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Cashing In On Your Pension



Since 6th April 2006, an individual can take all their pension benefits as a cash lump sum under the 'trivial commutation' rules if all of the following conditions can be met:

- The total value of benefits under all pension arrangements, including any already in payment, is not more than 1% of the lifetime allowance (£16,500 in 2008/09)
- The individual is aged between 60 and 75 and the lump sum is paid before their 75th birthday
- The payment fully extinguishes all their pension rights held under the pension arrangement(s) being commuted
- All benefits are commuted within one single 12 month period. There is no further opportunity to commute benefits on the grounds of triviality outside this 12 month period

If the benefits being commuted are not already in payment, 25% of the fund can be paid as a tax free lump sum. The remaining 75% will also be paid as a lump sum but subject to income tax. In contrast, if the benefits being commuted are already in payment, the whole amount will be taxed.

In a welcome move however, the Government has recently confirmed that it will introduce legislation in the 2008 Finance Bill to enable an individual to take 'stranded pots' held under an occupational scheme as a cash lump sum on the grounds of triviality, as long as the value of those benefits are below £2,000.

The regulations will define the meaning of "stranded pots" and spell out the particular circumstance in which these can be commuted, although the 2008 budget notes confirm that these payments will be in addition to the normal 1% of standard lifetime allowance limit (£16,500 in 2008/09).

Where partial transfers are allowed under an occupational scheme the Government fears that people will transfer enough of the fund to leave £2,000 under the scheme and then claim under the 'stranded pot' trivial commutation rules. They therefore intend to introduce further, as yet unclarified, restrictions to counter this.

The rules differ where an individual's pension benefits are commuted on the grounds of serious ill-health. Serious ill-health is where life expectancy is less than 12 months. Since 6th April 2006 it is possible to commute benefits on serious ill-health from all registered pension schemes including personal pensions and stakeholder pension plans.

Commutation on the grounds of serious ill-health is only available where benefits are not already in payment and where:

- The individual's lifetime allowance (the maximum amount of pension savings that can benefit from tax relief - £1.65m for 2008/09) has not been exhausted.
- The payment is made before age 75 (there is no minimum age).

Confirmation must be obtained from a registered medical practitioner that life expectancy is less than 12 months before the scheme pays the 'serious ill-health lump sum'. If medical evidence is not obtained before commutation of benefits there may be a punitive tax charge.

When benefits are fully commuted on the grounds of serious ill-health they are tested against the available lifetime allowance to ensure that they are within this limit. Once tested there will be no tax liability on the proceeds as long as the amount payable is within the individual's available lifetime allowance.

In 2006 the Department for Work and Pensions (DWP) confirmed that serious ill-health commutation would be allowed for contracted-out rights, but excluding any entitlement to a survivor's pension. This means that where benefits have been accrued from contracting out of the State Earnings Related Pension Scheme (SERPS) or the State Second Pension (S2P) – where a survivor's pension must be provided for, and the individual is married or has a civil partner, 50% of these rights must be held in a separate arrangement to provide a survivor's pension.

The levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.

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A taxing decision?



The pre-Budget announcement on 9th October 2007 brought sweeping changes to the capital gains tax system resulting in some winners and some losers. The changes mean that, for disposals of assets after 5 April 2008, any resulting capital gain will now be taxed at a flat rate of 18% rather than either 20% (the basic rate) or 40% (the higher rate), which applied to capital gains made prior to 6 April 2008. However, investors no longer benefit from taper relief, which reduced the amount of gain subject to tax if the asset had been held for more than 3 years. Taper relief could reduce the 'effective' rate of tax to as low as 12% for basic rate taxpayers and 24% for higher rate taxpayers.

The revisions to capital gains tax (CGT) met with particular resistance from the life assurance industry who initially felt that the changes resulted in an 'uneven playing field' between different investments - the main investments available for those who have already used their ISA allowances being unit trusts (gains from which are subject to CGT - now at a rate of 18%) and investment bonds (gains from which are subject to income tax - either 20% or 40% depending on the individual's tax rate). As we will explain though, when the issues are considered further the disparity is not necessarily as wide as it appears at face value.

It is important to make clear that there are no direct changes to the way gains from UK investment bonds are taxed. Higher rate taxpayers need to consider the new 18% rate on gains from investments such as unit trusts against a total tax rate of 40% on gains from investment bonds. The trouble is that this simply compares the tax on any capital gains made from each type of investment whereas, in reality, many funds generate investment growth from investing in assets that produce income rather than from trying to generate gains from 'buying' and 'selling' assets. An investment bond may have a tax advantage here for higher rate taxpayers as it can 'shelter' this income from higher rate tax, whereas a higher rate taxpayer has a total liability of 32.5% on dividend income from unit trusts.



It is perhaps also misleading to state that higher rate taxpayers pay tax equivalent to 40% on gains from investment bonds - the rate of internal tax applicable to funds within UK investment bonds is deemed to be 20% and, although higher rate taxpayers have an additional 20% liability to tax, this is based on the net gain. In other words, if gains within the investment total £10,000, after 20% tax has been paid by the fund manager, the net gain is £8,000. On encashment this leaves the investor with a tax liability of £1,600 (20% x £8,000) resulting in total tax of £3,600 or an effective rate of 36%.

What about basic rate taxpayers? The decision here is perhaps less clear cut. The deemed internal tax of 20% on funds in investment bonds meets a basic rate taxpayer's personal liability to tax on surrender. The effective rate of tax paid internally by the fund manager can actually be slightly lower than the 20% mentioned earlier, due to the continuing availability of indexation when calculating gains made within life funds. This contrasts neatly with the position for unit trusts which internally pay no tax on capital gains, but the individual is liable for capital gains tax at a rate of 18% on gains over the annual CGT exemption when they dispose of the investment.

As you can see, the analysis of which type of investment is the most tax-efficient is not a straightforward one! It will depend on factors such as your tax position (not only now, but when you encash the investment), the type of fund(s) you are going to invest in, whether you are making use of your annual CGT exemption (currently £9,600 for 2008/9), and the amount you have to invest. It may also be the case that it is not simply an 'either/or' decision and that unit trusts are an appropriate vehicle for some funds within your portfolio and that other funds are best held in a bond. Of course, use of your allowances for tax efficient investments such as an Individual Savings Account (ISA) should always be considered first.

For clients who already hold investment bonds it is important to stress that the changes do not mean that these investments are no longer suitable. Nothing has changed in respect of the tax treatment of investment bonds as tax 'wrappers' although for those making future investments the new rate of CGT means that a closer comparison of all the alternatives is warranted.

As always, tax is not the only consideration - for example charges will reduce overall returns (and vary widely from product to product) and it is also just as important to pick the right funds when building a portfolio. It is therefore essential to take professional advice before making any decisions.

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A Capital Way of Saving Tax



In 1988 the Conservatives changed the Income Tax rate to a maximum of 40% and aligned the Capital Gains Tax (CGT) rate. This had a dramatic effect on income tax planning that was in place at the time. Prior to this the Income Tax rate was up to 60% (super tax) and the Capital Gains Tax rate was 30% (after allowing for indexation). A large amount of anti-avoidance legislation was in place to prevent income being classified as capital gain.

As paying 30% (capital gains) was preferable to paying 60% tax on income a number of schemes were established to effectively create an income stream, but have this classed as a capital gain. This type of plan was eradicated by the Conservatives aligning the tax rates for both income and capital gains.

So why does this matter today? Well the Chancellor has kindly removed this equilibrium by introducing a flat rate of 18% tax for capital gains (ignoring the even better entrepreneur rate of 10%) and this has reintroduced the potential for tax planning by using capital gains to provide income. The following is an example of how it could work:

Mr Joe Average is a higher rate tax payer and wishes to provide an additional income of £12,000 per year from a lump sum of £200,000.

- **Solution 1** would be to put the monies in a high interest account paying say 6% interest. This would provide the £12,000, but tax would reduce this to £7,200 (20% tax at source then 20% on the tax return as he is a higher rate tax payer).
- **Solution 2** would be to put the £200,000 into another investment, say a Zero (explained below) which aims to pay £212,000 in twelve months – as the gain is subject to Capital Gains Tax the £12,000 profit is taxed at an 18% flat rate, resulting in a net figure of £9,840 (this could be even more if the annual gains exemption is available to be used).

Solution 2 seems the obvious choice BUT normally the key aspect of an income is that this needs to be stable and not deviate too much. This is where option 2 has some key issues. When investing in a bank account the deposit should be safe (although recent history has taught us some lessons in this area) and the interest rate should be a known factor, especially on fixed accounts. Other investments are subject to investment risk (especially considering the current credit crunch!) and can therefore fall and rise in value. The question is - is this risk worth the income tax saving? This is where the skills of a financial adviser are paramount to help determine if you can afford the risk, or if reliability is the key.

There are other risks linked into this, from the past few budgets the Chancellor is looking to ensure that the tax take is maximised to help offset ongoing budget deficits. The Government could therefore create further legislation to remove this tax imbalance, although given the CGT and 10% income tax change controversy this may not be on the immediate radar.

Below are some investments which could provide income in the form of a capital gain:

Zero coupon preference shares - Zero coupon preference shares (zeros) in investment trusts offer a pre-determined maturity value at the maturity date, provided there are sufficient assets in the trust at this time. There was a high profile issue in the first part of this century which saw some zero investors lose their full investment (known as Split Caps) and this highlights some of the risks. The consensus is that lessons have been learnt from this and therefore it should not be repeated, but this is not guaranteed.

Structured products - The tax treatment of structured products can be complex. Most retail structured products take the form of medium term notes (MTNs), which are normally subject to CGT on gains. If a minimum return on maturity is provided (eg; 115% of the original investment), this element will be subject to Income Tax. However, CGT will apply where there is a digital return, eg 22% at the end of three years, provided the FTSE 100 is not lower than at the start of the term as this type of return is linked to an investment performance.

The structured product market is a weird and wonderful one right now with all forms of exotic investment areas as well as the more traditional being offered, which in itself offers its own risks

Offshore cash funds - These can be attractive short-term investments from a Capital Gains Tax viewpoint if they are single-priced. There is nothing to stop an investor buying a cash fund immediately after it goes ex-dividend (shares are not entitled to recently declared dividends) and then selling it just before the next ex-dividend date arrives. The fund price will reflect the accrued (gross) income over the period, but the investor's profit will be taxed as capital gain.

The exercise would be pointless for a basic rate taxpayer as they would have no further liability on the income, but for a higher rate taxpayer it may be worthwhile, particularly if their annual exemption is still available. There is legislation to stop this type of exercise – the accrued income scheme – but it is directed at investment in fixed interest securities, not funds.

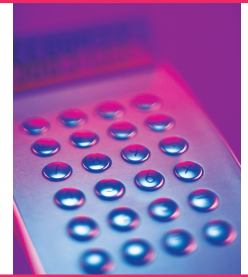
It must be remembered that cash funds can fall in value and there is no guarantee that they will always rise, it is therefore possible that no income will be produced.

These investments do not include the same security of capital which is afforded with a deposit account.

As mentioned before this an extremely complex aspect of tax planning and should not be entered into without appropriate financial advice from a professional, both on the tax and the investment elements. The above is merely a brief overview of the subject of using capital gains for income purposes and should not be relied upon in isolation, or as a substitute for advice when making investment decisions

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The Transferable Nil-Rate Band



With regard to Inheritance Tax everyone is entitled to an amount that is chargeable at a nil-rate of tax – the nil-rate band (NRB). For the current tax year 2008/09 this amount is £312,000.

The Finance Bill 2008 will introduce legislation to allow a claim to be made to transfer any unused nil-rate band on a person's death to the estate of a surviving spouse or civil partner who dies on or after 9 October 2007, irrespective of when the first person died (including deaths before 1986 when Inheritance Tax was introduced).

The amount that can be transferred is the percentage of unused NRB on first death, and this percentage is then applied to the value of the then NRB when the survivor dies.

The maximum percentage of unused NRB that can be claimed is 100% (which would double the NRB available) and this allowance can be built up from the estate of more than one deceased spouse or civil partner. The following example may help:

Mr A is married to Mrs B. Mr A dies and a few years later Mrs B marries Mr C. A couple of years after this Mrs B dies.

Action available to Mrs B's personal representatives

Mrs B's personal representatives on her death could claim any unused percentage of Mr A's NRB, even though she had subsequently got married to Mr C.

If Mr C had also predeceased Mrs B then her personal representatives could claim any unused percentage of Mr C's nil-rate band as well, as long as the total amount being claimed did not exceed 100%.

Under the draft legislation as it stands, if Mrs B had out-lived Mr A, but died before Mr C and her personal representatives had not made a claim for Mr A's unused NRB, then on Mr C's subsequent death, his personal representatives could only claim any unused percentage of Mrs B's NRB and would not be entitled to any of Mr A's unused NRB.

An amendment has been made to the draft legislation and is to be included in the 2008 Finance Bill. This amendment will permit the personal representatives of Mr C to claim not only any unused percentage of Mrs B's NRB, but also any unused percentage of Mr A's NRB which the personal representatives of Mrs B could have claimed, but didn't - subject to the overall limit that no amount in total can be claimed which exceeds 100% of the NRB.

In order to claim any unused NRB, the personal representatives of the surviving spouse will need to submit a form, IHT 216, to HMRC within 24 months from the end of the month in which the survivor dies. (www.hmrc.gov.uk/cto/ih216.pdf)

This claim form has to be submitted at the same time as the IHT 200 form on the death of the survivor, together with other supporting documents such as:

- The death certificate of the first to die
- A copy of the will (if one was made)
- A copy of the grant of probate
- A copy of the marriage/civil partnership certificate for the couple
- If a deed of variation was issued to change the people who inherited the estate on the first to die, a copy of the deed
- Details of any gifts/transfers which the first to die made in the 7 years before their death (which would become chargeable transfers on death and therefore use up some of their NRB)
- Details of any exemptions and reliefs, other than the spouse/civil partner exemption, which would be relied upon to calculate the IHT on the estate of the first person to die e.g. business property relief

Whilst this might not appear to be a particularly onerous process, it is essential that these documents are kept together following the first death to make this claim easier. If not, it is possible in some cases that the personal representatives may find themselves in a position where they could make a claim, but are unable to do so simply because these documents either have not been retained or they have been misplaced.

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