e-NEWS

MARCH 2006

2006 BUDGET SUMMARY

THIS SECOND EDITION OF OUR E-NEWS PROVIDES A SUMMARY OF THE CHANCELLOR'S 2006 BUDGET REPORT AND FOCUSES ON THE CHANGES AFFECTING THE LIFE AND PENSIONS INDUSTRY. KEY POINTS FROM THIS YEAR'S BUDGET REPORT INCLUDE:

- **Major changes to inheritance tax and trusts effective immediately.**
- **Clarification of inheritance tax treatment of pension death benefits post A-Day.**
- **Further details of changes to pension tax-free lump sum recycling.**

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SHOCK ANNOUNCEMENT ON INHERITANCE TAX AND TRUSTS

This represents a major change to the inheritance tax treatment of interest in possession (IIP) trusts and accumulation & maintenance (A&M) trusts. Measures are to be introduced in Finance Bill 2006, effective from 22 March 2006, to bring the majority of these trusts within the same inheritance tax regime that currently applies to discretionary trusts.

Current inheritance tax treatment of IIP and A&M trusts

Lifetime transfers into these types of trusts are exempt from inheritance tax if the settlor survives 7 years under the potentially exempt transfer (PET) rules. In addition, these trusts are not subject to the 10 yearly periodic charge and exit charge normally associated with discretionary trusts.

Proposed inheritance tax treatment of IIP and A&M trusts

In respect of new trusts created on or after 22 March 2006, these will no longer be treated as PETs unless they are set up for a disabled person. Such trusts will now be immediately chargeable to inheritance tax. However, if the value of the transfer is within the available nil-rate band (£285,000 for 2006/07), there will, in effect, be no charge.

As a consequence of the proposals these trusts will be subject to the 10 year periodic charge and exit charge.

Limitation on new proposals

The proposals will not apply to trusts that are:

- created on death by a parent for a minor child who will become absolutely entitled at age 18.
- created on death and give a life interest that cannot be altered and on the death of the life tenant there are beneficiaries who become absolutely entitled to the capital.
- created on death or during lifetime for the benefit of a disabled person (as defined by the inheritance tax legislation).

Impact on existing A&M trusts

The current inheritance tax treatment will continue where the beneficiary will become absolutely entitled to the trust property at age 18. A&M trusts that do not comply with this requirement have until 6 April 2008 to alter the terms of the trust in order to comply. If they do not do so, the 10-year periodic charge and exit charges will apply. The 10-year periodic charge will be calculated by reference to the original date of the settlement.

Impact on existing IIP trusts

The current inheritance tax treatment will continue provided that when the current interest in possession comes to an end (either on death or during lifetime) someone becomes absolutely entitled to the trust property.

Where the current interest in possession comes to an end and the property remains on trust, this will be treated as creating a new trust. If this change occurs during the lifetime of the interest in possession beneficiary, this will be immediately chargeable to inheritance tax and also liable to the periodic and exit charges.

Where the current interest in possession comes to an end on death of the beneficiary, it will form part of that person's estate and the settled property will then come within the new charging provisions as stated above.

Capital gains tax and hold-over relief

The changes to the inheritance tax treatment of IIP trusts and A&M trusts mean that where the new rules apply to a trust, they will automatically be eligible for capital gains tax hold-over relief.

For A&M trusts, hold-over relief for capital gains tax will only apply where the beneficiary becomes absolutely entitled no later than age 18.

Capital gains tax rebasing

Under the current rules, where the life tenant under an IIP trust dies, the value of the assets representing their interest are rebased for capital gains tax purposes. Today's proposals will restrict the application of the current rules unless the IIP trust meets the new inheritance tax rules. We expect further clarification on this measure when the Finance Bill is published.

INHERITANCE TAX (IHT) AND PENSIONS SIMPLIFICATION

The Chancellor has at last clarified the IHT treatment of pension death benefits from A-Day (6 April 2006). The new IHT rules will be included in the Finance Act 2006.

The IHT position is different depending on whether death happens before age 75 or not, with the real aim being to stop abuse of the new alternatively secured pension (ASP) facility to pass on pension assets outside the estate.

Death before age 75

The current IHT treatment where a pension scheme member dies before age 75 will continue, but the existing practice will be formalised in legislation. Pension death benefits will not normally generate an IHT liability in these circumstances.

Death on or after age 75 in ASP

On a pensioner's death in ASP, the remaining ASP fund must be used to provide pensions for any surviving dependants of the pensioner. Dependant means widow(er), civil partner or other financial dependant. In these circumstances, there will be no IHT liability.

If there is no surviving dependant, the ASP fund can either be paid to charity or reallocated to other members of the pension scheme as a transfer lump sum death benefit (TLSDB).

- Payments to a charity will be exempt from IHT.
- TLSDBs will be chargeable to IHT as if they were part of the pensioner's estate.

If a dependant dies after inheriting an ASP fund, any remaining fund will be chargeable to IHT. These funds will normally be treated as if they were part of the original pensioner's estate.

However, where a dependant dies in ASP having inherited the ASP funds from someone who died before age 75, any remaining funds will be chargeable to IHT as if they were part of the dependant's estate.

The double tax hit

The same funds can suffer a double tax charge in some cases. This applies if a dependant inherits funds on a pensioner's death in ASP and then dies before age 75. In this case, the fund is not only chargeable to IHT, the remaining fund after IHT is also subject to the usual 35% tax charge if paid as a lump sum.

Who pays the tax?

The scheme administrator will have to account for, and pay, any IHT due on ASP funds. The personal representatives of estates will have to provide information about the ASP funds in the estate account.

NEW RULES TO STOP RECYCLING OF TAX-FREE LUMP SUMS

As previously announced, new rules will be brought in by the Finance Act 2006 to stop deliberate abuse of the pension tax system by recycling tax-free lump sums (known as pension commencement lump sums) under registered pension schemes. Some changes have been made from the original proposal.

These new recycling rules will introduce tax bills where much larger pension contributions are made for an individual as a direct and pre-planned result of drawing a tax-free lump sum from a registered pension scheme after 5 April 2006. The new rules will apply when:

- the tax-free lump sum (together with any other tax-free lump sums taken in the last year and after 5 April 2006) is more than 1% of the lifetime allowance (this means £15,000 for tax year 2006/07);
- the pension contributions made are significantly (generally 30%) larger than might have been expected; and
- the total of the increases in pension contributions in the tax year (and the two tax years before or two tax years after it) is at least 30% of the tax-free lump sum.

Any lump sum caught by the recycling rule will be treated as an unauthorised payment. This will mean a tax charge of up to 55% of the lump sum for the individual and up to 40% for the pension scheme (although the scheme can escape tax charges where it was not aware of the recycling plan).

It remains to be seen how this recycling rule will be policed and applied in practice.

MODERNISING THE TAX SYSTEM FOR TRUSTS

Further details relating to the modernisation of the tax system for trusts have been announced. The key changes are:

- The standard rate band of £500 which was effective from 6 April 2005 is to be increased to £1,000.
- Common definitions for 'settled property', 'settlement' and 'settlor' included in draft legislation published by HMRC on the 31 January 2006 will be included in the Finance Bill 2006.
- A common test to determine whether the trustees of a settlement are resident in the UK for both income tax and capital gains tax.
- The income of settlor-interested trusts is to be treated as though it had arisen directly on the settlor.
- The practice of not taxing beneficiaries who receive income payments from settlor-interested trusts will now be included in legislation.
- Settlements created for the settlor's unmarried minor children will now be assessed on the settlor for the purposes of capital gains tax.

The expected changes in relation to income streaming and capital gains tax charges on the administration of estate will not be included in this Finance Bill. All the changes will take effect from 6 April 2006 apart from the harmonised residence test for trustees which will now take effect from 6 April 2007.

SELF-DIRECTED PENSIONS SCHEMES – PROHIBITED ASSETS

As expected, the Chancellor has confirmed that there will be heavy tax bills in future where self-directed pension schemes like SSAS or SIPP invest in prohibited assets. However, frustratingly, there are still no proper details of what investments will be regarded as prohibited assets (although it appears clear that residential property, fine wines, classic cars, works of art and antiques will be on the list). The details of the new rules, which will apply from 6 April 2006, will be set out in the Finance Act 2006.

CHANGES TO THE CORPORATION TAX REGIME

As announced in the Pre-Budget Report, the starting and non-corporate distribution rates of corporation tax will be removed from 1 April 2006.

UK REAL ESTATE INVESTMENT TRUSTS (UK-REITs)

An updated version of the explanatory notes setting out the framework for UK-REITs has been published.

From 1 January 2007, companies or groups whose main business is property investment will be able to elect for special rules to apply to their property business and their distributions. Under this regime, rental income and gains on disposal of investment properties will be exempt from tax.

Distributions, as far as they are made from tax exempt income and gains, will be treated as UK property income and paid to investors under deduction of basic rate income tax (22%).

CHANGES TO VENTURE CAPITAL SCHEMES

Changes are being made to Venture Capital Trusts (VCT), Enterprise Investment Schemes (EIS) and Corporate Venturing Schemes (CVS).

The changes relate to the rate of tax relief (VCT), annual investment limit (EIS), minimum investment period (VCT), and maximum size of the companies (all). They can be summarised as follows:

VCT

- In 2004, there was a temporary increase in the rate of tax relief from 20% to 40%, with the intention that this would revert to 20% in tax year 2006/07. The rate of relief, applicable to VCT shares issued on or after 6 April 2006, will now be 30%.
- The minimum investment period for VCT shares to be held to retain the income tax relief will rise from 3 years to 5 years.
- At least 70% by value of a VCT's assets must be held as shares or securities in qualifying holdings, and it must also have no more than 15% of its total investments in any one company. From 6 April 2007 any money held on behalf of a VCT or within the VCT itself will be classed as an investment for the purpose of these tests.

EIS

- The annual investment limit for income tax relief is doubled from £200,000 to £400,000, and the carry-back facility is also doubled – from £25,000 to £50,000.

EIS, VCT and CVS

- There is currently a limit on the size of companies allowed to raise money under these schemes of £15m before the investment and £16m afterwards. These limits reduce to £7m and £8m respectively.
- Broadly, the new limits apply from 6 April 2006, but refer to the HMRC website for a detailed explanation.

QUALIFYING LIFE INSURANCE POLICIES

Qualifying life insurance policies may lose their qualifying policy status if a significant variation occurs. For policies issued before 14 March 1984 there could also be a loss of life assurance premium relief (LAPR). Altering a policy from with-profits to unit-linked or vice-versa has been treated as a significant variation since February 1988.

Alterations to the method of calculating policyholder returns, such as from with-profits to unit-linked, will not be treated as significant variations from 7 October 2005. Therefore, such changes will no longer lead to a loss of LAPR or qualifying policy status. In addition, this treatment is backdated where the variation came about as a result of a transfer of insurance business from one company to another.

ANTI-AVOIDANCE MEASURES: 'EMPLOYMENT-RELATED SECURITIES'

The Finance Bill 2006 will contain measures to ensure that employers and employees will be unable to avoid paying the proper amount of income tax and National Insurance contributions by the use of contrived schemes involving shares, securities or options over shares or securities. The legislation will be backdated to 2 December 2004, in accordance with an announcement made by the Government on that date.

EXTENSION OF THE DISCLOSURE REGIME

From 1 July 2006, the disclosure regime will be extended to include schemes that have as one of the main objectives the avoidance of income tax, capital gains tax or corporation tax. Responsibility for disclosure will fall upon scheme promoters and, in some cases, users. The time limit for disclosure will be 30 days from the scheme implementation date. 'Hallmarks' will define the criteria by which notifiable schemes are to be identified.

INTERNATIONAL TAX ENFORCEMENT AGREEMENTS

The Government plans to increase and broaden its powers to enter into agreements with other countries' tax authorities, which would lead to more extensive application of the following powers:

- Exchange of information.
- Service of documents.
- Recovery action on behalf of an overseas tax authority.

The measures still need to be debated and approved, but could potentially become effective from the date of Royal Assent to the 2006 Finance Bill (normally given in July).

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STAMP DUTY LAND TAX – THRESHOLD INCREASED

The threshold for stamp duty land tax on residential property transactions is increased from £120,000 to £125,000.

This will affect transactions with an effective date on or after 23 March 2006. The effective date is normally the date of completion, but may exceptionally be earlier if the contract is 'substantially performed' before completion.

Further changes were announced, mainly in order to clarify and simplify existing rules. For example, a gift of property where the donee or beneficiary agrees, or is required, to pay capital gains tax or inheritance tax arising on the gift will not be treated as for consideration.

RATE OF FIRST-YEAR CAPITAL ALLOWANCES FOR SMALL BUSINESSES

During the year starting on 1 April 2006 (or 6 April 2006 for businesses that are chargeable to income tax), the rate of first-year allowances (FYAs) for expenditure by small businesses on plant and machinery will increase from 40% to 50%. The rate for medium-sized businesses will stay at 40%.

CHILD TRUST FUND

Under the Child Trust Fund, all children born since 1 September 2002 receive £250 with those from lower income families receiving £500. The Chancellor has now announced that all children will receive a further £250 at age 7 with those from lower income families receiving a further £500.

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