# AUTUMN 2014
# PROFESSIONALS NEWSLETTER

## Inheritance Tax and Discretionary Trusts - changes on the horizon

The Government, and HMRC specifically, is determined to simplify the calculation of IHT on discretionary trusts. And as part of that simplification it wishes to restrict the IHT planning opportunities using multiple trusts. As part of this process, HMRC has already issued two Consultation Documents which, in general, have been rejected as unworkable by interested parties. The most recent Consultation Document, issued on 6 June 2014, represents a compromise. Following a further period of consultation, legislation is expected to be introduced on 6 April 2015.

So what are the main proposals as they stand? These can be summarised as follows:-

- in calculating IHT periodic and exit charges on a discretionary trust, the cumulative chargeable total of the settlor in the seven years before the trust was created will be ignored

- any IHT charge will be at 6% over and above the nil rate band at the time of the charge

- the settlor will be given one nil rate band for use against all of the trusts they have created that fall within the new rules – a settlement nil rate band (SNRB). This is in addition to the settlor's own individual nil rate band. The settlor can elect to allocate a proportion of the SNRB against any trust that is subject to the new rules.

- the trusts that can use the SNRB will include those created by the settlor on their death (ie. Will trusts)

- not more than 100% of the SNRB can be allocated in this way
- a proportion of the SNRB that has been allocated to a trust can be changed at any time up to the time of the first chargeable event eg. the first 10 year periodic charge. After that point the specified proportion can be increased but not reduced.

These changes will apply to all trusts created after 6 June 2014 and to funds added after 6 June 2014 to trusts created before 7 June 2014.

If the new rules are enacted, they will undoubtedly simplify the calculation of IHT on discretionary trusts. They will also neutralise the ability for people to carry out what is known as “Rysaffe planning”. This enabled an individual to create a number of discretionary trusts on different days and for each to be entitled to its own full nil rate band diminished only by chargeable transfers made by the settlor in the seven immediately preceding years. To reiterate then, for trusts created after 6 June 2014, they will only be entitled to one nil rate band between them – the SNRB – and this will be allocated in the proportions elected by the settlor.

## ACTION

IHT planning using trusts will still be attractive. In short, a trust enables a donor to make a gift to the next generation yet still retain some control over who benefits and when with, in the meantime, investment growth accruing outside the settlor’s taxable estate. Of course, given the high levels of income tax and CGT that a trust can pay, it is important to choose the right underlying tax-efficient investment(s).There is also a range of other trust plans that enable an individual to make a gift to a trust and continue to enjoy capital payments without causing an IHT gift with reservation. These plans will remain attractive. Call us for more information.

## Don’t be a casualty of ‘stealth taxation’

The Office for Budget Responsibility (OBR) has recently published projections for the number of estates subject to inheritance tax, based on forecasts by the Office for National Statistics. It found:

- During the last tax year (2013/14), an estimated 26,337 deaths resulted in estates being charged inheritance tax.
- An extra 9,274 estates will be dragged into inheritance tax during the 2014/15 tax year, a rise of 35% over 12 months.
- In 2015/16, the number of estates liable for inheritance tax will rise to 43,811. By 2016, the number of families who must pay inheritance tax will have risen by 66% in two years.
- In total, 236,000 deaths over the next five years will result in inheritance tax liabilities for those who benefit from a relation’s legacy.
- By the 2018/19 tax year, almost 10% of estates will be subject to inheritance tax, compared with 2.8% in 2010/11.

These figures illustrate that an increasing number of individuals are likely to be caught in the IHT net and many probably don’t realise it. With this in mind, clients ought to be considering whether they are carrying out sufficient estate planning to reduce any potential inheritance tax liability, broadly, using exemptions, lifetime planning, Will trust planning and deeds of variation.

So, in brief, what action should a client be considering in planning for IHT? Here is a very quick overview of the key planning opportunities that individuals should consider.

- Make a Will to ensure that assets will go to whom the deceased wished them to pass to on their death. For clients who are married or in a civil partnership, thought should be given as to whether the nil rate band of the first to die should be used on the first death or use made of the transferable nil rate band. Given that the nil rate band is frozen until 2017/18 more people are now making use of their nil rate band on the first death as growth on investments gifted is then outside the estate of the survivor.

- Make regular lifetime gifts so as to use the annual exemption and (if possible) the normal expenditure out of income exemption

- Consider bigger gifts. Outright gifts will be potentially exempt transfers (PETs) and so will not attract any IHT provided the donor survives for 7 years. Take into account any capital gains tax (CGT) that could arise on the gift.

- If ongoing control of the asset gifted is required, consider using a discretionary trust. Clients should not exceed their available nil rate band as otherwise lifetime IHT will be payable. If CGT is likely to arise, consider whether a claim for CGT hold-over relief can be made – this will depend on who the beneficiaries are under the trust. The advantages of a discretionary trust are that the donor (the settlor) can, as a trustee, have some control over the investments of the trust and so determine who will benefit and when. However, the settlor cannot be a beneficiary and so cannot receive any income/capital as otherwise the gift with reservation rules will apply.

- Fortunately, certain schemes have existed for a long time that can provide the settlor with the ability to place a lump sum in trust yet enjoy an "income" (or more precisely a stream of capital payments). HMRC has confirmed that these plans will not be subject to the gift with reservation rules or the pre-owned assets tax (POAT) rules.

  *For more details of these plans – known as loan trusts and discounted gift trusts – please call us.*

- For clients who are unlikely to live for 7 years, a lifetime gift will not be so appropriate. For them, provided they have the right investment perspective, an investment into an Enterprise Investment Scheme (EIS) that invests in a basket of shares may be appropriate. Here, once the investments have been owned for 2 years they will be outside the investor's estate for IHT purposes. Furthermore, the investor should qualify for income tax relief at up to 30% on the investment.

- If the client owns business assets – such as shares in a private limited company – any planning should aim to maximise the use of business property relief. Thought should be given to gifting such assets either directly to children or into trusts for children on the client's death to utilise the generous 100% level of business property relief that is currently available.

- Where the client is a member of a pension scheme under which they have substantial death benefits, if those benefits are paid to a surviving spouse that payment will add to any IHT problem on the surviving spouse's subsequent death. In such cases, consider the merits of the client creating a by-pass trust as a vehicle to receive the lump sum death benefits and give ongoing wealth protection and IHT protection for the family yet still ensuring that the widow/widower can benefit.

- Planning may be more difficult for those clients who face a substantial potential inheritance tax liability because they own assets that, by their nature, are difficult to gift – for example a private residence.  For these clients, they could consider "covering" the liability by effecting a joint lives last survivor life assurance policy in trust for the beneficiaries who will suffer because of the tax liability. This will mean that such people will have cash to meet the tax liability and this will preserve the assets in the estate.

## ACTION

Inheritance tax is set to affect more people.  Early action by clients can draw its teeth. Call us for more information on what we recommend for your clients based on their circumstances.

## Funding the costs of a university education just got NISA…

We have now just passed the "exam result" season. Many eighteen year olds will have bitten their nails with nervousness over their grades in the anticipation of whether they will gain entry to the university of their choice.

Many parents may equally be biting their nails wondering if they can afford to fund their children going to the university of their choice.

The costs of a university education can be enormous - £57,000 is not an unreasonable estimate when one adds the maintenance/daily living costs of, say, £10,000 per annum to the tuition fees of up to £9,000 per annum in England.

Whilst there is a loan facility in place to help university students with these costs, many parents are concerned that their children may be leaving university with a substantial debt that may take years to repay. Indeed, due to the addition of interest, which can be as much as RPI plus 3% (5.5% in September 2014) the outstanding debt will increase for those with higher incomes in later life. And, of course, that outstanding debt may have a significant impact on another important financial issue for children – namely the desire to obtain a mortgage to purchase a house.

In order to give the child financial assistance at the right time, parents and grandparents should put savings in place. And the earlier the better. For many parents this will involve saving money on a regular basis. And, of course, when setting up a savings plan to provide for a child's university costs, it is worth bearing in mind that the more tax efficient the investment, the greater the potential return at the required date.

And the good news here is that the Government has given this whole area a huge boost in the 2014 Budget with the introduction of its new tax free savings plan, the NISA.

The main rules that apply to NISAs are now as follows:

- All adult ISAs are now known as NISAs (new ISAs).
- The maximum contribution in 2014/15 is £15,000 for an adult NISA and £4,000 for a Junior ISA (still known as a JISA).
- There is no longer a 50% maximum contribution limit on cash investment: an investor can place their full £15,000 in a cash NISA.
- The rule which permitted a transfer from a cash ISA to a stock & shares ISA, but not the opposite, has been scrapped. NISAs can be transferred in either direction.

- The investment rules have been relaxed to allow short-term bonds with less than five years to maturity to be held in a stocks & shares NISA.
- The flat rate 20% tax charge on interest on cash in stocks and shares NISAs has been abolished.

The Government is also examining how to include peer-to-peer loans as permitted investments for NISAs.

The changes that have turned ISAs into NISAs have made them more attractive and flexible products. The key to making the most of NISAs – as with ISAs – is to keep contributing. That way, over time it is quite possible to build up a six figure portfolio free of UK income tax and capital gains tax (although 10% dividend tax credits cannot be repaid).

**How much is needed?**

The amount of cash needed to see a student through university can be substantial. Let's take a parent who wishes to advance fund for the university costs of their three-year old daughter. They estimate they need to target a total £57,000 (based on current values) ie. £19,000 per annum (tuition fees of £9,000 per annum and living costs of (say) £10,000 per annum.) for 3 years, in 15 years' time. Based on a growth rate of 5% per annum net and ignoring tax on any encashed amounts, this would mean that a lump sum of £27,418 would need to be invested now. Alternatively, the parent could pay £215 per month. However, should costs increase by 2% per annum (not unrealistic), the cash needed in 15 years' time would increase to a whopping £76,714.

So what savings vehicle should be used to fund for this? For many parents (and grandparents), it will frequently be the case that regular saving is the only option. So given the improvements that have just been announced, a sensible starting point should therefore be the JISA and then the NISA.

**(1) The Junior ISA**

The Junior ISA:-

- is available for any child under age 18 who does not have a CTF account. Therefore the child must have been born before 1 September 2002 or after 2 January 2011

- permits contributions of up to £4,000 per annum. These contributions would normally be paid by a relative, such as a parent or grandparent

- can be invested in cash funds and/or stocks and shares and

- provides tax freedom on capital gains and investment income (although the tax credit on dividends cannot be recovered).

Although the proceeds are not accessible until the child gets to age 18 that can fit in nicely with the plan proceeds being used to fund university costs as we explain below.

The Junior ISA will enable a parent to invest £4,000 per annum. If the full £4,000 is invested each year for 18 years then, assuming growth at 5% net per annum and ignoring ongoing charges, this will produce a tax free fund of about £118,156 after 18 years – more than enough to cover the current cost of the three-year university degree course we refer to above.

The obvious benefits of the Junior ISA are that it is tax free. In the case of parental contributions, because the £100 parental settlor income tax rule will not apply, income arising in the Junior ISA will never be assessed on the parents and will, in effect, accrue tax free.

The downside is that there is no control over the child's ability to access the fund at age 18 and, of course, they may not then be university material!

Parents or grandparents who are concerned about this point could consider keeping any investment in their own name until the child attends university. Appropriate investments here could be the "parental" ISA (see (2) below) or growth collectives (see (3) below).

## (2) Parental NISA

Here it is contemplated that the parent would effect the NISA in their own name and therefore keep complete control over the time when the NISA is encashed.

For a taxpaying investor, it is still undoubtedly the case that the NISA is still the main method of investing savings with freedom from income tax and capital gains tax without giving up the flexibility of access to the investments.

Because, as we explain above, the new NISA now permits a contribution of up to £15,000 per annum which can be split in any proportion between the cash and stocks and shares elements. This means a couple could between them invest £30,000 each year.

Of course, no tax relief applies on the payments into a NISA but income and capital gains are free of tax. The tax credit on a dividend is not recoverable and so, for the basic rate taxpayer, a NISA invested in equities gives no income tax advantage. However, for a 40% taxpayer, tax freedom means the net dividend income yield improves by 25% and for a 45% taxpayer by 43.9%.

The tax efficiency of a NISA is that investments have scope to accumulate in value at a faster pace. The earlier a programme of NISA savings is established the better. Moreover, "own-name" NISAs will enable the parent to automatically exercise control over the timing of any encashment of the NISA and the application of the NISA proceeds.

## (3) Growth-oriented unit trusts/OEICs savings plans

Given the relatively high current rates of income tax as compared to the current rates of capital gains tax (CGT), it can make sense from a tax standpoint to invest for capital growth as opposed to income. This is particularly the case for the higher/additional rate taxpayer. A regular monthly saving into a growth-oriented unit trust/OEIC may therefore be appropriate.

Although income (dividends and interest) on collectives is taxable – even if accumulated - if this can be limited then so can any tax charge on the investment. Instead, if emphasis is put on investing for capital growth, not only will there be no tax on gains accrued or realised by the fund managers, it should also be possible to make use of the investor's annual CGT exemption (currently £11,000) on later encashments. This would enable the investor to enjoy a stream of tax-free capital payments that can be used to meet university costs. Gains in excess of the annual exempt amount only suffer CGT at 18% and/or 28% currently (depending on the investor's income tax position). For couples, it makes sense for each of them to invest in order to be able to use both annual CGT exemptions when investments are encashed.

Of course, as for all financial planning, a careful balance needs to be struck between investment appropriateness and tax effectiveness. While investment performance through capital growth is obviously tax attractive, reliance on growth at the expense of income can introduce (possibly unacceptable) risk.

For all of the investments mentioned above, if and when the investment or the proceeds are transferred to or used for the child, IHT would need to be considered. Where parents or grandparents wish to make the transfer earlier (eg at outset), but retain some control over who receives the benefit and by when, some form of trust may be considered.

### ACTION

*If you are interested in advance funding for university costs, a JISA, NISA and/or unit trust/OEICs savings plans can be a tremendous benefit.*

*Call us for more information on the most appropriate investments to meet your circumstances and objectives.*

## Pensions flexibility on the horizon

The big announcement in this year's Budget was the Government's proposed reforms to the taxation of pensions. As well as the changes that apply in 2014/15 to capped drawdown, flexible drawdown, trivial commutation and small pots, more fundamental changes are scheduled for next Spring. The most important change is that from 6 April 2015 it will be possible to draw down all of the cash in a money purchase pension plan without needing to satisfy any conditions with regard to having a minimum level of other pension income.

However, whether and, if so, how to take advantage of this new flexibility needs a good deal of thought as to all the implications of the new pension rules and, of course, the appropriate tax legislation. To make sure that all aspects are considered and to make sure that all views will be taken into account, the Government has embarked on a process of consultation with interested parties. That consultation process ended in June and as a result the Government has published the Taxation of Pensions Bill. This puts quite a bit of flesh on the bone of the 2015 changes.

In particular, we now know that the following rules will apply:-

- *Flexi-access drawdown* Flexible drawdown will disappear and capped drawdown will only remain if it was set up before 6 April 2015. The new drawdown regime for money purchase schemes will allow a person to draw what they want, when they want, from their drawdown fund, taxed as income. As now, when they designate part of their pension plan to be used in drawdown, they will also be able to draw a 25% tax-free lump sum.

- *Uncrystallised funds pension lump sum* This cumbersome phrase hides a simplified way of drawing a one-off lump sum from a money purchase pension. Instead of designating part of the fund to drawdown, making a 100% withdrawal and taking the related tax-free lump sum, a person can just take an uncrystallised funds pension lump sum (see example below), leaving the rest of their pension arrangement untouched.

- *Annual allowance reduction* To prevent the new rules being used as a tax-efficient way of paying an employee aged 55 or over, the Bill imposes a new "money purchase annual allowance" of £10,000 for contributions to money purchase schemes if a person uses either of the facilities described above to draw income.

- *More flexible annuities* The current restrictions that generally prevent annuity income from being reduced once in payment will disappear, as will the 10 year ceiling on the maximum period for which payments may be guaranteed.

So how will the Uncrystallised Funds Pension Lump Sum work?

## Example - Joan

Joan reckons that she has income of £45,000 in 2015/16 and wants £50,000 net from her pension plan to help her son buy his first home. She speaks to her adviser who suggests that she takes £71,429 from her self-invested personal pension as an uncrystallised funds pension lump sum. This would provide her with her £50,000 net as follows:

| | £ | £ |
|---|---|---|
| Gross lump sum | 71,429 | 71,429 |
| Tax free element (25%) | | (17,857) |
| Taxable income balance | | 53,572 |
| Tax @ 40% on balance | (21,429) | |
| Net amount | 50,000 | |

Joan had better not have much more than £45,000 income, as with the taxable element of the pension lump sum added, her total income is over £98,000 – close to the £100,000 threshold at which she will start to lose her personal allowance and suffer an effective 60% marginal rate of income tax.

Other areas are still being addressed – such as the level of taxation of lump sum death benefits and some detail may change – but the proposed structure of the new regime is now clear.

These tax changes will give rise to considerable opportunity for not only people who are considering making further contributions to pension schemes but also to those who are contemplating a withdrawal of benefits in the not too distant future.

We look at a couple of opportunities in relation to new pension contributions in the article that follows this one below.

Capped drawdown will continue for those who are already in it at 6 April 2015. Provided income withdrawals continue within permitted parameters, the tax position will not change – which means the member can still have a £40,000 annual allowance for contributions to money purchase schemes. However, if they exceed the income limit from their capped drawdown arrangement, they will automatically be switched into flexi–access drawdown with a consequent reduction in the allowance for money purchase schemes to £10,000. For such people, if the pension provider permits, it may be worth them transferring other pension benefits to the capped drawdown plan before next April. By augmenting the fund in this way, they will be able to draw more income within limits and will retain a £40,000 annual allowance.

## Maximise pension contributions to access increased flexibility

The ability (from 6 April 2015) to draw down all of a money purchase pension plan from age 55 is likely to encourage people – particularly higher rate taxpayers – to commit more to pensions.

However, there are limits. In general the maximum contribution will continue to be restricted by two factors:-

- the annual allowance of £40,000 and
- the lifetime allowance of £1.25 million which applies to the value of all registered pension plans.

Assuming that an individual is well within their lifetime allowance, the individual may wish to maximise their contributions. With this in mind there are two special rules that apply:-

(i) The individual can only pay contributions within their annual allowance of £40,000. However, provided the individual has been a member of a plan for the previous 3 years and the full contribution not made in those years, a contribution can be paid in the current year for those years. This is known as “carry forward” and when calculating carry forward it is possible to use the annual allowance that applied in that particular year eg. £50,000 for each of the years 2013/14, 2012/13 and 2011/12. Also don’t forget that:-

- the individual must extinguish the current year's allowance by making a contribution of £40,000 before accessing carry forward from a previous tax year, and
- for personal contributions, the individual must have relevant earnings at least equal to the grossed-up contribution that is being paid.

**Example – Janet**

Janet has relevant UK earnings of £60,000 in 2014/15. She wants to maximise her pension contributions in this year. In the last three years she has made a (grossed-up) contribution of £35,000 in each year. She therefore has unused relief of £15,000 for 2013/14, 2012/13 and 2011/12.

If Janet makes a contribution of £60,000 in 2014/15 this will:-

- use her £40,000 annual allowance in 2014/15
- use £15,000 of unused relief for 2011/12 and
- use £5,000 of unused relief for 2012/13 leaving £10,000 remaining

(ii) Where an individual wants to pay more into a pension plan than is allowed by their available annual allowance (and carried forward allowance – if available) another form of planning may work. The annual allowance applies per pension input period – the accounting periods that apply to pensions. The member could therefore consider starting two schemes and change the pension input period (PIP) end date for one so that one ends on 5 April 2015 (ie. in 2014/15) and one ends after 5 April 2015 – say 1 May 2015 (ie. in 2015/16). Contributions of up to £80,000 can then be made between 1 May 2014 and 5 April 2015.

Such a strategy may be particularly useful for individuals who have no ability to carry forward unused relief because they didn't have a pension plan in force in earlier years.

(iii) Some clients may now welcome the prospect of a higher contribution to a pension scheme but not have the funds or sufficient relevant earnings to make it themselves. In such cases it may be that an employer company contribution will work. Where the employee is a director, this should be fairly easy to organise. For people who are mainstream employees, a salary sacrifice arrangement may be attractive whereby the employee gives up a salary that the employer contributes to the pension scheme. In both cases there will be the advantage of a NIC saving for the employer (and employee) that the employer may be prepared to add to the contribution. Whilst such contributions do count toward the employee's annual allowance they do not need to be tested against relevant earnings. The employer will receive a deduction against profits for the accounting year in which the contribution is actually made.

## ACTION

*Pensions will be more attractive to clients under the proposed new flexible pension rules.*

*Call us for more information on both the current and post 5 April 2015 rules in relation to contributions and benefit withdrawal.*

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

**T: 01872 225885**
**E: enq@watsonfrench.co.uk**