PROFESSIONAL NEWSLETTER
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BREXIT

TAX AND FINANCIAL PLANNING OUTLOOK

Earlier in the same week that the UK voted for Brexit, the Treasury published the government borrowing figures for May along with an updated estimate for 2015/16 borrowing. Such was the focus on referendum debate, the numbers attracted little attention. However, in contemplation of a post-Brexit world, the Treasury's data may be a useful starting point to answering the 'What next?' question:

- The revised borrowing number for 2015/16 was £74.9bn, £2.7bn higher than the March 2016 Budget projection from the Office for Budget Responsibility (OBR), but £16.7bn below the 2014/15 outcome. In the grand scheme of things, £2.7bn is a small difference, but one in the wrong direction

- The OBR's projection for 2016/17 borrowing is £55.5bn, which it now turns out is £19.4bn below last year's figure not £16.7bn

- After two months of 2016/17, borrowing has totalled £17.9bn, £0.2bn up on the same period last year. To be on track, the number should have been £13.1bn

- The maths mean that, to hit target, borrowing in the next ten months must be £19.6bn lower than 2015/16, ie about £2bn a month less on average.

Thus, even before the referendum, the Treasury data suggested that the then Chancellor was not going to hit his 2016/17 borrowing target, regardless of the outcome – perhaps, in part, due to cooling UK economic conditions brought about by government-induced Brexit uncertainty.

With the vote in favour of "Leave", there is a new large dose of uncertainty to deal with and this one has no clear end date.

With pre-Brexit rumours of an 'austerity Budget' quashed, the short-term recessionary economic outlook suggests that any fiscal moves will be towards stimulation rather than tightening. Of course, the new Chancellor will want to see how markets settle before deciding on next steps. However, early indications are that we may see a move away from an austerity-based fiscal programme in the forthcoming Budget process.

Further developments between now and the Autumn Statement will have a very strong influence on the direction that will be taken.

Even if tax rises are avoided or taxes reduced, action against aggressive tax avoidance will certainly continue.

This has been confirmed by Theresa May. The so-called 'Base Erosion and Profit Shifting' (BEPS) tax avoidance project, targeting multinational corporations, is, in any event, OECD driven and draft legislation, which will implement the proposed reforms to the taxation of non-domiciles, has now been published – despite widespread scepticism that the government would be able to adhere to its original timetable post-Brexit.

Consultation is also now under way on proposals designed to create transparency in relation to the IHT treatment of UK-sited properties held in offshore structures - with a view to legislating for this in Finance Bill 2017.

DIVIDEND GROWTH

The outlook for dividends in 2016 is not particularly bright. Capita's latest quarterly dividend monitor suggests that the picture has now changed, largely due to sterling's demise since the Brexit vote. According to Capita:

- The second quarter of 2016 saw UK dividends rise to a quarterly record of £28.8bn, up 7.6%

- Special dividends quadrupled, with a record 22 companies making such payments

- The Q2 dividend growth is not all it seems. Capita reckons that underlying dividend payouts (ie excluding the one-off specials) fell by 2.7% year on year

- All industries, except basic materials, saw dividend payouts increase. However, dividends from miners halved year on year as the fall in commodity prices worked through to the bottom line

- Financial companies were the largest payers in Q2, helped by a doubling of Lloyds' dividend and big increases by life insurers. Banks are now under orders not to increase their dividends, following the Bank of England's relaxation of capital rules in response to Brexit

- Payouts from the top 100 companies rose 9.9% year on year, helped by special dividends. The more UK-focused Mid 250 registered a 5.5% decline, mainly due to changes in constituents

- 'The Brexit vote has completely changed the picture for dividends this year and beyond.' Underlying dividends are now forecast to grow by 0.5% in 2016 and total payouts by 3.8%. In Q1, Capita's corresponding figures were falls of 1.7% and 1.5%. The pound's demise has added £4.5bn to the amount of dividend payments. Five of Q2's top dividend payers set their payments in dollars.

The demise of sterling benefits not only dividends from UK-listed companies with overseas exposure. It will also mean higher sterling-translated dividends from non-UK holdings. If nothing else, Brexit has served as a reminder of the virtues of diversification outside the UK.

PENSIONS

Let’s be clear, nobody forecast the result of the referendum with confidence and nobody has forecast the consequences with confidence.

There will undoubtedly be an impact on pensions over the longer term (we are still members of the EU at the moment) and the markets will probably twitch at regular intervals in the absence of certainty as to their destination.

Those twitches will be magnified further by the sheer difficulty of trying to divine how significant is the latest economic shock or encouragement.

Where do we go now?

This is not the place to discuss investment strategies and what the markets might have in store for us, important though they are to pension schemes, whether defined contribution or defined benefit. Suffice to say that the world and its markets is a much bigger place than the UK and the options available to the investment manager extend beyond UK shares, gilts and property, significant though they may be.

Pension fund managers and individual members will be looking at opportunities that they may have shied away from in the past and there will be time to adjust portfolios, if appropriate.

The impact of Brexit (or the consequences of Brexit) on pension arrangements is largely unknown although most people suggest that the legislators will be busy over the next few years.
This is important in itself. We cannot know just how busy until we know the terms of the UK withdrawal.

For example, if we are to be partially linked to the EU, we may find that we are part of the single market, but without some of the social requirements (however unlikely that may be). At the other extreme, we would be looking at total withdrawal in all aspects.

Withdrawal from the EU does not mean that all the rules relating to pensions are automatically reversed or that they will necessarily be reversed. Similarly, judgements of the European Court of Justice do not necessarily become irrelevant.

The main areas of concern

What seems clear is that there are three main areas that we should be thinking about, subject to the negotiated terms of the government:

- What will be the impact of the administrative burden on government and pension administrators?
- What will be the impact on our domestic legislation and, indeed, our legal institutions?
- What will be the impact on public opinion as rights and obligations are adjusted?

Although an apparently mundane topic, the impact of administrative overload is important. It seems inconceivable that pension reform could continue at the pace of the last few years in addition to the adjustments required of a negotiated Brexit. This means that some measures will be shelved, but which would those be.

In theory, EU law does not extend to influencing income tax or corporation tax policy which means, in effect, that changes to the taxation of pensions are not affected by Brexit. This is optimistic. There will inevitably be consequential amendments to related legislation even if only to vary the terminology.

The most obvious example is the body of legislation that deals with overseas pension schemes and qualifying recognised overseas pension schemes. There are references to what is, in effect, the European Economic Area (EU plus) and there is no reason why the substance of the reference should not continue even if the wording is slightly changed.

This may mean some minor negotiation to ensure there is no 'leakage' of tax for avoidance purposes when there are cross-border pension arrangements.

Although one would not expect the Treasury to be too occupied by changes to pension tax legislation, during a period of financial constraint it is not fanciful to suggest that Civil Service resources will be redeployed to address what could be a massive task for some other areas and, of course, tax considerations do not only apply to pensions.

Having said that, the administrators may plan for as many contingencies as they like, but there is little they can do until the substance of the agreement is known. So although it is possible that the withdrawal of the Pensions Bill promised for late 2016 is on the cards, common sense would suggest that planning for the Bill is well advanced and that a Brexit agreement is unlikely to be settled (or have been settled for long) by the time this rather technical Bill comes up for debate.

After that, we must assume that very little will change in terms of scheme governance because there will be no time to change it. The same may be said for tax legislation relating to pensions though fiscal change, not necessarily reforming, will always be given priority if the economic circumstances require it.

Impact on DWP legislation

The impact of Brexit on our legislation is a topic which will keep the legal academics amused for a long time, but we can make some general observations. The way pension legislation has been influenced by the EU has started with the publication of Directives.

These are very high level instruments that are akin to legislative objectives. When they are issued, it is for the member states to adopt those statements of principle into more detailed domestic legislation.

This may be by way of statute or statutory instrument passed by our Houses of Parliament or it may be by way of case law. Case law is essentially about how EU law should be interpreted in this instance. So, if there is a dispute involving the content of an EU Directive, the case may be referred from the UK courts to the European Court of Justice (ECJ). The ECJ will then pronounce on the application of EU law to the circumstances and may then refer the case back to the UK for a decision on the facts of the case.

Much of the legislation that is 'blamed' on the EU is not driven by the EU at all, but rather the domestic legislators as they apply EU principles. Of course, there are EU regulations and they are binding, but these are not generally present in the world of pensions.

Taking control of legislation and courts

During the referendum debate those who wanted withdrawal made a great deal of either taking control of our borders (not relevant to pensions) and/or taking back control of our laws (very relevant to pensions).

We must assume that Brexit would significantly restore the supremacy of Parliament as our law-making body (which, in effect, means having control of the principles and the political dimension), but also restoring the Supreme Court as the final court of appeal on matters of detail and principle in legislation.

Unlike the present structure, the Supreme Court would not be able to establish the framework within which the legislature should operate, a power currently available to the ECJ.

Rights and obligations

Of course, another great unknown is the popular or political reaction to any changes to pension law as a consequence of Brexit. It is unlikely that withdrawal from the EU will have much impact on the substance of pension law. It will have little direct impact on tax rules relating to pensions. It will have no direct impact on the state pension.

The area which could be affected is that of member rights and protections which is part of a wider body of rules relating to employee rights and protections. These rights and protections have been incorporated into UK law by UK legislation so it would seem that withdrawal would not automatically mean a withdrawal of those rights and obligations, but future case law could lead to a divergence of interpretation from the EU.

Those who criticise the ‘red-tape’ that they consider bedevils business (small businesses in particular) and is seen to emanate from the EU would do well to recognise that one person’s obligation in this area is another person’s protection or rights. So to remove an employer’s obligation is to remove an employee’s rights.

That has been the delicate balance which the Social Security Acts, the Pension Schemes Act and the Pensions Act attempted to achieve in the 1980s and 1990s. Already that balance has changed and, of course, one of the consequences is the demise of defined benefit schemes although, ironically, quite slowly because of the protections afforded to members under scheme funding and winding-up rules.

Nobody seems to be suggesting that member protections should be withdrawn when the opportunity presents itself under Brexit, but the trade unions, no doubt, will be on their guard, especially since pensions are now so much part of their watching brief.

Of course, we would do well to note that most of the complaints about ‘red tape’ come from the smaller employers who are less able to manage them than their larger counterparts, but those smaller employers are less likely to experience the problems of an employer-sponsored scheme.

What is on the horizon?

George Osborne is no longer Chancellor and there seem to be no major measures left on which to legislate to make pensions more flexible (but how about measures to make them simpler?). Flexibility is unlikely to occupy Mr Hammond’s thoughts.
The Pensions Bill is to propose additional protection for members of master trusts and measures designed to cap exit fees in order better to lubricate the flexibility reforms.

Then there is the issue of Lifetime ISAs. Their implementation would swallow resource and they have some influential enemies, such as the recently departed pensions minister. So, although there is no Brexit logic for dropping them from the agenda, they may be lost in the flurry of what is going on. Indeed, providers are now urging the government to push back the intended April launch date for one year warning that they will not have time to build products in time with much of the technical detail still largely unknown.

The IORP II Directive is due to be implemented in 2018 by which time the future will be clearer. The areas dealt with by IORP II are:

• Cross-border schemes
• Cross-border transfers
• Governance
• Member communications
• Regulatory supervision of IORPs

Even where IORP seemed more exacting, as in the funding requirements, lawyers say it has been relaxed. Funding requirements have been withdrawn from the Directive to be left to domestic law and, where there are requirements for cross-border schemes, the proposals have been relaxed to allow funding plans to be agreed when there is a deficit. Unfortunately, there are certain technical inconsistences with UK law and we can have no idea at this stage whether these points will be reconciled.

ACTION

Financial advisers are likely to be confronted by some worried clients although the lesson of the past is that making any changes at times of volatility can be dangerous. Although there was an element of bungee jumping in the immediate aftermath we have since seen recovery. Yes, the world had changed, but exactly how is going to be unclear for some time.

Should you have any questions or require further information please do not hesitate to contact us

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