amount cashed in. At the end of the 5 year term, the funds can be reinvested in another NS&I account or investment if desired. The maximum investment is £3,000 per child in each issue of the Bond. Interest is paid annually at a guaranteed rate for a set term of 5 years and is tax free.

(v) Unit trusts, investment trusts and OEICs

In most cases, these investments would be made by those over age 18 on behalf of the child, usually using a designated account. Here the unit trust/ OEIC certificate will be issued in the name of the adult nominee, followed (usually) by the child's name or initials to indicate the beneficial ownership. The nominee will have power to sell units/ shares and to reinvest any investment income. The disadvantage of a designated account is that the money may be "locked in" to the original investment until the child is 18, although practice will vary. At 18, the ownership of the investment can be transferred to the beneficiary - a stock transfer form (or equivalent for nominee holdings) would be needed.

If active investment management is planned, or it is desired to take advantage of tax planning opportunities, it will usually be preferable for the donor to create an appropriate express trust and for the trustees to invest for the benefit of the child. This gives greater certainty, as well as the potential for flexibility and control.

(vi) Life assurance policies

Generally speaking, life offices which enter into contracts with minors take the commercial risk that such a contract may be repudiated by the minor on reaching the age of 18.

Regardless of the above, some companies are happy to take this risk and a few life assurance companies and friendly societies are in a special position whereby an Act of Parliament enables them to issue policies on the life of a child and obtain a discharge from a child in the same way as from adult policyholders.

Typically though, it will be necessary to use a trust where it is desired to invest in life assurance policies for the benefit of a child. Any chargeable gains made while the policy is in trust and the beneficiary is a minor will be assessed on the settlor, except where the trust is a bare trust and the settlor was other than the minor beneficiary's parent. Offshore policies held in this way can offer tax-free accumulation and the potential for tax-free/ tax reduced returns e.g. under a bare trust where the beneficiary is taxed and has unused personal allowance and 0% tax bands (for parental settlements this will only work after the child attains age 18).

(vii) Friendly societies' tax free savings plans

Up to £25 per month (or £270 per year) can be paid to a friendly society plan on behalf of a child. A plan may be taken out by an adult in his own name, in which case it may be made subject to a trust for a child. Or, a plan can be taken out in the child's name, so that the child is the legal owner of the policy although the parent/ guardian will sign documents on the child's behalf until they reach age 16.

(viii) The Child Trust Fund

No new CTFs can be established from 1 January 2011, but CTFs set up before that date can continue and top-ups can be made (although, of course, no further Government contributions are paid). From 6 April 2015, it has been possible for those with a CTF to transfer into Junior ISA (JISA), should they wish to do so.

Using trusts when investing for children

Many investment strategies for children will, or should, involve a trust. Sometimes, there will be an implicit trust that has arisen through the operation of the law (for example, where funds have been paid over to a parent or other adult on the condition that they will be used to benefit the child). In other cases, the donor may want to expressly create a trust for the child – either for tax reasons or to benefit from the additional flexibility and control that trusts can offer. The question then arises as to what type of trust should be established. This will depend on the rights it is intended to confer on the beneficiary, how much flexibility is to be retained, the importance of

the any tax considerations (for example, where the settlor is the parent of a minor, unmarried child not in a civil partnership) and what the underlying investment is to be.

Generally, one of three types of trust can be appropriate. These are:

- An absolute (bare) trust;
- An interest in possession trust with power of appointment (sometimes referred to as a flexible trust); or
- A discretionary trust.

Where there is a desire to optimise the CGT position on investments for children, a bare (absolute) trust will often be considered. The advantage is that all capital gains are taxed as the child's with the benefit of a full CGT annual exempt amount, but a significant downside is that the child can demand the trust fund to be paid to him/ her once he/ she attains age 18 (16 in Scotland).

This will not be an attractive proposition for many donors, especially where larger sums are involved that they would not want the child to be able to access at such a young age, and the potential for continued control and flexibility will often outweigh any CGT and/ or income tax advantages. The alternatives, a discretionary trust or a flexible interest in possession trust, with a trustee CGT annual exempt amount (at one half the individual exemption) even in cases where the settlor´s minor, unmarried children can benefit, may not be so detrimental. It will all depend on the facts – especially the level of anticipated gains and income.

The choice of an appropriate trust will depend on the circumstances and objectives – all advisers should know about trusts and their tax treatment before advising on this.